



Jump start

**Reviving the US financial system:
The Financial Stability Plan**



Howard Margolin

Calls to action in combating the ongoing economic crisis are coming from all parts of the globe. In particular, governments are faced with far-reaching policy decisions to try to stem the tide of foreclosures, job losses, and disappearing savings. With the US financial system taking much heat for its role in the recent economic turmoil, many acknowledge that a strong US financial system is also one of the keys to recovery. **Howard Margolin** explains.

On February 17, 2009, President Barack Obama signed into law the Financial Stability Plan (FSP) to help stabilize the US financial system and restore confidence in the markets. The FSP is a multi-pronged offensive designed to boost the nation's economy by eliminating the uncertainty surrounding financial institution assets and stimulating lending while imposing new measures around financial service industry accountability, oversight, and transparency.

The FSP includes the following components:

Capital Assistance Program

As a means of reducing uncertainty over whether certain financial institutions have sufficient capital to weather the financial storm, the Capital Assistance Program (CAP) requires US banking organizations with assets of US\$100 billion or more to undergo a more thorough regulatory review. This includes a comprehensive 'stress test' designed to assess the balance sheet exposures of these institutions, should there be a greater than expected decline in the economic environment.

Should the results indicate that capital is inadequate, such institutions will have six months to raise the necessary capital buffer via private funds. Lacking such private funds, they may access capital through CAP in the form of convertible preferred stock.

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The stress test results were released on May 7, 2009, indicating that the largest banks had adequate capital to meet adverse (not 'worst case') economic conditions. Capital shortfalls for the largest banks totaled approximately US\$75 billion. Many banks have issued, or plan to issue, common stock to meet the shortfalls. Others plan to convert preferred stock to common stock or sell assets. A limited number of more capital-constrained banks may be forced to sell operations or curtail certain activities.

Public-Private Investment Program

The Public-Private Investment Program (PPIP) has been created to address the challenge of cleansing balance sheets of 'legacy' assets. PPIP seeks to lure new private capital into the market by providing government equity co-investment and attractive private financing to reduce the risks inherent in investing in these legacy loans and securities. Equity co-investment is intended to protect US taxpayers from overpaying for assets through a market-based valuation approach – as opposed to prices being set by the public sector – and taxpayers stand to benefit by sharing in any profits derived from these assets.

Both potential sellers and buyers are still seeking clarification on many fronts, such as pricing mechanisms, the accounting impact of such transactions on capital levels, and other sale terms. The impact that recent changes by the Financial Accounting Standards Board – relating to the recognition and measurement of credit impairment losses on debt securities – has on the demand for this program remains to be seen. Additionally, the impact of the stress test results on PPIP participation has yet to be determined.

Term Asset-Backed Securities Lending Facility

This joint initiative of the Federal Reserve and the Treasury Department seeks to encourage consumer and business lending through the renewed issuance of certain asset-backed securities (e.g. those supported by auto, credit card and student loans, mortgages, and other assets) at reduced interest rate spreads. Already in existence, funding for the Term Asset-Backed Securities Lending Facility (TALF) has been greatly expanded under the FSP.

Those receiving FSP funds will be required to engage in mortgage foreclosure mitigation efforts; whether other lenders may be required or otherwise encouraged to participate in these efforts remains to be seen.

Mortgage Loan Modification Program

The FSP includes a proposal to reduce mortgage rates through Federal Reserve and Treasury Department purchases of up to US\$600 billion of Government-Sponsored Enterprise mortgage-backed securities and debt. Additionally, the FSP calls for issuance of formal loan modification guidelines and standards applicable to government and private programs. Those receiving FSP funds will be required to engage in mortgage foreclosure mitigation efforts; whether other lenders may be required or otherwise encouraged to participate in these efforts remains to be seen.

Small Business and Community Bank Lending Initiative

In light of the increased capital pressures on lending institutions and the lack of demand for Small Business Association (SBA) loans in the secondary markets, the FSP addresses the precipitous decline in SBA lending. A joint Treasury Department and SBA initiative will seek to increase such lending by financing the purchase of AAA-rated SBA loans and pursuing efforts to increase the Federal guarantee up to 90 percent for eligible loans.

Transparency and Accountability Agenda

The Treasury Department will require all FSP fund recipients to conform to intensified requirements for transparency, accountability, reporting, and monitoring.

Reporting requirements include a one-time plan discussing the recipient's intended use of government funds to preserve and strengthen lending capacity. Further, there will be monthly reporting on new lending activities and tracking of CAP funds separate from other assets.

Additional FSP conditions include restrictions on dividends on stock repurchases and acquisitions, limitations on executive compensation, and restrictions on lobbying.

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Implications

These far-ranging initiatives have broad consequences for both financial institutions and government agencies. Each FSP component will have unique accounting, tax, and financial considerations depending on a company's particular circumstances. Management should consider these implications as strategic decisions are surrounding participation in the FSP. Similarly, assessments of modeling techniques, expanded data and disclosure requirements, systems capabilities, and staffing will be essential to plans for moving forward. The sheer magnitude of changes and level of regulatory scrutiny will present sizable implementation challenges, and companies may find the need for project management teams to try to keep all initiatives on track.

The private sector now has multiple fronts through which to cleanse its balance sheets and reinvigorate lending activities. At the same time, these initiatives significantly expand the role and power of government, necessitate changes to current processes and controls, and place additional requirements on both financial institutions and government related to reporting, monitoring, and compliance activities.

Over the coming months, additional details will emerge regarding these programs, and institutions should remain vigilant to the strategic opportunities that could result, while maintaining appropriate discipline and controls to satisfy the attendant increased reporting and compliance activities.

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