



## MEMORANDUM

**TO:** Interested Parties

**FROM:** APCO Worldwide

**DATE:** October 2, 2008 *Update*

**RE:** *Sweetened Bailout Bill Passes Senate, Heads to House*

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### Summary

Late Tuesday night, the Congressional leadership in the U.S. Senate decided to tackle the unpopularity of the \$700 billion financial services bailout bill by attaching to it a wide array of tax sweeteners, designed to provide something for everyone. These popular tax-break extenders had previously been endorsed by all but two members of the Senate which voted it out to the House of Representatives on September 24. The Senate bill had remained stalled, however, because of disagreements between the two houses on how to pay for the tax cuts, with House "Blue Dog" Democrats seeking to have more of them paid for by eliminating other tax preferences. Late last night, the new combined legislation of bailout plus tax breaks passed the Senate by a 3-1 majority vote of 74 to 25. The House is now due to vote on it on Friday.

The bet made by the Senate leadership is that the combined bill contains so many popular items that House members who opposed the bailout on its own will be forced to say "yes" to this bill as the only means available to deliver tax relief to key constituencies prior to the elections. Prominent among the sweeteners are the fix to the Alternative Minimum Tax (AMT), which otherwise would hit 26 million Americans, most of whom have incomes well below \$200,000 a year, as well as the new temporary increase to federal deposit insurance to \$250,000 per account from its current limit of \$100,000.

This memorandum summarizes the major provisions of the massive 451-page bill, focusing on the elements of the final bailout compromise, which now includes dividing the \$700 billion payout into three installments.

Probably the most important implication of the approach now being taken is that this bailout remains largely untrammelled by rigid legislative limitations, being governed generally by guidelines, rather than fixed mandates. Accordingly, it will remain a work in progress over many weeks and months. The legislation is deliberately designed to grant Treasury maximum flexibility and Congress maximum oversight. As a result, there are likely to be an unprecedented amount of ongoing consultations and activities relating to the bailout involving many, many constituencies for the

foreseeable future, as they seek to affect one or more of the broad range of policy, legislative, regulatory, and public opinion issues that the bill impacts.

### **What Survives In the Revised Bailout**

1. *Wide Discretion for the Secretary of the Treasury, with Constant Consultations.* The consistent approach on all contentious issues was to grant the Secretary broad authority with some guidelines and extensive requirements to report back to Congress whenever a decision is made. Comment: The compromise allows Treasury more or less complete freedom to do whatever it wants, especially over the next few weeks, but also puts Congress in the position of breathing down Treasury's neck if it does anything controversial, making it possible for essentially any constituency to go its elected member of Congress to complain and seek redress if it has an issue with any Treasury decision.
2. *Broad Coverage of all types of troubled assets.* "Troubled Assets" are defined with the broadest possible scope. In essence, the bill covers not only mortgage related assets, but literally *any* type of financial instrument, troubled or otherwise, that the Secretary decides needs to be purchased by the U.S. government to promote financial market stability. Comment: Many types of businesses holding troubled assets, from student loans, to credit card debt, to automobile loans, and even small business or municipal debt that turns bad may be lobbying the Treasury for coverage here, not to mention those holding complex derivatives instruments whose pricing may be difficult to assess.
3. *Immediate authority to implement a "Troubled Assets Relief Program," or "TARP," even before regulations are issued.* The final legislation, unlike Secretary Henry M. Paulson, Jr.'s original three-page bill, requires the Department of the Treasury to establish formal processes, systems and regulations as is the normal case in any governmental program. But; it also grants him broad authority to act even before any such regulations are issued in light of the perceived financial services emergency. Comment: This provision represents a compromise between Treasury's initial demand for no constraints on its action in an emergency, and Congressional goals of preserving a wide array of procedural controls. These will come into place eventually, but appear not to apply to whatever Treasury chooses to do over the next few weeks.
4. *Deposit insurance through the end of 2009 at \$250,000 per account, instead of \$100,000.* Following reports of consumers removing funds from banks across the country, both presidential candidates have advocated raising the federal guarantee on bank deposits to \$250,000. The revised bailout bill would raise insurance to \$250,000 per account for the next 15 months. Comment: This provision is likely to be both popular and reassuring, and provides another reason for House members who previously opposed the

legislation to change their position. Short-term, it also makes economic sense, by keeping deposits within the formal banking system.

5. *Creation of a new Treasury Office of Financial Stability to administer all aspects of the bailout.* Until a new administration is in place, this office will be headed by an interim appointee who does not require advice and consent of the Senate.
6. *Program guidelines, rather than regulations, for the purchase of troubled assets, issued within 45 days.* The bill requires Treasury to publish what it calls “program guidelines” that specify the mechanisms for purchasing troubled assets, methods for pricing and valuation, procedures for selecting asset managers, and criteria for identifying troubled assets, no later than 45 days from enactment. Comment: The details of the buy-back program don’t have to be provided to the public until mid-November, *after* the U.S. federal elections. Once provided, they will surely be subject to extensive public comment and ultimately, of Congressional hearings, possibly during any lame-duck session that might be scheduled. (The probabilities of such a session have been *substantially* reduced as a result of Congress passing on September 25 a continuing resolution to keep the government going until March 2009.)
7. *Generic requirements to prevent unjust enrichment, but with a large loop-hole.* The bill requires the Treasury Secretary to prevent “unjust enrichment” by financial institutions participating in the TARP, but in concrete terms, this only requires him not to pay more for an asset than the original purchase price, which is unlikely to be an issue in connection with any troubled asset. Moreover, troubled assets acquired in a merger or acquisition are excluded entirely from this requirement. Comment: This exception could be politically contentious. It appears to suggest that a company such as Citibank, Bank of America, or JP Morgan Chase that has purchased such assets in connection with an acquisition of another institution may well be able to sell assets to Treasury for more than what they paid for the asset.
8. *Federal insurance for troubled assets.* The new bill has language originally proposed by House Republicans that would establish an FDIC-type insurance program for all types of troubled assets, starting with but not limited to mortgage-backed securities, so long as they were issued on or before March 14, 2008. In essence, the government would guarantee the timely payment of the principal and interest on these assets, and any financial institution participating in the guarantee program would be required in return to pay the premiums, with premiums adjusted for the risks of the type of assets they are seeking to guarantee. Comment: Independent experts have already questioned whether the premiums required for this type of program will be too large for the program to be sufficiently attractive for financial institutions to wish to participate. As with the rest of the bailout, it appears that Treasury could extend this type of program to include credit-card, automobile, student

loans, municipal bonds, or any other form of troubled asset in the days to come.

9. *Financial Stability Oversight Board.* As with previous versions of the bailout, the bill would create a Financial Stability Oversight Board to oversee the entire program. In its final form, the Board is made up of financial regulators, plus the Secretary of Housing and Urban Development.
10. *Modernization of U.S. financial regulatory structure.* The bill requires Treasury to provide Congress recommendations on modernizing the U.S. financial services regulatory system no later than April 30, 2009, expressly including the need to deal with over-the-counter swap markets implicated in the current crisis. Comment: This provision essentially ensures that the new Administration and Congress will be returning to these issues throughout 2009.
11. *Contracting procedures.* The bailout is exempt from normal U.S. government contracting rules, to whatever extent the Secretary of the Treasury decides there are “urgent and compelling” reasons for ignoring the normal contracting rules. Notably, however, it requires immediate reporting to Congress whenever the Treasury has chosen to waive the normal provisions of the government.
12. *Conflicts of interest.* The bill requires the Secretary to issue regulations or guidelines to deal with conflicts associated with the hiring of contractors, advisors, asset managers, purchases of troubled assets, and post-employment issues. It provides no guidance on the specifics.
13. *Foreclosure mitigation.* As a very general matter, Treasury is required to maximize help to homeowners by encouraging those servicing mortgages to take advantage of government programs to minimize foreclosures, and to modify mortgages at risk of foreclosure when possible in connection with any assets relating to residential property held, owned, or controlled by the government. It would also allow the Secretary to use loan guarantees and credit enhancements to avoid foreclosures. Comment: Some in Congress view these provisions to be inadequate to address the foreclosure problem. They still want mortgages on primary residences to be modifiable in bankruptcy. This issue is likely to return next year.
14. *Limits on executive compensation.* When Treasury purchases assets from a company, the company will be required to observe some very general standards on corporate incentives and golden parachutes. When Treasury buys more than \$300 million in assets at auction from any company, that firm will be subject to a 20 percent excise tax on golden parachute payments and will not be able to deduct taxes as business expenses for any executive compensation over \$500,000 per year. Comment: Some analysts have already suggested these provisions will be easily circumvented by companies developing structural work-arounds to avoid them.

15. *Bailout by installments.* The funds will be divided into installments of \$250 billion immediately, \$100 billion if the President certifies it is needed, and a final \$350 billion if the President sends Congress a report requesting such authority. Congress then has 15 days to say “no,” if it objects to that request. Comment: This change was designed to allow members of Congress to tell their constituents that they were able to reduce the total authority in half from the original Treasury request.
16. *Judicial review.* In great contrast to the original Paulson bill, the final legislation provides for judicial review to ensure that the Secretary’s actions are not arbitrary, capricious, or illegal. Comment: This is the lowest standard for judicial review of administrative decisions, but replaces the Administration’s request that the decisions be subject to no judicial review at all.
17. *Congressional Oversight Panel.* The bill would establish a new outside review body, made up of five members selected by the Congressional leadership, supported by a paid staff, to oversee the bailout.
18. *Mark-to-Market Accounting.* The Securities and Exchange Commission (SEC) would be granted the authority to suspend market-to-market accounting if it determines that it is in the public interest and protects investors. Comment: Such a decision by the SEC would be controversial, as it would defer the recognition of losses on any category of financial instruments covered, but it has been heavily pushed by House Republicans. One should expect immediate Congressional hearings if this authority were to be used.
19. *A Placeholder on “Recoupment.”* The bill requires that the President submit a proposal to the Congress within five years that recoups from the financial industry any losses to the taxpayer. Comment: This provision is barely a fig-leaf covering the reality that the losses are likely to be substantial, deferring the submission of a proposed “recoupment” strategy *until 2013*.

### **The Tax Sweetener Package**

This package of tax breaks, previously passed the Senate by a vote of 93-2 on September 23, and was then stopped by the House for failing to meet the pay-as-you-go (PAYGO) budget rules. Major elements of the package include:

1. An increase in the income threshold at which Americans become subject to the higher alternative minimum tax. This measure would protect more than 21 million taxpayers from higher taxes at a cost of \$64 billion. The cost of the AMT “patch” is not offset.
2. Clean energy tax incentives totaling approximately \$18 billion, paid for by several offset provisions including a delay of the tax deduction for domestic manufacturing activities of major American oil and gas companies. The energy

- provisions include extending for one or two years and expanding production tax credits for wind, refined coal, biomass and marine renewables; extending the investment tax credit for solar energy through 2016 for businesses, as well as for residential; providing new tax credits for creation of advanced coal electricity projects and coal gasification projects; establishing a new credit for plug-in electric drive vehicles, and extending credit for energy-efficient improvements to existing homes.
3. Tightened rules by which oil and gas companies pay taxes on income earned overseas.
  4. Extensions of expiring family and business tax cuts and other policies – including an expansion of the child tax credit, legislation providing parity for mental health treatment in the U.S. health care system, and tax relief for victims of natural disasters.

### **Onto the House**

There is a wide-spread assumption that the changes to the bailout bill, starting with the provision that limits it to \$350 billion in the absence of a further chance for Congress to vote down more money, provide enough cover to achieve substantially more than the 12 additional votes needed for its passage on Friday. This is especially likely now after the super-majority in favor of the legislation reached in the Senate, supported by a substantial majority of both Republicans and Democrats. However, with populist constituencies in both political parties still agitating against the legislation, including by way of political advertisements and talk radio, it remains conceivable, if currently unlikely, that something unexpected could yet happen.

### **If Enacted**

Assuming it passes, this massive piece of legislation is merely the beginning of the process, as both the new Congress and the new Administration will be carrying out extensive consultations on how to implement all of these changes. Working groups will be created by the incoming Administration during the Presidential transition period to obtain a head-start on most if not all of the areas covered by the bailout bill. Congressional leaders and their staffs will also be seeking to get a head-start on the demands of the first days of the new Congress through sketching out their initial oversight activities on the bailout, as well as proceeding with broader financial services regulatory reform during 2009. Work on a more comprehensive energy plan for 2009 will also be ongoing.

APCO's political intelligence and government affairs group in Washington continues active monitoring of the situation and remains available to brief.

## APCO's Key Experts

### **Don Riegle, chairman, government relations**

Don Riegle, former United States senator, served six years as chairman of the Senate Banking Committee and led several major financial restructuring bills to enactment.

### **Don Bonker, executive vice president**

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

### **Marc Ginsberg, senior vice president**

Marc Ginsberg is former United States 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 the former United States deputy assistant secretary of state for international law enforcement. At the State Department, he was one of the architects of United States international policies and strategies in financial services regulation and enforcement.