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Paulson, Bernanke Testify Before the House Financial Services Committee

Secretary of the Treasury Henry Paulson and Chairman of the Board of Governors of the Federal Reserve System Ben Bernanke testified today before the House Financial Services Committee on the “The Future of Financial Services: Exploring Solutions for the Market Crisis.” The Secretary and the Chairman offered opening statements that echoed most of what was stated yesterday during testimony before the Senate Banking Committee. In answering questions from members, the Secretary and the Chairman offered additional details on the Administration’s Plan:

- Executive compensation must be addressed as part of the Plan. Many Representatives stated the need that executives of firms selling securities to the Treasury must not be permitted to reap huge pay and/or severance packages. Secretary Paulson said that pay for performance, and conversely no pay for failure, should be a part of the Plan but that such a provision cannot undermine the purposes of the Plan.
- Both Paulson and Bernanke stated that the Administration’s Plan is the best plan, among several alternatives, to address the issues faced by the economy. Chairman Bernanke stated that the real benefit to the taxpayers is that the Plan will hasten the recovery of the economy as well as open the credit markets. Alternative plans that have been discussed but rejected to date include creating an RTC type of corporation and permitting the Treasury to purchase preferred stock of troubled institutions.
- The bailout plan is just the beginning stage of addressing the larger issues facing the U.S. economy. Additional measures are needed to address an outdated regulatory structure, inefficiencies and problems in the structure of the credit markets.
- In responding to comments from Chairman Barney Frank (D-MA), Secretary Paulson reiterated that the Plan is meant to aid small and big banks, credit unions, thrifts and other financial firms alike. Chairman Frank also asked about providing tax relief to holders of GSE preferred stock by allowing losses on such stock to be recognized as an ordinary loss rather than as a capital loss. Secretary Paulson responded that the Plan is meant to be flexible to utilize whatever means are necessary to protect the economic system. Both Paulson and Bernanke stated that other actions may be utilized to address the crisis but that the most immediate need is to pass the legislation immediately.
- Secretary Paulson provided additional comment on the mechanism that will be used to purchase troubled assets. The Secretary and Chairman made clear that the key will be to use a market system to properly value the troubled assets. Chairman Bernanke felt that the government by merely being in the market will result in an increase in valuations from the current fire-sale prices. However, both the Secretary and the Chairman agreed that while the Treasury may be paying more for the assets than their current value, that value should increase beyond what was paid as the economy recovers. This led Secretary Paulson to state his belief that the ultimate cost to the taxpayer should be “minimal.”
- Secretary Paulson stated his disagreement with allowing bankruptcy judges to “cram down” revisions to first mortgage loans to assist homeowners. He felt that such authority would result in a decrease in available credit, a result which is the exact opposite of what the economy needs at this time.
- Secretary Paulson also deviated from the Plan by stating his desire that there be established appropriate oversight of the Plan. This is directly contrary to the language of the bill which states that the actions of the Secretary are unreviewable by any court or administrative agency.
- Chairman Bernanke addressed the possibility of the Plan negatively impacting the value of the dollar. He stated that the best method to protect the value of the dollar is to strengthen the economy and the credit markets and that this Plan will accomplish both of those results. Secretary Paulson added that the system is out of balance and that regulatory and market discipline are needed. He stated that the Too Big To Fail concept is a problem but that it was an

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issue that should be addressed after the Plan is in place.

- Chairman Bernanke stated that higher unemployment, increased foreclosures and less credit for consumers will result if the Plan is not passed.
- During a period in which members of the Committee were given an opportunity to present a statement, several members questioned the need to rush the legislation to passage in less than a week; cited other alternatives and courses of action taken during previous financial crises; reiterated the need that the Plan address executive compensation; and suggested that action be taken to suspend the capital gains tax and mark-to-market accounting rules.

Comment from the Banking Trade Groups

To date the two national trade groups representing the banking industry, the American Bankers Association (“ABA”) and the Independent Community Bankers of America (“ICBA”), have focused their efforts on addressing the Treasury’s program to guaranty money market mutual funds, tax implications of losses on Government Sponsored Enterprises (“GSE”) issued preferred stock and fair value accounting. In particular, the ABA and the ICBA have requested that banks be allowed to treat losses on GSE issued preferred stock as ordinary losses. The ICBA has also suggested that the Treasury purchase GSE issued preferred stock at values that will minimize loss, and that the guaranty fund established for money market mutual funds charge rates that are comparable to FDIC assessments, that such guaranty program be temporary only and that the money market funds be subject to the same type of supervision and regulation as banks. The ABA has also stated that the SEC should address the issues that fair value accounting has had on the valuation of assets. The ABA suggested that the SEC provide immediate guidance that intrinsic value or economic value are appropriate proxies for fair value and that the SEC suspend all new accounting standards unless there has been a thorough analysis as to whether the proposed standards are clearly to the benefit of the users of financial statements and whether the impact of the proposal on the marketplace has been adequately taken into account and provided for.

The ABA’s concern over GSE issued preferred stock held by banks resulted from the miscalculation by the Treasury as to the impact losses on such stock would have on the financial industry. Due to the lack of specificity in the reports filed by banks and thrifts, the Treasury severely underestimated the impact that the government’s takeover of the GSE’s would have on financial institutions. A recent industry survey found that the loss from the government’s takeover has resulted in the loss of \$10-\$15 billion. Indeed the impact of the government’s action in this regard has resulted in the announced merger of one institution.

Comment from the White House and Presidential Debate

The President is expected to address the nation tonight on the current financial crisis. Meanwhile Republican Presidential Nominee John McCain called for a delay in the Presidential debate scheduled for this Friday in order to return to Washington to address the financial crisis. Democratic Presidential Nominee Barack Obama has rejected McCain’s call to delay the debate stating that the voters need to hear from the candidates on this issue.

ABOUT THE AUTHORS

Douglas P. Faucette is a banking attorney in Locke Lord Bissell & Liddell’s corporate department in Washington, DC. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions. In the past decade, he has been involved in the passage of all major financial institution legislation including FIRREA and FDICIA.

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