

## EXTRAORDINARY GOVERNMENT INTERVENTION TO BOLSTER BANK BALANCE SHEETS

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### I. INTRODUCTION

The financial crisis has brought many banks, both large and small, to their knees. In 2008, twenty-five banks failed,<sup>1</sup> more than in any year since 1993. Moreover, one of those failed banks – Washington Mutual (WaMu) – was the largest bank failure in history.<sup>2</sup> Three of the four largest U.S. banking institutions were so at risk that one – Wachovia – was acquired by Wells Fargo, a smaller institution,<sup>3</sup> and two – Citigroup and Bank of America – were forced to request government investments in excess of the initial government investments they received under the Troubled Asset Relief Program (TARP).<sup>4</sup> The aggressive responses to the crisis by Congress, the Treasury Department, the Federal Reserve Board of Governors (FRB), and the Federal Deposit Insurance Corporation (FDIC) to help banks improve their capital positions and liquidity have dramatically altered the liability and equity

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1. Joe Adler, *Two More Failures Brings 2008 Tally to 25*, AM. BANKER, Dec. 15, 2008, at 16. See also FDIC, Bank Failures & Assistance, <http://www.fdic.gov/bank/historical/bank/2008/index.html> (last visited Feb. 8, 2009).

2. The WaMu failure was resolved at no cost to the FDIC, however, as J.P. Morgan Chase & Co. purchased its banking operations for \$1.9 billion. Joe Adler, *Success with Failures*, AM. BANKER, Dec. 29, 2008, at 1.

3. As of June 30, 2008, Wachovia's assets stood at \$812.4 billion, thirty-three percent larger than Wells Fargo's \$609 billion in assets. *Bank and Thrift Holding Companies with the Most Assets on June 30, 2008*, AM. BANKER, Jan. 15, 2009.

4. Citigroup and Bank of America each received additional TARP funds beyond that in the initial Capital Purchase Program. The government's investment in preferred stock in each institution now stands at \$45 billion. See *infra* text accompanying notes 26-31.

sides of bank balance sheets. In 2009, it is likely that government purchases and guarantees of bank assets will increasingly be used to assist particular institutions and foster financial market stability.<sup>5</sup> This unprecedented government assistance to prevent widespread bank failure and to provide support for those institutions “too big to fail” underscores the vital role that banks play in our economy. This Comment explores these actions and discusses some of their implications.

## II. GOVERNMENT INVESTMENT IN BANKS – PREFERRED STOCK AND WARRANTS FOR COMMON STOCK

Congress’ initial legislative response to the financial crisis, but not likely to be its last, was the Emergency Economic Stabilization Act of 2008 (EESA), enacted on October 3, 2008. The \$700 billion in funds authorized by Congress in EESA to assist in the financial crisis clean-up, labeled “Troubled Asset Repurchase Program” (TARP), were quickly diverted by Treasury Secretary Henry Paulson from buying troubled mortgage-related assets held by banks to purchasing preferred, non-voting stock in banks under what is called the Capital Purchase Program (CPP).<sup>6</sup> A second bank investment program, the Targeted Investment Program (TIP), was announced on November 23, 2008, and has been used to fund additional preferred stock investments in Citigroup and Bank of America beyond the initial CPP investments.

The first tranche of funds released by Congress for the TARP amounted to \$250 billion, and all of it has been committed for CPP and TIP preferred stock purchases, although as of the beginning of 2009, only \$187.5 billion had actually been disbursed.<sup>7</sup>

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5. See Emily Flitter, *Giving B of A More Help, Did Government Tip Hand?* AM. BANKER, Jan. 20, 2009, at 1. See *infra* text accompanying notes 26 and 29.

6. See Press Release, U.S. Treas. Dept., Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), <http://www.treas.gov/press/releases/hp1207.htm> [hereinafter *TARP Capital Purchase Program Description*].

7. U.S. TREAS. DEPT., FOURTH TRANCHE REPORT TO CONGRESS 1 (Jan. 7, 2009), available at <http://www.treas.gov/initiatives/eesa/docs/Fourth-Tranche-Report.pdf>. Disbursement of the remaining allocated funds is subject to approval of capital applications by bank regulators, shareholder approval in some cases, and other closing procedures. *Id.* at 4-5. See Mike Ferullo, *Treasury Financing: Treasury*

Secretary Paulson deemed the CPP a more expeditious way to inject capital into the banking system than attempting to value and purchase troubled mortgage-related assets held by banks. Paulson originally strongly resisted government stock purchases, calling taking preferred stock in banks “what you do when you have failure” and stating “[t]his is about success.”<sup>8</sup> His opposition to government stock purchases was in stark contrast with the lead of other countries, including the United Kingdom, Germany, France, Spain, and Italy. But, he soon did an about face, announcing the CPP on October 14, 2008.<sup>9</sup>

The Treasury Secretary’s authority under EESA to use the so-called “bailout” funds to buy preferred stock is somewhat convoluted. The Secretary is authorized by EESA to “purchase, and to make and fund commitments to purchase, troubled assets from any financial institution.”<sup>10</sup> “Troubled assets” are defined to

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*Disclosed \$15 Billion in Funds to Banks Under Capital Purchase Program*, 92 BNA BANKING REP. 131 (Jan. 20, 2009). The amount of preferred stock that the government purchased in any one institution could not be less than one percent of the institution’s risk-weighted assets, and not more than the lesser of \$25 billion or three percent of risk-weighted assets. U.S. TREAS. DEPT., PROGRAM DESCRIPTIONS, CAPITAL PURCHASE PROGRAM 1-2 (Jan. 7, 2009), available at <http://www.treas.gov/initiatives/eesa/program-descriptions/cpp.shtml> (hereafter “Program Description”). JP Morgan Chase, Citigroup, Wells Fargo, and Bank of America (following the consummation of its merger with Merrill Lynch) each received the maximum investment of \$25 billion. U.S. TREAS. DEPT., APPENDIX 1, FOURTH TRANCHE REPORT TO CONGRESS 1 (Jan. 7, 2009), available at <http://www.treas.gov/initiatives/eesa/docs/Fourth-Tranche-Report-Appendix.pdf> [hereinafter *Fourth Tranche Appendix*].

Such widespread government ownership of bank stock is not without precedent. The Reconstruction Finance Corporation, established in 1932, bought stock in 6,000 banks at a cost of \$1.3 billion, which would be approximately \$200 billion in today’s dollars, and the government about broke even on the subsequent sale of bank stock to investors or back to the banks. More recently, in 1984, the United States took an eighty percent ownership stake in Continental Illinois National Bank, at the time the country’s seventh largest bank. See Steve Lohr, *Intervention is Bold, but Has a Basis in History*, N.Y. TIMES, Oct. 14, 2008, at A1.

8. Edmund L. Andrews & Mark Landler, *White House Overhauling Rescue Plan*, N.Y. TIMES, Oct. 12, 2008, at A1, available at <http://www.nytimes.com/2008/10/12/business/12imf.html> (quoting testimony before the United States Senate Committee on Banking, Housing and, Urban Affairs on September 23, 2008).

9. Press Release, U.S. Treas. Dept., Joint Statement by Treasury, Federal Reserve and FDIC (Oct. 14, 2008), <http://www.treas.gov/press/releases/hp1206.htm>. See also *supra* note 5.

10. H.R. REP. No. 110-1424, § 101(a)(1) (2008). “Financial institution” is defined as “any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer or insurance company . . . having significant

include the types of assets that most observers anticipated would be purchased – “residential or commercial mortgages and any securities, obligations, or other instruments, that are based on or related to such mortgages,”<sup>11</sup> as well as “any other financial instrument that the [Treasury] 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.”<sup>12</sup>

The term “financial instrument” is not, however, defined in the statute. A colloquy on the floor of the House of Representatives prior to the House vote in favor of EESA addressed the scope of the term. Representative Barney Frank, Chairman of the House Financial Services Committee, confirmed that the scope of the assets that the government may purchase “is intended to include capital instruments of an institution such as *common and preferred stock*, subordinated and senior debt, and equity rights.”<sup>13</sup> Frank noted that the “authority to buy equity” was added to EESA by the House and the Senate, and that the purpose of the expenditures “is not simply buying up the assets, it is to buy equity, and to buy equity in a way that the Federal Government will be able to benefit if there is an appreciation,”<sup>14</sup> and “to enable financial institutions to begin providing credit again.”<sup>15</sup> Representative Moran added that, if done effectively, equity infusions have the capacity to provide between ten and twelve times the amount of the initial government investment.<sup>16</sup>

As the CPP program was originally conceived, there were no specific requirements regarding how banks that received the government equity infusion should use it.<sup>17</sup> The statute did require

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operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.” *Id.* § 3(5).

11. *Id.* § 3(9)(A).

12. *Id.* § 3(9)(B).

13. 154 CONG. REC. 10763 (daily ed. Oct. 3, 2008) (statement of Rep. Frank) (emphasis added).

14. *Id.*

15. *Id.*

16. 154 CONG. REC. 10796 (daily ed. Oct. 3, 2008) (statement of Rep. Moran).

17. The expectation by Treasury officials and perhaps Congress seems to be that banks would use the additional capital to increase lending, when in fact much of it appears to have been used to shore up capital positions and, at least in one case,

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that certain executive compensation arrangements for CPP recipients would be limited.<sup>18</sup> In addition, banks receiving the investment money were required to sign a contract providing that the Treasury “may unilaterally amend any provision . . . to the extent required to comply with any changes after the Signing Date in applicable federal statutes.”<sup>19</sup> Some banks cited this open-ended commitment as the reason they either elected not to apply for TARP money or have yet to decide whether to accept it.<sup>20</sup> Political leaders have since called for additional accountability by banks regarding the use of these funds.<sup>21</sup>

Institutions accepting preferred stock investments by the United States also are required to pay quarterly dividends to the United States of five percent per year for the first five years of the investment and nine percent per year thereafter.<sup>22</sup> The institution may repurchase the preferred stock three years after its issuance for the purchase price plus accrued and unpaid dividends.<sup>23</sup> The government also receives warrants to buy common stock at a market price equal to fifteen percent of the preferred stock investment.<sup>24</sup> The exercise price for the warrants is the common stock price on the date of the investment.<sup>25</sup>

On November 23, 2008, the Treasury Department, FRB, and FDIC announced further actions to support Citigroup.<sup>26</sup> This

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finance an acquisition of an institution that did not have its request for TARP funds honored. See Joe Adler, *Success with Failures*, AM. BANKER, Dec. 29, 2008, at 1 (discussing PNC’s purchase of Nat City after Treasury declined to provide TARP funds to Nat City as a stand-alone entity).

18. See U.S. Treas. Dept., Emergency Economic Stabilization Act, Executive Compensation, <http://www.treas.gov/initiatives/eesa/executivecompensation.shtml> (last visited Feb. 8, 2009).

19. Press Release, U.S. Treas. Dept., Securities Purchase Agreement, Standard Terms (Oct. 31, 2008) at 35, <http://www.treas.gov/pres/releases/reports/spa.pdf>.

20. See Katie Kuehner-Hebert, *Approved for Infusions – But Hesitant*, AM. BANKER, Jan. 8, 2009, at 1.

21. See Stacy Karper, *House Debate Conditions for Rest of Tarp Funds*, AM. BANKER, JAN. 14, 2009, at 3.

22. See *TARP Capital Purchase Program Description*, *supra* note 6.

23. *Id.*

24. *Id.*

25. *Id.* (the market price at investment is to be calculated on a 20-trading day trailing average).

26. Press Release, FDIC, Joint Statement by Treasury, Federal Reserve, and FDIC on Citigroup (Nov. 23, 2008), <http://www.fdic.gov/news/news/press/208/pr08125.html>.

new effort included an additional \$20 billion investment in Citigroup preferred stock carrying an eight percent dividend, as opposed to the five percent dividend due to the Treasury during the first five years on its initial \$25 billion equity infusion.<sup>27</sup> Pursuant to this second extraordinary infusion of equity, the Treasury imposed some additional conditions. First, dividends on common stock are limited to one cent per share per quarter for three years unless the Treasury consents to additional dividend payments.<sup>28</sup> Second, there are additional restrictions on executive compensation, and third, Citigroup must adopt the FDIC's mortgage modification procedures developed in the conservatorship of IndyMac. Bank of America received a similar package of benefits, including another \$20 billion preferred stock investment, on January 16, 2009.<sup>29</sup> These additional equity investments in Citigroup and Bank of America were pursuant to a new TARP program labeled the Targeted Investment Program (TIP), rather than the CPP.<sup>30</sup> The purpose of TIP is to "foster market stability and thereby to strengthen the economy and protect American jobs, savings, and retirement security."<sup>31</sup>

### III. GOVERNMENT GUARANTEES OF BANK DEBT, INCLUDING INCREASED DEPOSIT INSURANCE

The largest source of funds for most banks is customer deposits. Deposits are liabilities of banks, and most deposits must be repaid to customers on demand. Banks may also raise funds by

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27. *Id.*

28. *Id.*

29. Press Release, FDIC, Treasury, Federal Reserve, and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009), <http://fdic.gov/news/news/press/2009/pr09004.html>.

30. There are currently two other TARP programs in addition to the CPP and TIP. One, for Systemically Significant Failing Institutions, was used to provide \$40 billion to AIG in exchange for preferred stock and warrants. See *Fourth Tranche Appendix, supra* note 7. The second, announced in December 2009, is the Automotive Industry Financing Program in which \$19.4 billion (and an additional \$4 billion subject to certain conditions) has been committed to GMAC, GM, and Chrysler. *Id.*

31. Press Release, U.S. Treas. Dept., Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009), <http://www.treas.gov/press/releases/hp1338.htm> (listing five eligibility considerations that Treasury may consider in providing additional capital under this program).

borrowing from other creditors. Congress and the FDIC increased the deposit insurance guarantee, and the FDIC has provided guarantees to other bank creditors in an effort to make lending to banks more attractive to lenders and less costly for banks.

EESA increased the deposit insurance amount from \$100,000 to \$250,000 until December 31, 2009, in order to further depositor confidence in banks and quell the destructive effect of bank runs.<sup>32</sup> Runs by creditors are a phenomenon unique to banks. The claim of bank depositors, unlike the claim of the creditors of other businesses, is due on demand and at par. In contrast, bondholders of General Motors (GM), for example, may not redeem their bonds from GM if they wish to call their loan to GM. Instead, the bondholder must either wait until the bond matures to receive repayment of principal or sell the bond on the market at its current market value, likely to be less than par. Bank runs were associated with the failure of WaMu and Wachovia,<sup>33</sup> and were prominently featured in the press following the FDIC's closure of IndyMac,<sup>34</sup> even though insured depositors' funds were safe under the FDIC deposit insurance guarantee.

The FDIC expanded deposit insurance coverage even further when it announced on October 14, 2008, not even two weeks after EESA's passage, the creation of its Temporary Liquidity Guaranty Program (TLGP).<sup>35</sup> The TLGP provides unlimited coverage to non-interest bearing transaction accounts typically maintained by business customers (the Transaction Account Guarantee Program) until December 31, 2009, and provides FDIC guarantees for certain bank unsecured debt (the

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32. H.R. 1424, Emergency Economic Stabilization Act of 2008, § 136 (amending 12 U.S.C. § 1821(a)(1)(E) to increase the standard maximum deposit insurance amount from \$100,000 to \$250,000).

33. See Rick Rothacker & Kerry Hall, *Wachovia faced a 'silent' bankrun: Fearing a loss of funding over the weekend the FDIC forced the sale*, CHARLOTTE OBSERVER, Oct. 2, 2008, at 1A.

34. See Joe Adler, *Success with Failures*, AM. BANKER, Dec. 29, 2008, at 1 (stating the "shower of news coverage [following IndyMac's failure] . . . panicked many depositors . . . not familiar with the ramifications of an FDIC takeover . . . [leading to] the first known bank run to occur after an institution had actually collapsed").

35. Press Release, FDIC, FDIC Announces Plan to Free Up Bank Liquidity, Creates New Program to Guarantee Bank Debt and Fully Insure Non-Interest Bearing Deposit Transaction Accounts (Oct. 14, 2008), <http://www.fdic.gov/news/news/press/2008/pr08100.html>.

Debt Guarantee Program) issued on or before June 30, 2009, with the guarantee extending to either the earlier of the debt's maturity or June 30, 2012.<sup>36</sup>

The FDIC cited the systemic risk exception as its authority for the TLGP. The systemic risk exception, added to the Federal Deposit Insurance Act in 1991, permits FDIC assistance to a troubled insured institution, including open bank assistance, even when that is not the least costly method, if the institution's failure would have "serious adverse effects on economic conditions or financial stability."<sup>37</sup> The systemic risk exception was invoked for the first time when the FDIC was negotiating a loss sharing arrangement with Citigroup as part of the possible purchase of Wachovia.<sup>38</sup>

As a result of EESA's deposit insurance increase and the TLGF's Transaction Account Guarantee Program, almost all bank deposits may have the benefit of the FDIC's deposit insurance guarantee. Slightly over 1000 insured institutions, however, have opted out of the additional deposit insurance coverage for non-interest bearing accounts.<sup>39</sup> A much larger number of banks and bank holding companies, 5,885, have opted out of the Debt Guarantee Program,<sup>40</sup> but many of these were smaller institutions that rely on funding sources other than non-deposit debt.<sup>41</sup> Thus, most liabilities of insured financial institutions are, for at least a temporary period of time, guaranteed by the federal government. Moreover, according to the FDIC's final rule on the TLGP, the FDIC's obligation under the Debt Guarantee Program is a full faith and credit obligation of the United States to make a timely

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36. *Id.*

37. 12 U.S.C. § 1823(c)(4)(G) (2006).

38. See Joe Adler, *Wachovia Deal Forces FDIC to use Systemic Tool*, AM. BANKER, Sept. 30, 2008, at 4. The Citigroup deal became moot when Wells Fargo agreed to merge with Wachovia without FDIC assistance. See generally Frank A. Hirsch, Jr. & Joseph S. Dowdy, *Whither Wachovia? Wells Fargo Wins the Battle for the Storied North Carolina Banking Institution*, 13 N.C. BANKING INST. 167 (2009).

39. FDIC, Temporary Liquidity Guarantee Program Opt-Out Lists, <http://www.fdic.gov/regulations/resources/TLGP/optout.html> (last visited Jan. 21, 2009) (there were 1077 insured depository institutions as of Jan. 21, 2009).

40. *Id.*

41. See Jessica Holzer, *Many Banks Opt out of FDIC Program*, WALL ST. J., Dec. 3, 2008, at C2.

payment of principal and interest on an uncured default in payment of the debt.<sup>42</sup> The FDIC guarantee should allow banks that have not opted out to borrow money at lower rates than would be available without it.<sup>43</sup> A number of institutions have taken advantage of this boost to borrowing, including Citigroup with its sale of \$5.5 billion of FDIC-guaranteed debt.<sup>44</sup>

In late January 2009, the FDIC indicated that it was considering proposing rule changes to the TLGP that would extend the maturity of the debt guarantee from three to ten years “where the debt is supported by collateral and the issuance supports new consumer lending.”<sup>45</sup> If adopted, the FDIC will then provide guarantees of secured bank debt as well as unsecured bank debt under the TLGP, providing deposit insurance guarantees for virtually all of a bank’s liabilities.

The FDIC’s costs for the additional insurance and the debt guarantees will be offset by the additional assessments insured institutions must pay for the additional deposit insurance or FDIC guarantee.<sup>46</sup> The FDIC also recently announced a doubling in its base deposit insurance assessment rate.<sup>47</sup>

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42. Final Rule, 73 FED. REG. 72244 (Nov. 26, 2008) (codified at 12 C.F.R. pt. 370).

43. For instance, Deere & Co., a savings and loan holding company, issued \$2 billion of FDIC-guaranteed debt through its credit arm at under three percent interest, compared with yields of over five percent on other non-FDIC-guaranteed Deere debt. See Liz Rappaport & Kellie Geressy, *Deere Gets Backing in \$2 Billion Debt Offer*, WALL ST. J., Dec. 17, 2008, at C3.

44. Romy Varghese, Kellie Geressy & Matthew Cowley, *H-P, Citi Debt Offerings Bring in Billions*, WALL ST. J., Dec. 3, 2008, at C2. See also Kellie Geressy, *Investors Buy \$17.25 Billion in Banks’ Bonds*, WALL ST. J., Nov. 28, 2008, at C2.

45. Press Release, FDIC, Treasury, Federal Reserve, and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009), at ¶ 5, <http://www.fdic.gov/news/news/press/2009/pr09004.html>. Banks wishing to take advantage of this ten-year guarantee are likely to be required to apply before July 2009 and will probably be subject to the TLGP caps on the aggregate outstanding debt that may be subject to the guarantee. Rob Blackwell, *Bair Looks to Put the ‘a’ Back in Tarp*, AM. BANKER, Jan. 20, 2009, at 1.

46. See *id.* (12 C.F.R. § 370.6 for debt guarantee program assessments and § 330.7 for Transaction Account Guarantee Program assessments).

47. Final Rule, 73 FED. REG. 78155 (Dec. 22, 2008) (For the first quarter of 2009, assessment rates for Category I banks will rise from five to seven cents per \$100 of deposits to twelve to fourteen cents.).

#### IV. ASSET-BASED INITIATIVES: THE ASSET GUARANTEE PROGRAM AND POTENTIAL ASSET PURCHASES

Although the expected use of TARP funds was to purchase troubled assets from financial institutions, the only TARP funds committed so far to assets are the asset pool guarantees provided to Citigroup and Bank of America as part of the additional preferred stock investments each institution received under the TIP. The Treasury's guarantees are part of a new Asset Guarantee Program (AGP). When the Treasury outlined this program in a report to Congress on December 31, 2008, it stated that the AGP "provides guarantees for assets held by systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets,"<sup>48</sup> and that "[i]t is not anticipated that the program will be made widely available."<sup>49</sup> The Treasury guarantees will be funded under the TARP program. The FDIC joined in these guarantees, but the FDIC guarantees will not be funded by TARP. Both the FDIC and Treasury will receive compensation for the guarantees in preferred stock and warrants of Citigroup and Bank of America. In the case of Bank of America, a \$118 billion pool of loans, and other assets including securities backed by residential and commercial real estate loans, will be subject to the guarantee. Bank of America will be responsible for the first \$10 billion in losses on the pool, with additional losses covered twenty-five percent by the FDIC up to a cap of \$2.5 billion, and seventy-five percent by the Treasury up to a cap of \$7.5 billion.<sup>50</sup> Ninety percent of any losses beyond the first \$20 billion will be covered by a nonrecourse loan by the Federal Reserve.<sup>51</sup> The Citigroup deal presents even greater exposure for the Treasury and the FDIC.<sup>52</sup>

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48. U.S. TREAS. DEPT., REPORT TO CONGRESS PURSUANT TO SECTION 102 OF THE EMERGENCY ECONOMIC STABILIZATION ACT 1, *available at* <http://www.treasury.gov/initiatives/eesa/congressionalreports102.shtml>.

49. *Id.*

50. Press Release, FDIC, Explanation of FDIC's Loss Sharing Exposure (Jan. 16, 2009), <http://www.fdic.gov/news/news/press/2009/pr09004b.html>. *See also* Rob Blackwell, *Bair Looks to Put the 'a' Back in Tarp*, AM. BANKER, Jan. 20, 2009, at 1.

51. *Id.*

52. The Citigroup asset pool may be up to \$306 billion in size. Citigroup is to absorb the first \$29 billion in losses. For losses in excess of that amount, ninety

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The assets guaranteed by the Treasury and the FDIC stay on the books of the financial institutions. It is possible that additional TARP funds may be used to fund other government loss sharing on financial institution assets.<sup>53</sup>

FDIC Chairman Sheila Bair joined Federal Reserve Chairman Ben Bernanke in advocating the exploration of a “bad bank” or “aggregator bank” funded in part by TARP that would buy troubled assets from financial institutions,<sup>54</sup> although the Treasury still does not seem inclined to engage in asset purchases because of valuation difficulties and cost concerns.<sup>55</sup>

#### V. IMPLICATIONS OF UNPRECEDENTED GOVERNMENT ASSISTANCE

The combined effect of these programs is a profound government exposure to ensuring the funding of banks through preferred stock purchases, the potential exercises of warrants to purchase common stock, and the guarantees of virtually all bank borrowings – from depositors, other unsecured creditors, and potentially secured creditors. On the asset side, the government has agreed to guarantee losses from specific asset pools for two systemically significant institutions, Citigroup and Bank of America, which could be extended to other institutions in some form in 2009.

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percent of the losses will be absorbed by the Treasury Department (up to the first \$5 billion) under TARP and the then to the FDIC (up to \$10 billion). The remaining ten percent of the losses will be borne by Citigroup. Once the losses exceed the amounts committed by the Treasury and the FDIC, the Federal Reserve will fund the remaining pool of assets with a nonrecourse loan with Citigroup still responsible for ten percent of the loss. Press Release, FDIC, Joint Statement by Treasury, Federal Reserve, and FDIC on Citigroup (Nov. 23, 2008), [http://www.treas.gov/press/releases/reports/cititermsheet\\_112308.pdf](http://www.treas.gov/press/releases/reports/cititermsheet_112308.pdf).

53. See Deborah Solomon & Damian Paletta, *Treasury Plans More Expansive Approach to Financial Rescue*, WALL ST. J., Feb. 7, 2009, at A3.

54. See Rob Blackwell, *Bair Looks to Put the ‘a’ Back in Tarp*, AM. BANKER, Jan. 20, 2009, at 1. Chairman Bernanke stated in a speech on January 13, 2009: “Yet another approach would be to set up and capitalize so-called bad banks, which would purchase assets from financial institutions in exchange for cash and equity in the bad bank.” Ben S. Bernanke, Chairman, U.S. Fed. Res. Sys., *The Crisis and the Policy Response* (Jan. 13, 2009) (transcript available at [http://www.federalreserve.gov/news\\_events/speech/bernanke20090113a.htm](http://www.federalreserve.gov/news_events/speech/bernanke20090113a.htm)).

55. Solomon & Paletta, *supra* note 53.

*A. Equity*

The purchase of preferred stock under the CPP program for those financial institutions that applied and were approved comes at a cost. The dividend due to the government is five percent for the first five years, increasing to nine percent thereafter. Furthermore, the preferred stock cannot be repurchased from the government by the institution for the first three years after its issuance. Preferred stock issued to Citigroup and Bank of America pursuant to the TIP program for systemically significant institutions is even more costly, carrying an eight percent dividend. The cost of this source of funds is offset by the lower cost funds that a bank may raise through insured deposits and debt that carry the FDIC's guarantee. Banks must then find lending opportunities that return more than their cost of funds,<sup>56</sup> but yet meet the safety and soundness requirements expected by bank examiners. Thus, the cost of the preferred stock purchases may induce risky lending behavior by banks rationally seeking a high enough return on loans to offset the bank's cost of funds, including the preferred stock dividend to be paid to the government. At the same time, however, loan portfolios will be scrupulously examined by bank regulators to ensure prudent lending practices. The first implication of the extraordinary government intervention is that the cost of the preferred stock and the caution of bank examiners may result in a standoff in which the new equity does not make its way into increased lending, as was originally anticipated.

A second implication of the preferred stock purchases is that the government has an increased interest in the success of the institutions in which it has invested. The Treasury will not be paid its dividend or be repaid its investment upon a repurchase of the stock by the institution if the institution fails. The government's financial stake in the institution could conceivably influence its

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56. In the first week of January 2009, the average rate on a thirty-year home mortgage loan was only 5.01%, declining in the week of January 15 to just 4.96%, and rebounding the week of January 22 to 5.12%. See Freddie Mac, Weekly Primary Mortgage Market Survey, <http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp> (last visited Feb. 8, 2009).

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decision to continue to provide assistance to the institution to prevent the failure from wiping out its equity interest. This incentive would presumably be greatest where the government has the most to lose – the largest institutions in which its investment is most significant, including Citigroup and Bank of America in which the government has made additional targeted investments under TIP because of the systemic significance of those institutions. A further implication of the TIP limitation of dividends on common stock to one cent per share for three years is that the attractiveness of the common stock has been reduced for private shareholders, possibly making it harder for these two institutions to attract new, private capital during this critical period.

An interesting by-product of this unprecedented government effort to shore up the ability of banks and their holding companies to borrow and raise capital is the exploding popularity of bank holding companies. The FRB approved the applications of Goldman Sachs, Morgan Stanley, American Express, and General Motors Acceptance Corporation (GMAC), among others, to become bank holding companies, notwithstanding the Bank Holding Company Act's (BHCA) limitations on mixing banking and commerce. Until this financial crisis, all of these institutions assiduously avoided characterization as a bank holding company because of the limitations that designation places on nonbanking and nonfinancial activities of the holding company and because of the desire to avoid the additional regulation and oversight imposed by the FRB under the BHCA. The capital infusions through CPP, increased deposit insurance and government guarantees, and the public perception that institutions subject to FRB oversight are safer and sounder than less regulated entities, however, have made the bank holding company status quite popular. It remains to be seen what long-term implications these holding companies will present for the continued separation of banking from other commercial enterprises, and whether these firms will gain an unfair advantage over their competitors who have not elected or cannot qualify for bank holding company status.

*B. Liabilities*

In EESA, Congress provided for a temporary boost in the standard deposit insurance amount. The FDIC followed less than two weeks later with an unlimited expansion of deposit insurance for non-interest bearing transaction accounts and for FDIC guarantees of unsecured bank debt, all pursuant to the systemic risk exception added to the FDIC Act in 1991. The use of that authority has not been challenged, but it could be argued that it was meant to apply only to FDIC aid aimed at a *particular* institution rather than to potentially all financial institutions. Moreover, does the voluntary nature of the participation in both the Transaction Account Guarantee Program and the Debt Guarantee Program undercut the conclusion that not offering these programs would result in “serious adverse effects on economic conditions or financial stability?”<sup>57</sup>

Normally, increases in deposit insurance and government guarantees would be met with concerns about the increase in moral hazard. With the FDIC agreeing to insure depositors and guarantee unsecured credits, depositor and creditor discipline of the risk-taking behavior of banks is diminished, increasing the potential moral hazard of bank lending practices. One obvious check on bank risk-taking is the bank supervision and examination process. Examiners have been especially critical of bank credit quality during this time. Another check on risk-taking may be that banks’ cost of funds from insured depositors and FDIC-guaranteed creditors should be close to a risk-free rate,<sup>58</sup> perhaps permitting a sufficient interest rate spread without making an excessively risky loan. Banks according to some, however, have been too reluctant to lend and are hoarding their funds, including those funds provided by government preferred stock purchases, to build war chests to take advantage of strategic acquisition

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57. 12 U.S.C. § 1823(c)(4)(G) (2006).

58. Deere & Co., a savings and loan holding company, issued \$2 billion of FDIC-guaranteed debt through its credit arm at less than three percent, compared with over five percent yields on other non-FDIC-guaranteed Deere debt. Three percent may not be a risk-free rate, but it is certainly less than the interest rate demanded by Deere creditors who do not benefit from the guarantee. *See* Rappaport & Geressy, *supra* note 43.

opportunities. For the TLGP to achieve its purpose of “favorably impact[ing] both the availability and the cost of credit,”<sup>59</sup> bankers and bank examiners will have to find the proper balance between increasing credit while maintaining prudent underwriting standards and an adequate capital cushion.

Another interesting implication of the Debt Guarantee Program is that the FDIC’s final rule on the TGLF proclaims that it is backed by the full faith and credit of the United States government.<sup>60</sup> Whether that statement is sufficient to bind the government should FDIC reserves be insufficient, will hopefully never be tested. But, if the statement is true, this puts banks’ unsecured creditors in a theoretically better position than insured bank depositors. Bank depositors will be paid from the FDIC’s reserves. Should those reserves run out, Congress would no doubt appropriate more money to honor the FDIC deposit insurance guarantee, but there is no requirement that it do so.<sup>61</sup>

The possibility of depleting FDIC reserves is, of course, one of the reasons this extraordinary government intervention is taking place – to keep banks from failing and imposing costs on the FDIC. The Federal Deposit Insurance Reform Act of 2006 requires that the FDIC maintain reserves that equal at least 1.15% of insured deposits.<sup>62</sup> Although reserves were at 1.19% at the end of the first quarter of 2008, they have steadily declined since then – to 1.01% at the end of the second quarter and 0.76% at the end of the third quarter. Even with projected increased premiums, the FDIC estimates the reserves could be at 0.63% by the end of the first quarter in 2009.<sup>63</sup> By statute, the FDIC has five years to return the ratio to the 1.15% minimum.<sup>64</sup> At the same time, the FDIC’s costs are increasing as it adds additional personnel to deal with the current failed institutions and to monitor the 171

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59. Final Rule, 73 FED. REG. 72244, 72244 (Nov. 26, 2008).

60. *Id.*

61. See Rob Blackwell & Joe Adler, *Industry Backs Giving FDIC More Power*, AM. BANKER, Feb. 3, 2009, at 1 (describing proposed legislation to more than triple the FDIC’s borrowing authority from the Treasury to \$100 billion).

62. 12 U.S.C. § 1817(b)(3) (2006).

63. See Joe Adler, *As Failures Multiply, So Does FDIC ‘09 Budget*, AM. BANKER, Dec. 17, 2008, at 1.

64. 12 U.S.C. § 1817(b)(3) (2006).

institutions that remain on its troubled bank list.<sup>65</sup> The FDIC assessments for the Deposit Account Guarantee Program and the Debt Guarantee Program will help replenish the FDIC coffers. In addition, the FDIC recently increased its assessment rates for its basic deposit insurance coverage, effectively doubling the deposit insurance expense for the healthiest banks from five to seven cents per \$100 of deposits to twelve to fourteen cents.<sup>66</sup> Thus, a serious implication of the government's intervention into bank balance sheets is the effect on the FDIC reserves, and whether the solvency of the FDIC could itself be at risk.

How will banks cope with the increased costs associated with this extraordinary government aid through preferred stock dividend payments to the government, a doubling of the base deposit insurance assessment, and additional assessments for those institutions participating in the Transaction Account Guarantee Program or the Debt Guarantee Program? It is likely that one implication is that banks will be forced to consolidate. Those that need additional capital will seek out those with excess capital. Combining banks may allow the surviving institution to significantly reduce personnel costs by layoffs of employees performing redundant functions, but creating further economic implications for the families so affected.

### C.      *Assets*

The Asset Guarantee Program (AGP) for the systemically significant institutions, Citigroup and Bank of America, is funded out of TARP. The FDIC's associated guarantee, however, is not TARP funded. It is not clear whether the FDIC's guarantee is backed by the full faith and credit of the U.S. government or the FDIC's reserve fund. Given the significant strains currently existing on the FDIC reserve fund, this is a significant issue which will hopefully be clarified in the coming months. It may be inappropriate for the FDIC's insurance fund to be at risk for the amount of the FDIC guarantee since assessments for the

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65. See Joe Adler, *Success with Failures*, AM. BANKER, Dec. 29, 2008, at 1.

66. Final Rule, 73 FED. REG. 78155 (Dec. 22, 2008).

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guarantee will not be added to the reserve fund. The payment for the guarantee is more preferred stock and common stock warrants, which will only have value if the issuing institutions return to health and prosperity.

One consequence of continuing to avoid bad asset purchases by an external entity funded by the government, private entities, or some combination of the two, is that financial institutions may be unable to attract private capital with the bad assets continuing to bloody their balance sheets, becoming wholly dependent on government equity.

*D. Nationalization of Systemically Significant Institutions*

A final implication is that the two institutions so far identified as systemically significant and needing government aid have been effectively nationalized. In this case, it seems clear that the term “systemically significant” institutions is a thinly veiled code-name for institutions that are “too big to fail.” The preferred stock purchased by the government or given to the Treasury or the FDIC in exchange for the guarantees of the asset pools equals over one-third of Citigroup’s stockholder’s equity and one-fifth of Bank of America’s consolidated equity following its merger with Merrill Lynch. The Treasury and the FDIC have collectively guaranteed another \$12.5 billion to each institution should the losses on the asset pools subject to the guarantee exceed the amount of the institution’s first loss position. The government is by far the largest equity holder of each of these institutions.

<b>Government Assistance (in billions)</b>	<b>Citigroup</b>	<b>Bank of America</b>
TARP		
-Capital Purchase Program (CPP)	\$25	\$25
-Targeted Investment Program (TIP)	20	20
Asset Guarantee Program For preferred stock	4	3
<b>Treasury total preferred stock</b>	<b>\$49</b>	<b>\$48</b>
FDIC Asset Guarantee For preferred stock	3	1

<b>Total Treasury and FDIC preferred stock</b>	\$52	\$49
TARP – Asset Guarantee Program (AGP) Max. guarantee on asset pool	5	10
FDIC Max. guarantee on asset pool	7.5	2.5
<b>Total Treasury and FDIC exposure on asset pools</b>	\$12.5	\$12.5
Stockholders' Equity as of 12/31/08	\$150.8	\$236.1 <sup>67</sup>
Total Treasury and FDIC preferred stock/Stockholders' Equity	34.5%	22.7%

## VI. CONCLUSION

As it stands, the liability and equity side of bank balance sheets are being significantly impacted by government efforts to infuse capital through preferred stock purchases under the CPP (which carry warrants for the government to buy common stock in the banks) and insurance and guarantees which lower the cost of borrowing to fund the bank's operations under the TLGP. An expansion of the TLGP will provide even longer term bank debt guarantees if the bank can collateralize the guarantee with certain recently originated consumer loans. Whether and how long it will take to wean banks from these government subsidies when the economy and financial system return to health remains to be seen.

The Treasury is likely the largest single equity holder of many of the institutions which have qualified for and accepted CPP funds. Does this ownership stake affect the government's decisions about whether to let these institutions fail? Notwithstanding its extensive interest, can the government effectively protect its investment with nonvoting preferred stock? What additional conditions is the government likely to impose on the institutions that have accepted CPP money? Will financial

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67. This number includes the \$20 billion in preferred stock committed to Bank of America on January 16, 2009, which has been added to Bank of America's 2008 year-end stockholders' equity.

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institutions be able to pay the preferred stock dividends to the Treasury and the increased deposit insurance assessments to the FDIC, without failing or compromising the safety and soundness of the institution?

Since October 3, 2008, the government has made extraordinary interventions to bolster bank balance sheets and avoid bank failures. Whether these efforts are successful in avoiding widespread bank failure, it is clear that they have dramatically changed the relationship between banks and the government for the foreseeable future.