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Issue Alert – Review of Key Provisions of the Bailout Plan To be Voted Upon by the Congress

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Background:

During this past weekend, Congressional leaders, the Treasury Secretary and key staff continued to negotiate the terms of emergency legislation now titled the *Emergency Economic Stabilization Act of 2008*. Text available as of about 9 pm Sunday evening is presumed to be final or as nearly final as possible. This report provides a summary of key provisions of this latest language in an effort to keep you informed. A fuller report will be issued once the language is formally adopted.

Currently, Congressional leaders anticipate that the House of Representatives will vote on the measure on Monday, *September 29*, and that Senate may vote on or before Wednesday. While the vote count remains preliminary at this stage, about 60 to 100 House Republicans may support the proposal; an estimated total vote count of 80 Senators may support the measure.

Authorization to purchase troubled assets.

Authorizes the Treasury Secretary to purchase and fund commitments to purchase troubled assets from any eligible financial institutions. Terms and conditions of these actions will be determined by the Treasury Secretary. These activities are to be conducted through an *Office of Financial Stability* to be created within the Treasury Department and headed by an Assistant Secretary of the Treasury. The Treasury Secretary is granted broad authority to appoint employees to carry out the bailout activities, to hire outside parties, to establish vehicles to purchase troubled assets and issue obligations, and to issue regulations and other guidance as deemed necessary or appropriate. The draft includes a *consultation requirement by the Secretary in exercising authority under the Act*. Consultation is required with the Federal Reserve Board, the Federal Reserve Bank of New York, the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Secretary of Housing and Urban Development.

Includes language directing the Secretary to take such steps as may be necessary to prevent unjust enrichment of financial institutions participating in the bailout program, including by preventing the resale of a troubled asset to the Secretary at a higher price than what the seller paid to purchase the asset. This provision will not apply to troubled assets acquired in a merger or acquisition or a purchase from a financial institution in conservatorship or receivership, or from a financial institution that initiated bankruptcy proceedings under the bankruptcy code.

Program guidelines.

The Secretary must issue, before the earlier of the end of the second business day beginning on the date of the first purchase of troubled assets and the end of the 45 day period beginning on the date of enactment, guidelines for purchases, pricing methods, processes for selecting asset managers, and criteria for identifying troubled assets.

Coordination with foreign authorities and central banks.

Requires the Secretary to coordinate, as appropriate, with foreign financial authorities and central banks to work toward the establishment of similar programs by such authorities and central banks. If they held troubled assets as a result of extending financial t financial institutions that have failed or defaulted on such financing, such troubled assets qualify for purchase under the bailout program.

Graduated authorization to purchase.

On the date of enactment, the Secretary would be authorized to purchase troubled assets up to \$250 billion. That amount may be increased by \$100 billion if President submits written notification to Congress. The Secretary may purchase troubled assets up to \$700 billion outstanding at any one time if the President submits a written report to Congress detailing the Secretary's plan. The Secretary would be prohibited from exercising authority to make purchases exceeding \$350 billion if, within 15 days after the receipt of the report submitted to Congress, Congress enacts a joint resolution disapproving the plan. The aggregate purchase price is to be determined for purposes of the dollar amount limitations by aggregating the purchase prices of all troubled assets held.

Definition of troubled assets.

Defines "troubled assets" to mean: (a) residential or commercial mortgages, and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case were originated or issued on or before *March 14, 2008*; and (b) upon the determination of the Secretary, in consultation with the *Chairman* of the Federal Reserve Board, any other financial instrument, as the Secretary determines necessary to promote financial market stability, but only upon transmittal of such determination in writing to the appropriate committees of Congress..

Definition of eligible financial institutions.

Defines "financial institution" to mean any institution including, but not limited to, banks, savings associations, credit unions, broker-dealers, and insurance companies established and regulated under the laws of the US or any State, territory, or possession of the US, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Marianas Islands, Guam, American Samoa, or the US Virgin Islands, and having significant operations in the US, but excluding any central bank of, or institution owned by, a foreign government.

Termination of emergency authority.

The emergency authority granted to the Secretary expires on *December 31, 2009*. Allows an extension of this authority for period *not later than two years* from the date of enactment upon submission of a written certification by the Secretary to the Congress. The certification must state why the extension is necessary to benefit American families and stabilize the financial markets, as well as the expected costs to the taxpayers of the extension.

Treasury rights, management and sale of troubled assets.

Authorizes the Treasury Secretary to manage troubled assets purchased, including revenues and portfolio risks. Also grants the Secretary broad authority to sell or enter into securities loans, repurchase transactions, or other financial transactions with respect to any troubled asset purchased under the program.

Profits on sale of troubled assets purchased.

Requires that at least 20 percent of any profit realized on the sale of each troubled asset purchased must be set aside and deposited into designated accounts. For example, of that amount, 65 percent must be deposited into the Housing Trust Fund established under the *Housing and Economic Recovery Act of 2008*; and 35 percent must be deposited into the Capital Magnet Fund established under that Act. Any remaining profits must be paid into the General Fund of the Treasury for reduction of the public debt.

Considerations for purchase of troubled assets.

Requires the Secretary to take into consideration various factors in exercising the authorities granted, including providing assistance to financial institutions, including those serving low- and moderate-income populations and other underserved communities, and that have assets less than \$1 billion that were well or adequately capitalized as of *June 30, 2008*, and that as a result of the devaluation of the preferred government-sponsored enterprises stock will drop one or more capital levels, in a manner sufficient to restore the financial institutions to at least an adequately capitalized level.

The Secretary also may consider the utility of purchasing other real estate owned and instruments backed by mortgages on multifamily properties.

Receipt of warrants/senior debt.

The Secretary may not purchase, or make any commitment to purchase, any troubled asset under this bailout plan unless:

- With respect to a financial institution that is registered (or approved for registration) and traded on a national securities exchange or a national securities association registered pursuant to section 15A of the Securities Exchange Act, a *warrant* is issued to the Secretary to receive non-voting common stock or preferred stock in the financial institution, as the Secretary determines appropriate;
- With respect to any other type of financial institution, the Secretary receives a *senior debt instrument*.

A warrant or senior debt issued to the Secretary must meet the following requirements:

- Provide reasonable participation by the Secretary in equity appreciation in the case of a warrant, or a reasonable interest rate premium, in the case of a debt instrument for the benefit of taxpayers;
- Provide additional protection for the taxpayer against losses from the sale of assets by the Secretary and for administrative expenses.

The Secretary is authorized to sell, exercise, or surrender a warrant or any senior debt instrument received. If the financial institution issuing the warrant is no longer listed or traded on a national securities exchange or securities association, the warrant must provide that it will be converted to senior debt, in an amount determined by the Secretary.

Any warrant received by the Secretary must contain anti-dilution provisions. The exercise price for any warrant will be set by the Secretary. If the financial institution does not have sufficient authorized shares, the Secretary may accept a contingent senior debt note in anticipation of a shareholder vote for such authorization. The note must be for a short, limited period of time, as determined by the Secretary, and will include a penalty whenever such period expires.

The Secretary is authorized to establish a *de minimis* exception to these requirements based on the size of the financial institution or the size of the cumulative transactions of troubled assets purchased from any one financial institution for the duration of the program, at not more than \$100 million. The Secretary also is authorized to determine other appropriate exceptions to protect financial institutions that are legally prohibited from issuing securities or debt instruments.

Guarantee of troubled assets.

The Secretary will have discretionary authority to provide for a guarantee of principal and interest on troubled assets upon request of a financial institution. This also allows the Secretary to collect premiums from any financial institution participating in such a program of guarantees.

Market transparency.

The Secretary is required to make publicly available, in electronic form, a description, amounts, and pricing of assets acquired under the program, within two business days of purchase, trade, or other disposition.

Oversight of Treasury actions.

Creates a Financial Stability Oversight Board to review the Secretary's exercise of authority under the bailout program. The Oversight Board's members will include the Chairman of the Federal Reserve Board, the Secretary, the Chairman of the SEC, the Director of the Federal Housing Finance Agency, and the Secretary of Housing and Urban Development. The members of this board will elect the chairperson from among the members other than the Secretary. The Oversight Board may establish a credit review committee to evaluate the exercise of the purchase authority provided for. The Oversight Board is required to submit regular periodic reports to the Congress. Among the required reports are those describing transactions entered into under the program; the pricing mechanism for the transactions; justification of the price paid for and other financial terms associated with the transactions; and a description of challenges remaining in the financial system. These reports must be submitted no later than 7 days after the date on which commitments to purchase troubled assets reach an aggregate of \$50 billion.

The Financial Stability Oversight Board also is directed to report to Congress not later than *April 30, 2009* on the current state of the regulatory system and its effectiveness at overseeing the participants in the financial markets, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system and the rationale underlying such recommendations.

Establishes a *Congressional Oversight Panel* to review the current state of the financial markets and the regulatory system and submit regular reports to Congress on the Secretary's exercise of authority granted under the program; and the impact of purchases made under the program on the financial markets and financial institutions. The panel would be composed of *five individuals* generally appointed by the Senate and House Majority and Minority Leadership. The panel would terminate six months after the termination of the bailout program.

Contracting procedures.

Authorizes the Secretary in awarding contracts to asset managers, servicers, property managers, and others, that would otherwise be subject to the Federal Acquisition Regulation, to solicit proposals from a broad range of qualified vendors interested in performing the work.

FDIC role in managing residential mortgages and residential mortgage-backed securities purchased by Treasury.

Provides that the FDIC will be eligible to be considered in the selection of asset managers for residential mortgage loans and residential mortgage-backed securities purchased by the Secretary. The Secretary would be required to reimburse the FDIC for services rendered.

FDIC enforcement enhancement.

Expands the authority of the FDIC to enforce against false advertising, misuse of FDIC names, and misrepresentation of insured status by allowing the FDIC to recommend to the appropriate Federal banking agency that that agency take enforcement action against any person regulated by that banking agency or any institution-affiliated party if that banking agency does not act on its own. If the other banking agency fails to take appropriate action within 30 days after receiving the FDIC recommendation, the FDIC may take action on its own.

Funding.

Allows Treasury to fund the costs of the program by selling securities.

Debt limit increase.

Increases the public debt level from \$10.6 trillion to \$11.3 trillion.

Limits on review of Treasury decisions.

Provides that any action by the Secretary pursuant to the authority granted by the bailout program will not be set aside unless it is arbitrary, capricious, an abuse of discretion, or not in accordance with the law. Generally, other than in cases involving constitutional claims, no injunction or other form of equitable relief may be issued against the Secretary. An injunction will be automatically stayed. The stay will be lifted unless the Secretary seeks a stay from a higher court within three days after the date on which the relief is issued. A temporary restraining order or preliminary injunction may be issued under certain expedited processes. Also, sellers of assets to the Treasury generally will not be permitted to bring legal action against the Secretary.

Assistance to homeowners.

To the extent that the Secretary acquires mortgages, mortgage backed securities, and other assets secured by residential real estate, the Secretary is required to maximize assistance to the underlying mortgagors. The Secretary is required to use his authority to encourage servicers, using net present value analysis, to take advantage of the Hope for Homeowners

Program recently enacted into law to minimize foreclosures. The Secretary is required to coordinate with the FDIC, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and other Federal government entities holding troubled assets to attempt to identify opportunities for the acquisition of classes of troubled assets that will improve the Secretary's ability to improve the loan modification and restructuring process. Where permissible, the Secretary is directed to use his authority to permit *bona fide* tenants who are renters to remain in their homes under the terms of their leases.

The Secretary is required to request loan servicers servicing mortgage loans purchased to avoid preventable foreclosures to the greatest extent possible. The Secretary would be required to consent, where appropriate, to reasonable requests for loss mitigation measures, including term extensions, rate reductions, principal write-downs, increases in the proportion of loans within a trust or other structure allowed to be modified or removal of other limits on loan modifications.

Conflicts of interest.

Requires the Secretary to issue regulations to address conflicts of interest that may arise in connection with the administration and execution of the bailout program. The rules must address, among other things: conflicts arising in the selection or hiring of contractors or advisors, including asset managers; the purchase of troubled assets; the management of the troubled assets held; post-employment restrictions on employees; and any other potential conflict of interest, as the Secretary deems necessary or appropriate in the public interest. These rules must be issued as soon as practicable after the date of enactment.

Recoupment.

Five years after the date of enactment of the program, the Director of the Office of Management and Budget in consultation with the Congressional Budget Office must report on the bailout program. If the report determines that there is a shortfall to taxpayers, the President must submit a proposal to Congress for recoupment of the shortfall from financial institutions.

Annual financial reports and audits.

Requires the Comptroller General, upon establishment of the troubled assets relief program (TARP) to begin oversight of the activities and performance of the TARP and of any agents and representatives of the TARP, including vehicles established by the Secretary under this program. Also requires the Comptroller General to annually audit the TARP's public audited financial statements prepared in accordance with GAAP.

Inspector general for the troubled asset program.

Establishes the *Office of the Special Inspector General* for the Troubled Asset Program. The inspector general is to be appointed by the President and confirmed by the Senate. The inspector general is expected to file regular reports with the Congress summarizing its activities for the reporting period.

Restrictions on executive compensation.

Requires that all entities selling troubled assets to the Secretary to meet appropriate standards for executive compensation and shareholder disclosure in order to be eligible. States that the standards with respect to any financial institution directly selling troubled assets to the Treasury must include the following:

- Limits on compensation to exclude incentives for executive officers to take risks that the Secretary deems to be inappropriate or excessive during such participation;
- Provision for the recovery by the financial institution of any bonus or other incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be false or inaccurate; and
- A prohibition on the financial institution making any golden parachute payment to senior executive officers during the period that the Secretary holds an equity or debt position in the financial institution.

If the Secretary makes auction purchases, and only where such purchases per financial institution in the aggregate exceed \$300 million (including direct purchases), the financial institution is prohibited in any new employment contract with the senior executive officer to provide for a golden parachute in the event of involuntary termination, bankruptcy, insolvency or receivership.

Tax treatment of executive compensation of employers participating in the bailout program.

Employer companies participating in the bailout program generally will not be able to take tax deductions for executive remuneration exceeding \$500,000 for any applicable tax year. This provision will be applicable to a financial institution which has sold to the Treasury troubled assets in the aggregate exceeding \$300 million for all taxable years. Certain assets directly purchased by the Secretary will not be included in that computation.

Gain or loss from sale or exchange of certain preferred stock.

Generally, any depository institution holding preferred stock in Fannie Mae or Freddie Mac may treat the gain or loss from the sale or exchange of such shares as ordinary income or loss. The sale or exchange must occur after *September 6, 2008* and at all times during the period beginning on *September 6, 2008* and ending on the date of the sale or exchange of the preferred stock the institution must have been an applicable financial institution.

Money market mutual funds.

Prohibits the Secretary from using the Exchange Stabilization Fund for the establishment of any guaranty programs for the US money market mutual fund industry.

Modifications of mortgage loans for debtors in bankruptcy.

Permits mortgage loan modifications for homeowners in bankruptcy. The modifications generally may include extending the term of the loan, and revising the interest rate to a fixed interest rate in an amount equal to the then most recently published annual yield on conventional mortgages published by the Federal Reserve Board, plus a reasonable premium for risk. These provisions would apply only to bankruptcy cases commenced on or after the date of enactment of the bailout program.

Mark to market accounting.

Authorizes the SEC to suspend by rule or order the FASB's Statement 157 with respect to any class or category of transactions deemed necessary or appropriate in the public interest. The SEC is to conduct a study on market to market accounting and report to the Congress within 90 days of the date of enactment.

Discharge of indebtedness.

An earlier law passed by Congress allows homeowners to exclude from income a discharge of indebtedness from mortgage modifications. That provision expires on *January 1, 2010*. That period is extended until *January 1, 2013* with respect to an applicable discharge of indebtedness occurring on or after *January 1, 2010*.

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