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**Because of the rapidly changing conditions in the financial markets, we have established this special series of Client Alerts to advise you of the newest economic and legal developments and their wide-ranging business implications.**

## **An Introduction To The Loan Guarantee Program**

To date, the federal government's implementation of the Emergency Economic Stabilization Act of 2008, P.L. 110-343 ("EESA") has been focused on the Capital Purchase Program ("CPP") for banks and other financial institutions. The Department of the Treasury created this Program under Section 101 of EESA, as part of the Troubled Asset Relief Program ("TARP"). Hundreds of banks are in the process of applying for equity injections under the CPP. Given the amount of EESA funding allocated to the CPP thus far (\$250 billion of the \$700 billion total amount available under EESA), questions have arisen about the implementation of other important EESA-authorized programs. For example, the Treasury announced that purchase of "troubled assets" under the TARP will not take place in the near future.

Attention is turning to the loan guarantee program under Section 102 of EESA. Section 102 was added to the original House bill at the behest of members of Congress who favored a "rescue" solution not aimed at Wall Street issued securities but at the performance of the underlying assets, i.e., mortgage loans. The insurance program will be subject to certain of the same basic requirements and guidelines as the TARP, such as Section 103 (considerations by the Treasury Secretary) and Section 104 (Financial Stability Oversight Board). A loan guarantee program could be implemented within weeks, if Congress and federal regulators agree that it is lawful and feasible under EESA to make it part of a wider foreclosure avoidance effort. For example, FDIC just released its "Loss Sharing Proposal to Promote Affordable Loan Modifications," which if implemented may rely on EESA-related loan guarantee provisions. See [www.fdic.gov/consumers/loans/loanmod/index.html](http://www.fdic.gov/consumers/loans/loanmod/index.html).

Section 102 of EESA grants the Treasury Department authority to insure "troubled assets"<sup>1</sup> originated or issued prior to March 14, 2008 by establishing a Troubled Assets Insurance Financing Fund ("TAIFF"). Under Section 102(a)(3), "financial institutions" (as defined generally in EESA) may be able to purchase a guarantee of "timely payment of principal of, and interest on, troubled assets in amounts not to exceed 100 percent of such payments." In exchange for a premium payment, the financial institution that purchases the guarantee may receive the benefits of the original payment stream on a financial instrument that is a "troubled asset". The phrase "timely payment" suggests that the financial institution will not have to accelerate or otherwise collect on the debt before making a claim against the TAIFF. For example, the holder of a financial instrument – be it a mortgage or mortgage-backed security - that was to generate \$2,000 a month in principal and interest could be guaranteed to receive \$2,000 a month in principal and interest.

The potential benefits of the TAIFF guarantee program to the balance sheet of a participating financial institution would be significant. Simply stated, assets could be stated at their guaranteed value, which could be as much as their full value at par. Under the TAIFF guarantee program, the financial institution retains ownership of the asset, at least until a claim is made, such that if a guaranteed "troubled asset" starts to perform, the financial institution should receive the benefit of holding a "healthier" asset.

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<sup>1</sup> "Troubled asset" is defined broadly as "(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 was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and (b) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability. . . ."

The mechanics of the TAIFF guarantee program are not yet known. The Treasury Department has 90 days from enactment of EESA to get the program up and running. Treasury sought comments on the development of the program, in the form of answers to questions regarding the potential implementation and logistics for the TAIFF. See <http://edocket.access.gpo.gov/2008/E8-24686.htm>. It is uncertain whether a financial institution will be able to get TAIFF insurance on mortgage-related assets and then sell the assets to the TARP. There certainly will be guidelines on which “troubled assets” will be eligible for the guarantee option. Guidelines will determine whether an asset may be insured for 100% of the expected principal and income payments over the life of the asset, or whether only a lesser percentage and/or shorter duration will be guaranteed.

The major unknown affecting the desirability of the guaranty option is the calculation of premium. Sections 102(c)(2) and 102(c)(3) provide that premiums are to be set based on the risk of the “troubled asset” and to “create reserves sufficient to meet anticipated claims, based on an actuarial analysis, and to ensure that taxpayers are fully protected.” Premiums are to be risk-based and will differ based on the characteristics of the asset being insured. The Treasury is directed to be specific in its establishment premiums. Traditional insurance works as a risk spreading device. “Good risks” – those unlikely to result in claims - are aggregated with “bad risks” – those likely to result in claims - so that total premiums will exceed anticipated claims. However, under EESA, it is not clear how Treasury will deal with “adverse selection.” For troubled assets, a higher percentage of instruments already may be “bad risks,” which means premiums likely would be high in relation to the guarantee. For the guarantee program to meet the statutory guidelines and still be financially attractive, a financial institution seeking to purchase the guarantee may be required to insure “good risks” along with the “bad risks,” in effect with a blended premium. EESA provides the authority for such a requirement in that the definition of “troubled asset” extends to any financial instrument, “the purchase of which the Secretary determines promotes financial market stability” . . . and the “guarantee may be on such terms and conditions as are determined by the Secretary. . .” Regardless, there will need to be an underwriting function to evaluate the risks and determine the amount of the premium.

In evaluating whether to participate in the TAIFF guarantee program, a financial institution will have to weigh the costs of the guarantee premiums, with the potential positive effect on the balance sheet, against the effect on the balance sheet of the write down or sale of financial instruments at a potential loss. It may be advantageous to sell some assets and purchase a guarantee on others, depending on how the TARP ultimately is implemented. TAIFF’s guarantee program may be more desirable than the sale of assets. Under the guarantee program, the financial institution may retain ownership of the asset, at least until a claim is made (if not beyond), so that it could reap any increases if the economic value of the asset recovers. Until details emerge as to eligibility and premium calculation, companies will be unable to decide which option is more beneficial.

The mechanics of claims submission and payment also will determine whether the guarantee program is desirable. There are numerous logistical questions. For example, will the guarantee apply only to each periodic payment? Thus, if the income from a financial instrument stops, does the guarantee pay the full value of the financial instrument, or only for each expected payment as each payment comes due? The wording of the statute suggests the latter. Will multiple claims have to be filed? Will a company be required to take actions to get the income and principal payments from a financial instrument to resume? What will be the lag period between submission of a claim and payment? What rights will the government obtain when it makes guarantee payments? Will it have the right to pursue the obligor on the financial instruments, just as insurers normally have rights of subrogation against those responsible for losses? If there is a full default on a financial instrument, who obtains ownership of the security behind the instrument? These are some of the questions which will have to be answered, and several are questions the Treasury Department is seeking comments on by October 28.

The TAIFF guarantee program also presents opportunities for vendors and outsourced service providers. The U.S. government will need personnel to perform the actuarial risk assessments, to develop claims and underwriting guidelines and to operate the TAIFF guarantee program. As with other aspects of EESA, it is very likely that the Treasury will seek these resources from contractors and third-party providers.

Because the TAIFF guarantee program has yet to be established, it is difficult to predict with certainty its scope or effectiveness. EESA has many provisions, and financial institutions considering either the TAIFF or the TARP must examine the entire Act when deciding on an option. However, the possibilities for TAIFF are promising, and we will be following the developments in this area with great interest.

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