Weathering the Storm: Insurers Accessing TARP

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On September 15, 2008, Lehman Brothers filed for bankruptcy protection, unleashing chaos in the financial markets. In response to the financial turmoil, and in conjunction with other actions taken by agencies of the U.S. federal government and the U.S. Federal Reserve, on October 3, 2008, Congress passed, and President Bush signed into law, the Emergency Economic Stabilization Act of 2008, or EESA.[1] The U.S. Treasury began implementing programs under EESA almost immediately. Following the change in administrations, Treasury Secretary Timothy Geithner has unveiled additional programs discussed below.

Certain programs initiated in response to the crisis are relevant to insurance companies: the Troubled Asset Relief Program, or TARP, a related program, the Public Private Investment Program, or PPIP, the Capital Purchase Program, or the CPP, a follow-on program to the CPP, the Capital Assistance Program, or the CAP, and the Debt Guarantee Program, or the DGP. Consistent with the rapid development of the financial crisis, these programs are evolving on a daily basis. The purpose of this article is to provide an overview of these programs in effect at the time of this writing and how insurance companies may access these initiatives.

Troubled Asset Relief Program and Public Private Investment Program

TARP developed from the initial proposal of then-Treasury Secretary Henry Paulson and the U.S. Treasury to alleviate the credit crunch by purchasing illiquid mortgage-related assets held by financial institutions. According to Secretary Paulson, the "root cause is the housing correction which has resulted in illiquid mortgage-related assets that are choking off the flow of credit which is vitally important to our economy."[2] The U.S. Treasury seemed to suggest that by purchasing these illiquid assets, TARP would restore stable market pricing, enable financial institutions to replace bad assets with credit-worthy assets, and thereby restore normal flows of credit.

As TARP was originally conceived, the U.S. Treasury would purchase mortgage-backed securities directly or through an auction process and take an equity stake in participating financial institutions. Participants would also be subject to corporate governance and executive compensation restrictions set forth in Section 111 of EESA (discussed further below). Although TARP was the program contemplated by EESA, the U.S. Treasury initially chose instead to delay the implementation of TARP in favor of the CPP. Amid concerns about designing an efficient pricing mechanism and a suitable auction format, the most salient issue was one of speed: the U.S. Treasury believed it was much faster to implement the CPP in order to stem the banking crisis.[3]

On March 23, 2009, the U.S. Treasury took initial steps to implement TARP by releasing information concerning PPIP, the primary purpose of which is to purchase troubled assets, including mortgage loans, also known as legacy loans, and mortgage-backed securities, also known as legacy securities.[4] To that end, PPIP contemplates the establishment of public-private investment funds, or PPIFs, capitalized by a combination of equity from private investors and funds from the U.S. Treasury, which will be used to purchase troubled assets. As envisaged at the time of this writing, PPIFs will have different leverage structures depending upon whether a PPIF is purchasing legacy loans or legacy securities. It is contemplated that insurance companies will be able to participate in PPIP as investors in PPIFs, whether purchasing legacy loans or legacy securities, as sellers of legacy securities (but not legacy loans) to PPIFs and potentially as asset managers of PPIFs that purchase legacy securities.

PPIFs will purchase legacy loans through an auction process organized under the supervision of the FDIC. PPIFs may purchase legacy loans only from U.S. banks and savings and loans. The

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PPIP guidance indicates that the loans and supporting collateral eligible to be purchased by a PPIF must be situated primarily in the United States. Investors in PPIFs purchasing legacy loans must be pre-approved by the FDIC, and according to the PPIP guidance, eligible investors may include insurance companies. Any additional qualifications for investors have not yet been determined as of the time of this writing.

For a PPIF purchasing legacy loans, private investors will contribute equity. The U.S. Treasury will provide additional equity capital up to 50% of the total equity capital. The remainder of the capital will be debt issued by the PPIF which will be guaranteed by the FDIC. The maximum debt-to-equity ratio will be 6-to-1; the amount of debt the FDIC will guarantee for any pool of loans will depend upon the results of FDIC's due diligence and underwriting. The debt is described in the PPIP guidance as non-recourse, with recourse only to the assets supporting the debt. In addition, the U.S. Treasury will acquire warrants for additional equity in the PPIF consistent with the requirements of EESA.

PPIFs will purchase legacy securities from "financial institutions" as defined in Section 3(5) of EESA. The term "financial institution" includes insurance companies established and regulated under U.S. federal or state law and having "significant operations" in the United States. Eligible legacy securities will include non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) that were originally rated AAA by two nationally-recognized rating organizations without regard to external enhancements. Eligible assets must be secured directly by loans or similar assets situated primarily in the United States and do not include resecuritization securities. PPIFs will be prohibited from buying legacy securities from their affiliates. The PPIP guidance does not prohibit insurance companies from investing in legacy security PPIFs.

The PPIP guidance includes eligibility requirements for PPIF fund managers. Fund managers must be based in the United States and should have a demonstrated capacity to raise at least $500 million of private capital; have experience investing in eligible legacy securities; have a minimum of $10 billion of eligible legacy securities under management; and have the operational capacity to manage the fund consistent with the U.S. Treasury's guidelines. The PPIP guidance does not prohibit insurance companies or their affiliates from serving as fund managers. Potential fund managers must submit an application to the U.S. Treasury. At the time of this writing, the U.S. Treasury had pre-approved nine firms to participate as fund managers in the initial round of PPIP.[5]

The capital structure of legacy security PPIFs differs from the capital structure of the legacy loan PPIFs. For a legacy security PPIF, the U.S. Treasury will match private sector equity capital on a 1-to-1 basis as it will for legacy loan PPIFs. However, in contrast to the legacy loan PPIFs, the U.S. Treasury will provide non-recourse debt financing in an amount of only 50% of the total equity capital (public and private) in the legacy securities PPIFs. This non-recourse debt financing is available only if the PPIF does not permit private investors to have voluntary withdrawal rights. In certain circumstances, as yet not fully determined, the U.S. Treasury may increase the debt financing up to 100%. A PPIF may also apply for additional debt financing from the U.S. Federal Reserve under its Term Asset-Backed Securities Loan Facility, or TALF, and private lenders. Finally, the U.S. Treasury will acquire warrants for additional equity in the PPIF consistent with the requirements of EESA.

For both the legacy loan PPIFs and the legacy security PPIFs, further specifications of the terms of investments will be released at a later date. On June 3, 2009, the FDIC announced that development of the legacy loan portion of PPIP would continue, but that a previously planned pilot sale of assets by open banks would be postponed.[6]

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Capital Purchase Program and Capital Assistance Program

The CPP was the first implementation of EESA. Under the CPP, the U.S. Treasury would recapitalize banks by purchasing preferred stock issued by the banks or bank holding companies.[7] Since the passage of EESA, as of the time of this writing, the U.S. Treasury has used approximately $442 billion for purchases of capital stock and financing under the CPP of the $700 billion approved by Congress under EESA.[8] Although the CPP is not explicitly contemplated under EESA, Section 3(9) defines "troubled assets" to include "any other financial instrument that the Secretary . . . determines the purchase of which is necessary to promote financial market stability[.]"

Unlike TARP, however, the CPP is limited to U.S. banks, bank holding companies and savings and loan holding companies. An insurance company can participate in the CPP only to the extent that some member of its holding company system is a bank or a thrift. At the time the CPP came into effect, some insurance companies already had a bank or thrift affiliate and were regulated as bank or savings and loan holding companies. Other insurance companies sought to acquire thrifts in order to become bank holding companies, which would allow them to qualify for the CPP. Such an acquisition could potentially have a large payoff: under the CPP, an institution may qualify for up to 3% of the aggregate amount of assets in the holding company system taken as a whole, rather than those of the thrift subsidiary alone. On May 14, 2009, the U.S. Treasury granted preliminary approval for six insurance holding companies to receive funds under the CPP, including insurance conglomerates that recently acquired thrifts.[9]

The CPP is being implemented in stages. The first application deadline applied to public banks and bank holding companies, the second application deadline applied to private banks and bank holding companies, excluding S-corporations and mutual companies, and the third deadline applied to S-corporations and mutual companies. Mutual insurance companies that are bank holding companies and have a publicly-traded intermediate holding company may be able to qualify under the mutual company rules. Other mutual insurance companies may try to participate in the CPP by proposing a transaction that adapts the public or private company CPP requirements to mutuals. For instance, mutual insurance companies could offer to issue perpetual surplus notes instead of preferred stock (along with warrants to purchase additional perpetual surplus notes) and make the case to the U.S. Treasury that perpetual surplus notes are substantially similar to perpetual preferred stock. In the cases where the insurance company is owned by a mutual holding company, the intermediate holding company (which is directly owned by the mutual holding company) could offer to issue perpetual preferred stock (and the related warrants) and make the case to the U.S. Treasury that the intermediate holding company is the functional equivalent of the highest capital-issuing entity in the mutual holding company system.

Under the CPP, the U.S. Treasury purchases non-voting preferred stock and warrants issued by participating financial institutions. For public companies, the warrants are exercisable into common stock, and for private companies, the warrants are exercisable into additional preferred stock. The preferred stock includes restrictions on dividend payments on junior securities and the redemption of the preferred stock, other than redemptions using the proceeds of qualifying equity raises. The preferred stock is non-voting. However, if dividends are not paid for a total of six quarterly periods, then the U.S. Treasury can appoint two additional directors until the company pays the accrued but unpaid dividends. Participants in the CPP are also subject to the executive compensation restrictions imposed under Section 111 of EESA discussed below.

Warrants can only be exercised following the earlier of a qualifying equity raise and December 31, 2009. For public companies, warrants to acquire common stock are issued with registration rights. The purchase agreement contains an agreement by the U.S. Treasury not to exercise voting rights with respect to any common shares received upon exercise of the warrants, although transferees of any warrants are not subject to that agreement. For private companies,

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warrants to acquire preferred stock require registration only if the company subsequently becomes a public company.

Even though the U.S. Treasury has agreed not to vote common shares received upon its exercise of the warrants, the acquisition of 10% or more of the voting securities (including warrants to purchase voting securities) of a U.S. insurance company, directly or indirectly through a holding company, will generally trigger the Form A filing (i.e., a filing required upon a change in control) and prior approval requirements under the provisions of the Insurance Holding Company Act of an insurer's state of domicile. At the time of this writing, we are not aware of any uniform approach being taken by the various state insurance regulators regarding whether the U.S. Treasury may comply with rules requiring the filing of a Form A without making a full Form A filing. We understand, however, that certain insurance regulators may have considered allowing the U.S. Treasury to make a short-form Form A filing in satisfaction of the applicable requirements. In addition, state insurance regulators in many jurisdictions have the express statutory authority to exempt certain acquisitions from the Form A filing requirements. Certain insurance regulators may be amenable to granting such an exemption in light of the special circumstances involved in the acquisition of securities by the U.S. Treasury under the CPP. In addition, insurance companies with international operations will need to be cognizant of applicable laws and regulations of other countries. For instance, some countries prohibit foreign government ownership of an insurance company, a prohibition that may be triggered by the U.S. Treasury owning preferred stock or warrants, even if under applicable state insurance law, the U.S. Treasury would not be deemed to control the relevant insurer. Some states may also have similar restrictions barring government ownership of an insurance company, which restrictions must be considered in the context of any participation by insurance companies in the CPP.

On February 25, 2009, the U.S. Treasury announced the CAP, which is essentially a continuation (although not a replacement) of the CPP.[10] Participation in the CAP is again limited to U.S. banks, bank holding companies and savings and loan holding companies. The U.S. Treasury has not publicly announced whether insurance companies will be eligible to participate in the CAP. The amount of assistance for which a participant is eligible is 1% to 2% of total risk-weighted assets. At the time of this writing, the CAP is limited to public companies, although it is expected that the CAP will be expanded to include companies organized as non-publicly-traded, S-corporations or mutuals.[11] The rights of the U.S. Treasury under the non-voting preferred stock and the warrants purchased under the CAP are generally similar to those under the CPP, except that the preferred stock under the CAP bears a 9% dividend (as compared to 5% under the CPP) and is convertible to common stock. The preferred stock may be converted to common stock at the option of the financial institution at any time and by the holder upon certain specified corporate events, including certain sales, mergers or changes in control. The preferred stock is also mandatorily convertible on the seventh-year anniversary of issuance.

Debt Guarantee Program

The DGP was established as part of the Temporary Liquidity Guarantee Program administered by the FDIC to provide a government guarantee for qualifying debt issued by banks.[12] Insurance companies are eligible to participate in the DGP, provided they are affiliated with an FDIC-insured depository institution (i.e., a bank or a savings and loan) and are approved by the FDIC for participation.

Under the DGP, payments on principal and interest on unsecured senior debt issued on or after October 14, 2008 through October 31, 2009 are guaranteed by the FDIC through December 31, 2012.[13] The guarantee is triggered by a payment default and is backed by the full faith and credit of the United States. Such backing allows the obligation to carry a AAA rating and be exempt from registration under the federal securities laws. Unsecured senior debt includes notes and commercial paper, but excludes derivative instruments, convertible debt and, for insurance companies, capital or surplus notes.

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Executive Compensation Restrictions

EESA subjects financial institutions receiving government funding to executive compensation and corporate governance restrictions. Following some highly-publicized compensation payouts to executives of companies receiving funds under the CPP, the executive compensation restrictions were further tightened by the American Recovery and Reinvestment Act of 2009, which amended Section 111 of EESA.[14] For any entity that has received or will receive financial assistance under EESA, which would include participants in the CPP and the CAP, and may include sellers of legacy loans and legacy securities under PPIP, Section 111 of EESA, as amended, directs the Secretary of the Treasury to require that such participants meet "appropriate standards for executive compensation and corporate governance," including "limits on compensation that exclude incentives for senior executive officers…to take unnecessary and excessive risks that threaten the value of the recipient." Section 111 of EESA also includes a "clawback" policy relating to bonuses and incentive compensation paid to the recipient's senior executive officers and up to the 20 most highly-compensated employees based on financial information or other criteria that are found to be materially inaccurate and a reduction to $500,000 (from $1,000,000) on the amount of compensation paid to senior executive officers that may be deducted for U.S. federal income tax purposes, as well as an elimination of the exception to this limitation for performance-based compensation. Moreover, Section 111 of EESA contains a prohibition on severance payments to senior executive officers and the next five most highly-compensated employees during the period in which any obligation arising from the financial assistance is outstanding and a prohibition on the payment or accrual of any bonus, retention award or incentive compensation, other than restricted stock meeting specified requirements, to certain employees (the number of employees subject to this restriction depends on the amount of financial assistance received) during the period in which any obligation arising from the financial assistance is outstanding. Section 111 of EESA also requires recipients of financial assistance to adopt a policy regarding "excessive or luxury expenditures," and requires recipients to include a "say-on-pay" proposal in any proxy statement used in connection with an annual or other meeting of shareholders during the period in which any obligation arising from the acceptance of financial assistance is outstanding. The applicability of Section 111 of EESA to the PPIF structure, however, has not been fully determined. According to the currently announced policy at the time of this writing, the executive compensation limitations will not apply to "passive investors" in PPIFs, if such investors or institutions are not otherwise subject to such limitations (e.g., by accepting funds under the CPP or the CAP).[15] For insurance companies selling legacy securities to PPIFs, the U.S. Treasury has not yet provided clear guidance as to whether a sale to a PPIF would constitute receipt of financial assistance under TARP, which would subject those insurance companies to Section 111 of EESA. It is important to note that additional legislative and regulatory restrictions relating to TARP and other governmental financial assistance are currently under consideration.

Conclusion

As the financial crisis continues, the U.S. federal government continues to consider extraordinary measures to shore up the financial system. Insurance companies should remain alert to identify opportunities presented by the U.S. federal government programs discussed above, as well as those that continue to emerge. Insurers should also carefully consider the ramifications of participation.

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[2] U.S. Department of the Treasury, Testimony by Secretary Henry M. Paulson, Jr. before the Senate Banking Committee on Turmoil in US Credit Markets: Recent Actions regarding Government Sponsored Entities, Investment Banks and other Financial Institutions, http://www.treas.gov/press/releases/hp1153.htm.
[3] U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Actions to Protect the U.S. Economy, http://www.treas.gov/press/releases/hp1205.htm.
[4] U.S. Department of the Treasury, Treasury Department Releases Details on Public Private Partnership Investment Program (March 23, 2009), http://www.ustreas.gov/press/releases/tg65.htm. Materials relating to the PPIP, including the White Paper, the Legacy Securities Summary of Terms, the Legacy Securities FAQs, the Legacy Loans Summary of Terms and the Legacy Loans FAQs, are available at http://www.financialstability.gov/roadtostability/publicprivatefund.html.
[5] U.S. Department of the Treasury, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, and Chairman of the Federal Deposit Insurance Corporation Sheila Bair, Legacy Asset Program (July 8, 2009), http://www.financialstability.gov/latest/tg_07082009.html.
[6] Federal Deposit Insurance Corporation, FDIC Statement on the Status of the Legacy Loans Program (June 3, 2009), http://www.fdic.gov/news/news/press/2009/pr09084.html.
[7] Materials relating to the CPP, including the Fact Sheet, the Term Sheet and the application documents (including the forms of Securities Purchase Agreement, forms of Letter Agreement, forms of Certificate of Designation, forms of Warrant and other materials, in each case, relating to the specific types of financial institutions) are available at http://www.financialstability.gov/roadtostability/CPPappdocs.html.
[8] U.S. Department of the Treasury, Office of Financial Stability, Troubled Asset Relief Program Transaction Report for Period Ending July 1, 2009, http://www.financialstability.gov/docs/transaction-reports/transactions-report_070609.pdf. The aggregate amount of funding under the CPP includes funds used for the benefit of the automotive industry, funds to support TALF and other uses not discussed in this article.
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[12] The final rule for the Temporary Liquidity Guarantee Program is published as Federal Deposit Insurance Corporation, Temporary Liquidity Guarantee Program, 12 C.F.R. § 370 (2009).
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[14] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).
[15] U.S. Department of the Treasury, Legacy Securities Public-Private Investment Program (Legacy Securities PPIP) Additional Frequently Asked Questions, http://www.treas.gov/press/releases/reports/legacy_securities_faqs.pdf.

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