



September 26, 2008

UPDATE

MEMORANDUM

To: Affected Financial Services Industries

From: APCO Worldwide

RE: The Road Forward on U.S. Financial Services Bailout – UPDATE

Summary

Despite continuing expressions of anger and resentment from politicians in both political parties, and growing public opposition to the proposed bailout, as of Friday mid-day, the consensus remains that Congressional action is required to avoid the risk of a global financial market meltdown triggered by financial instruments relating to the U.S. mortgage market.

That action will not be based on the original plan tabled a week ago by Secretary of the Treasury Henry M. Paulson, Jr. As of now, the bailout is likely to build on proposals made public earlier this week by House Financial Services Committee Chairman Barney Frank (D-MA) and by Senate Banking Committee Chairman Christopher Dodd (D-CT) and integrated into a new 102-page single Discussion Draft dated Thursday, September 25.

As of mid-day Friday, September 26, Democrats also were considering how to incorporate some elements of the newly tabled House Republican Study Committee plan, which include enhanced oversight mechanisms, in return for a bipartisan agreement on a bailout. Still unresolved is whether foreign firms will be able to participate and whether the scope of financial instruments that could be purchased by the government will extend beyond mortgage-related products.

Regardless of the details of a final bailout bill, there will be ongoing opportunities to help shape the implementation by the Treasury in the months to come. These will come through:

- An extensive regulatory process, which will involve ongoing comment from industry participants even if the Treasury moves forward promptly with interim final rules to respond to the crisis, rather than the usual approach of proposed regulations.
- Broad opportunities to work with the government through the contracting process as the government retains firms to handle various aspects of

the implementation of the asset purchases, including valuation, servicing, information technology, auditing and accounting, and sales.

- Ongoing Congressional involvement in shaping and refining any package that may be enacted now.
- Further Congressional activity during the planned two- to three-week lame duck session to take place after the elections and before the Christmas holidays.
- Further initiatives from the new U.S. administration and Congress starting in January 2009 as economic facts, legal challenges and politics dictate, including the high likelihood of an effort to undertake comprehensive financial services regulatory reform.

Stakeholders participating in the process will include representatives of all of the major categories of financial institutions in the United States, as well as market participants beyond the United States. Ultimately, the issues relating to the bailout are likely to play into broader financial regulatory reform efforts in the United States and the European Union in 2009; new directions in tax policy, and extensive activity in connection with new direct foreign investment in the United States, made inevitable due to attractive valuations of U.S.-based assets, financial and otherwise.

Given these conditions, firms with business interests potentially affected by these developments may find opportunities to undertake added efforts to obtain political intelligence in the United States on an ongoing basis during this unusual period of policy, legislative and regulatory ferment.

APCO is actively monitoring these events and is available to provide briefings, strategic advice and government affairs services related to these ongoing developments.

Updated Situation Assessment

As of mid-day Friday, despite a rebellion among House Republicans, it appears that Secretary Paulson will obtain the authority for the \$700 billion bailout he has requested, with strings attached and possibly in a series of milestone payments, rather than the entire amount at once.

While the situation remains subject to rapid and unpredictable change, the most likely elements in the plan as set forth in the new Discussion Draft currently include:

- Authority for the Treasury to purchase “troubled assets,” defined as residential or commercial mortgages and any securities, obligations or other instruments that are based on or related to such mortgages. The Discussion Draft tabled by Senator Dodd and Congressman Frank would only include such assets originated or issued on or before March 14, 2008, but it remains unclear whether this limitation will remain.

- Financial services entities that put mortgage-related assets to the government will have to give up “reasonable participation” in equity that covers potential losses and administrative costs associated with buying, managing and disposing of troubled assets. Under the Discussion Draft, this would be implemented through warrants, interest rate premiums or by any other mechanism determined appropriate by the Secretary of the Treasury.
- Conflict-of-interest standards, designed to prevent companies involved in servicing loans or managing work-outs from securing other advantages from the work, and mechanisms to ensure independent evaluations of the assets.
- Other provisions sought by the Democrats in Congress would facilitate workouts by homeowners and discourage foreclosures, as one strategy to reduce further damage to the U.S. housing sector overall. Some of these provisions are in the Discussion Draft, but may not survive in a final bill.

Still unclear are whether non-U.S. firms will be allowed to participate in the sales of mortgage-related financial instruments and whether the bailout will be extended to include other types of highly distressed assets, such as instruments relating to student loans, automobile loans and credit card debt. The current Discussion Draft has bracketed the words “student loans” for possible inclusion in the bailout.

Treasury continues to avoid making clear statements on such issues to provide itself the greatest possible flexibility in determining where market intervention is necessary. In contrast, members of both political parties in Congress are fearful of a populist backlash against the bailout and are seeking to place controls on it, which may include sectoral, temporal and geographic limits on its extent. In particular, the treatment of companies such as Barclays and UBS, each holding substantial amounts of mortgage-backed securities, is proving contentious with the Congress. Keeping such firms from participating in the bailout may be difficult, however, in light of their substantial operations and structures within the United States.

What is evident, even today, is that all of the issues relating to the bailout are likely to involve extended negotiations among many stakeholders over an extended period that will be revisited as politics, time, money and experience may dictate.

We anticipate that the negotiated bill will be the first of a number of separate vehicles addressing the bailout and will certainly include most of the following elements that have now been informally put forward by Senator Dodd and Congressman Frank, together with some of the new further oversight mechanisms requested by the House Republicans.

The major elements of an agreement on the bailout in its current form include:

1. *An Oversight Board.* Congress will almost certainly create an oversight board with authority to review decisions of the secretary of the Treasury. The

current Discussion Draft would create a Financial Stability Oversight Board with the authority to review and override decisions made by the Secretary of the Treasury. Its members would include the chairman of the Federal Reserve; the FDIC; the SEC; and two private-sector outside members, one appointed by the Congressional Democratic leadership and the other appointed by the Congressional Republican leadership, with frequent periodic reporting obligations to the Congress. With this structure, there will be ongoing communication involving the Treasury, the regulators, the Congress and the private sector on the bailout throughout the process.

2. *Transparency Requirements.* Secretary Paulson's plan would have allowed the Treasury to go forward without having to issue regulations subject to judicial review. Any bailout agreement will now require the Treasury to promulgate rules that are transparent and subject to review, as well as to make the financial consequences of its decisions fully available to public view.

3. *Frequent Periodic Reporting to Congress and the Public.* The Discussion Draft would require detailed, periodic reports to Congress on all transactions. Negotiations continue on whether the Treasury would be required to issue a public report either monthly or as often as weekly (the period selected in the current Discussion Draft), specifying the total amount of assets purchased and sold during the preceding period. A report would also be required that details all transactions made during the previous period, including a description of the pricing mechanism for the transactions, and a justification of the price paid for and other financial terms associated with the transaction, with additional elements.

4. *Equity Stakes in Companies Which Receive Government Help.* Most members of Congress remain determined to require companies that sell troubled assets to the government to give back warrants in exchange, allowing the government to participate in profits the companies make later. The current Discussion Draft would require the secretary of the Treasury to obtain some form of equity in return for any purchase of a troubled asset, except purchases that are "de minimis," but provides no detailed guidance on pricing mechanisms. As of today, Secretary Paulson appears to have backed down from his earlier strong opposition to equity stakes in light of public and Congressional opinion on the issue.

5. *Conflicts of Interest.* These provisions would put into place conflict-of-interest standards to govern asset management firms who organize the purchases and/or sales of bad assets, as well as their sale.

6. *Executive Compensation.* Many Democrats in Congress and some Republicans are seeking to impose limits on executive compensation for officers of entities that seek to sell assets through the program. The new Discussion Draft would require the secretary of the Treasury to determine "appropriate standards" for executive compensation and to prohibit "inappropriate or excessive severance compensation," but provides limited guidance as to what this would mean in practice, other than the obligation to

claw back bonuses or other compensation made to executives based on statements of earnings, gains, or other criteria that are later proven to be false or inaccurate.

7. Contracting provisions. The Discussion Draft would allow for streamlined contracting provisions giving the Treasury much greater flexibility than would otherwise be permitted under normal federal contracting procedures, but mandates that the Secretary solicit proposals “from a broad range of qualified vendors,” apparently precluding sole source contracts.

8. Further Review Mechanisms. The Republican Study Committee plan would call on the SEC to audit reports of failed companies to determine whether financial statements were accurate and to review the performance of the credit rating agencies and to determine whether they failed to adequately assess risk. It also suggests the immediate creation of a blue ribbon panel of regulators to make further recommendations to Congress for financial sector reforms by January 1, 2009. The current Democratic Discussion Draft would require the Secretary of the Treasury to issue a “Regulatory Modernization Report” by April 30, 2009, covering the same issues. It would also create a special inspector general for the troubled-asset program.

Separately, there are many proposed changes affecting the treatment of distressed homeowners; these remain fluid as of today. The Discussion Draft would require the Secretary of the Treasury to “maximize assistance for homeowners,” develop a strategy to prevent foreclosures and take steps to encourage loan servicers to “avoid preventable foreclosures to the greatest extent possible.” In addition to these soft mandates, the Discussion Draft would make changes to existing U.S. bankruptcy law to allow for modification of loans secured by residences. This idea remains controversial, strongly opposed by many financial institutions and a number of members of Congress, and it is unclear whether it will survive in any final bill.

What’s Next?

As of today, there is both growing consensus that a deal is needed and imminent, but also continued unwillingness by Democrats to move forward on the bailout in the absence of participation by Republicans in the House of Representatives and the Senate.

House Republicans are now pushing for further capital gain tax cuts as the price of agreeing to the legislation. To date, there appears to be no appetite on the Democratic side for such tax cuts, and the impasse on this issue appears to be the principal immediate impediment to an agreement.

The gyrations of the financial markets continue to drive the process forward; the attitudes of voters, who remain negative about the bailout, provide a counter-weight that is slowing agreement.

Whatever happens over the next few days, revisions to the scope of the bailout and to the rules under which it takes place are likely to be ongoing for many months to come.

APCO's political intelligence and government affairs group in Washington, D.C., will be actively monitoring the situation and remains available to brief you.

APCO's Key Financial Experts

Don Riegler, chairman, government relations

Don Riegler, former U.S. senator, served six years as chairman of the Senate Banking Committee and lead several major financial restructuring bills to enactment.

Don Bonker, executive vice president

Don Bonker, former U.S. congressman, was a senior member of the House Foreign Affairs Committee and chairman of the Subcommittee on International Economic Policy and Trade.

Paul Clayman, senior vice president

Paul Clayman was an attorney for 15 years with the U.S. Department of State; he is former chief counsel to Senator Richard Lugar and former principal State Department attorney responsible for trade, export control and economic sanction issues.

Marc Ginsberg, senior vice president

Marc Ginsberg is a former U.S. ambassador to Morocco; former special U.S. coordinator for Mediterranean trade, investment and security affairs; and former chief financial officer at Galland, Kharasch, Morse & Garfinkle.

Jonathan Winer, senior vice president

Jonathan Winer is a former U.S. deputy assistant secretary of state for international law enforcement. At the State Department, he was one of the architects of U.S. international policies and strategies in financial services regulation and enforcement.

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