

September 2008

Client Alert

Financial Markets Developments

Fed's Role In Financial Markets Evolves And Increases As Financial Crisis Deepens

During 2008, the Board of Governors of the Federal Reserve System ("Federal Reserve Board") and the Federal Reserve Bank of New York ("New York Fed") have reshaped the US supervisory and regulatory framework for large financial institutions through a series of largely unprecedented actions and initiatives, taken without any additional legislative authority, to expand and change their role in order to deal with the financial crisis and attempt to stabilize the financial markets.

As can be seen from the chronology below, the Federal Reserve Board has dramatically altered the agency's lending operations, traditionally an unremarkable service provided to depository institutions in the ordinary course of business, to encompass the provision of liquidity lifelines directly to securities firms and, more recently, to money market funds on an indirect basis. The New York Fed has provided funding at the discount rate for JPMorgan Chase & Co.'s acquisition of Bear Stearns and has become the lender of last resort to the leading insurance conglomerate, American International Group, Inc. (AIG), in a stunning last-minute bailout. In making these extraordinary loans, the Federal Reserve Board and the New York Fed have relied upon authority granted by a Depression-era statute, Section 13(3) of the Federal Reserve Act, under which the Federal Reserve Board may, in "unusual and exigent circumstances," authorize any Reserve Bank "to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange." The New York Fed, along with the Treasury Department, largely engineered the acquisition of Bear Stearns and attempted to arrange similar private sector rescues of Lehman Brothers and AIG. Additionally, the Federal Reserve Board, acting on its own authority in its new capacity as lender to primary dealers in government securities, took on the supervisory responsibility of examining a number of the larger investment banks, and now has formal supervisory authority over three of the largest—Goldman Sachs, Morgan Stanley and Merrill Lynch—which have either become bank holding companies themselves or are coming under the control of bank holding companies.

The following chronology identifies the major actions along these lines taken this year by the Federal Reserve Board and the New York Fed. We believe the chronology is useful in analyzing how proactive and aggressive the Federal Reserve Board and the New York Fed have been in reshaping the regulatory framework without any further action by Congress, and also provides useful insight as to what further actions they may take in the future.

- **January 4:** Increase in Term Auction Facility Program. The Federal Reserve Board announces that it will offer US\$30 billion in each of two auctions to be held in January under the Term Auction Facility, a liquidity program established in December of 2007 under which the Federal Reserve makes funds available directly to depository institutions. The Term Auction Facility provides term funding on a collateralized basis, at interest rates and amounts set by auction,



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and is designed to improve liquidity by making it easier for sound institutions to borrow when the markets are not operating efficiently. The US\$30 billion figure for each of the two January auctions represents a US\$10 billion increase over the original auction amount under the program.

- **March 7:** Expansion of Liquidity Measures. The Federal Reserve Board announces that the amounts outstanding under the Term Auction Facility are being increased to US\$50 billion for each of the two auctions scheduled for March, representing a US\$20 billion increase over the previously-announced amount for each auction. The Federal Reserve also initiates a series of term repurchase transactions for primary dealers (i.e., government securities dealers that have an established trading relationship with the Federal Reserve) that are expected to cumulate to US\$100 billion. The latter transactions are to be conducted as 28-day term repurchase agreements in which primary dealers may elect to deliver any type of collateral that is eligible in the conventional open market operations of the New York Fed (e.g., Treasury or agency securities or agency mortgage-backed securities).
- **March 11:** Establishment of Term Securities Lending Facility. The Federal Reserve Board announces an expansion of its existing securities lending program for primary dealers. Under the new Term Securities Lending Facility, the Open Market Trading Desk at the New York Fed will lend up to US\$200 billion of Treasury securities to primary dealers for a term of 28 days (rather than overnight, as in the existing securities lending program), secured by a pledge of other securities, including federal agency debt, federal agency residential mortgage-backed securities and, most notably, non-agency AAA/Aaa-rated private-label residential mortgage-backed securities. (The list of eligible collateral is later expanded by the New York Fed on March 20, to also include agency collateralized-mortgage obligations and AAA/Aaa-rated commercial mortgage-backed securities.) The facility represents the first instance of the Federal Reserve lending Treasury securities in exchange for debt including mortgage-backed securities, and is intended to allow primary dealers to exchange debt that is less liquid for government securities that can be easily lent to other firms in return for cash.

- **March 16:** Fed Extends Discount Window Lending to Securities Firms. In a dramatic departure from its traditional role as lender of last resort solely to depository institutions, the New York Fed announces that it is establishing a Primary Dealer Credit Facility to improve the ability of primary dealers to provide financing to participants in securitization markets and to promote the orderly functioning of the financial markets generally. The facility provides for overnight funding at the primary credit rate (which fluctuates with the discount rate) for primary dealers in exchange for a specified range of collateral, including all collateral eligible for tri-party repurchase agreements arranged by the New York Fed as well as investment-grade corporate securities, municipal securities, mortgage-backed securities and asset-backed securities for which a price is available. The announcement states that the Primary Dealer Credit Facility is to remain in operation for a minimum of six months, subject to extension as conditions warrant.

In a related development, the Federal Open Market Committee (FOMC) on March 18 lowers the primary credit rate by 75 basis points, from 3.25 percent to 2.50 percent. (The FOMC lowers the primary credit rate again by 25 basis points to 2.25 percent on April 30.)

- **March 16:** Fed Engineers Acquisition of Bear Stearns by JPMorgan Chase and Provides Funding at Primary Credit Rate. Two days after the New York Fed agrees, along with JPMorgan Chase & Co., to provide a 28-day emergency credit line to Bear Stearns, an agreement is announced for JPMorgan Chase to acquire Bear Stearns. The New York Fed, together with senior Treasury Department officials, is heavily involved in arranging the deal. (This extensive involvement in private sector negotiations is later repeated in the cases of Lehman Brothers and American International Group, although for those two companies there are no white knights from the private sector.) The New York Fed also agrees to provide financing in the form of a US\$29 billion loan to a Delaware limited liability company being established to purchase US\$30 billion in troubled assets on Bear Stearns' books to be pledged to the New York Fed as security for its loan. JPMorgan Chase & Co. agrees to provide US\$1 billion in funding in the form of a note subordinated to the New York Fed's note, and the JPMorgan

Chase note is to be the first to absorb losses, if any, on the liquidation of the portfolio of assets. The New York Fed's note, which has a term of 10 years and is renewable by the Fed, provides for interest at the primary credit rate. The Delaware LLC is to be consolidated on the books of the New York Fed (which is the LLC's primary beneficiary), and the New York Fed retains BlackRock Financial Management to manage and liquidate the portfolio of Bear Stearns' assets. The New York Fed's loan is made pursuant to the authority of Section 13(3) of the Federal Reserve Act, as discussed above.

As a result of the collapse of Bear Stearns and the New York Fed's provision of financing for the acquisition by JPMorgan Chase, and also the establishment of the Primary Dealer Credit Facility, Federal Reserve examiners are reported to begin operating on-site, along with SEC examiners, at the largest investment banks. For the first time, Fed examiners begin evaluating those institutions' financial condition, leverage, liquidity, and funding.

- **May 2:** Further Expansion of Liquidity Measures. The Federal Reserve Board once again increases the amounts auctioned to depository institutions under the Term Auction Facility program. Additionally, in a move intended to promote improved financing conditions in a broader range of financial markets, it expands the types of collateral that can be pledged by primary dealers in the Term Securities Lending Facility to include AAA/Aaa-rated asset-backed securities.
- **May 13:** Fed Requests Immediate Authority to Pay Interest on Bank Reserves. The Federal Reserve Board requests that Congress accelerate the authority previously granted in the 2006 regulatory relief legislation to allow the Reserve Banks to begin paying interest on bank reserves immediately, rather than the October 2011 date established in the earlier legislation. The Federal Reserve Board states that the change will contribute to the US financial system's efficiency.
- **July 7:** Fed and SEC Sign MOU. In an action evidencing the growing role of the Federal Reserve Board in overseeing the financial condition of investment banks, the Board and the SEC enter into a memorandum of understanding providing for information sharing and cooperation in regulatory and supervisory matters involving bank holding companies that are affiliated with broker-dealers approved by the SEC to calculate net capital under the alternative method in Appendix E of the Net Capital Rule and "consolidated supervised entities" that own securities firms and that have voluntarily agreed to consolidated supervision by the SEC. The agencies agree to share information and analysis regarding the financial condition, risk management systems, internal controls and capital, liquidity and funding resources of the institutions under their supervisory jurisdiction.
- **July 13:** Emergency Fed Funding for Fannie Mae and Freddie Mac. The Federal Reserve Board authorizes the New York Fed to lend to Fannie Mae and Freddie Mac on an emergency basis as needed. Any lending is to be at the primary credit rate and collateralized by Treasury and agency securities. (On September 7, the Treasury Department seizes control of Fannie Mae and Freddie Mac, placing the two government-sponsored enterprises into Federal Housing Finance Agency conservatorship and initiating a huge federal bailout.)
- **July 30:** Additional Enhancements of Fed Liquidity Facilities. In yet another sign of the deepening of the financial crisis, the Federal Reserve Board announces a number of urgent actions to enhance the effectiveness of its existing liquidity facilities. These include extending the New York Fed's Primary Dealer Credit Facility and Term Securities Lending Facility through January 30, 2009, authorizing the New York Fed to auction options for primary dealers to borrow Treasury securities under the Term Securities Lending Facility and auctioning 84-day Term Auction Facility loans to depository institutions (while continuing to auction 28-day Term Auction Facility loans to depository institutions as originally authorized under that program).
- **September 14:** Further Enhancement of Fed Liquidity Facilities for Securities Firms in Wake of Lehman Brothers Bankruptcy. In an effort, in Federal Reserve Board Chairman Bernanke's words, "to mitigate the potential risks and disruptions to markets" in the wake of the Lehman Brothers Holdings Inc. bankruptcy filing on that day, the Federal Reserve Board announces a number of measures to provide additional support to financial markets. These include broadening the types of collateral that may be pledged at

the Primary Dealer Credit Facility (which had previously been limited to investment-grade debt securities) to match the types eligible in the tri-party repo systems of the two major clearing banks, as well as expanding the collateral eligible for the Term Securities Lending Facility (which had previously been limited to Treasury and agency securities and AAA/Aaa-rated mortgage-backed and asset-backed securities) to include all investment-grade debt securities. Additionally, Term Securities Lending Facility auctions are now to be conducted more frequently, and the amounts offered are increased.

The Federal Reserve Board also announces an interim final rule to provide a temporary, conditional exemption from the affiliate transaction restrictions and requirements of Section 23A of the Federal Reserve Act and the Board's Regulation W, until January 30, 2009, for banks to provide financing to affiliates, including broker-dealers, for securities or other assets that the affiliate ordinarily would have financed through the tri-party repurchase agreement market.

- **September 16:** Fed Bails Out AIG. In an unprecedented intervention in the market, and less than two weeks after the Treasury Department's bailout of Fannie Mae and Freddie Mac, the Federal Reserve Board authorizes the New York Fed to lend up to US\$85 billion to AIG. The loan is intended to assist AIG in meeting its obligations as they come due and to facilitate a sale of certain of AIG's businesses in an orderly manner. The credit facility, which has a 24-month term, provides for interest at a rate of three-month LIBOR plus 8.50 percent, a commitment fee on undrawn amounts at the same rate and an initial gross commitment fee of two percent, is collateralized by a pledge of assets of AIG and various subsidiaries, and contains a covenant by AIG to pay down the facility with the proceeds of asset sales and issuances of debt and equity. The US Treasury is to receive equity participation rights, including shareholder voting rights, corresponding to a 79.9 percent equity interest in AIG as a result of the issuance by AIG of convertible participating serial preferred stock to be held in trust for the Treasury's benefit, and the Treasury will have the right to veto the payment of dividends to common and preferred shareholders, among other things. Borrowings under the facility are conditioned on the New York Fed being reasonably satisfied with, among other things, AIG's corporate

governance. The New York Fed's loan is made pursuant to the authority of Section 13(3) of the Federal Reserve Act, as discussed above.

The New York Fed's action in bailing out AIG seems likely to stand out as a pivotal event in the push for Congressional action for a federal insurance charter.

- **September 19:** Liquidity Support for Money Market Funds. In an attempt to stem further contagion in financial markets that had already caused one money market mutual fund to "break the buck," the Federal Reserve announces several measures to provide liquidity to money market funds and the financial markets generally. The Federal Reserve Board's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, announced in conjunction with the Treasury Department's temporary federal guaranty program for money market funds, provides for the Federal Reserve Bank of Boston ("Boston Fed") to extend loans at the primary credit rate to depository institutions in the United States and bank holding companies to finance their purchases of high-quality asset-backed commercial paper from money market funds. The Boston Fed's loans are to be on a nonrecourse basis and secured by the asset-backed commercial paper being acquired, with the Boston Fed assuming market risk on the collateral.

In order to facilitate the participation by banking organizations in the lending facility, the Federal Reserve Board also announces two interim final rules to be in effect until January 30, 2009: one providing for a zero percent risk weight for leverage and risk-based capital purposes for asset-backed commercial paper purchased by state member banks and bank holding companies under the facility (and also excluding the amount of that asset-backed commercial paper from the banking organization's average total consolidated assets for purposes of calculating the leverage ratio), and the other providing for exemptions from the affiliate transaction restrictions and requirements of Sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W for purchases by a bank of asset-backed commercial paper from an affiliated money market mutual fund. The capital rule is particularly unprecedented, as it marks the first time that the Federal

Reserve Board has adjusted risk weightings and total assets calculations for banking organizations' capital requirements in order to accomplish market stability policy objectives.

The Federal Reserve also announces that the New York Fed's Open Market Trading Desk will begin purchasing short-term debt obligations issued by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks in the secondary market from primary dealers.

- **September 21:** Fed Consolidates its Supervisory Authority Over Wall Street. In the latest breathtaking development, the Federal Reserve Board, acting on an expedited timetable without precedent in the agency's history and without public notice and comment, approves the applications by Goldman Sachs and Morgan Stanley to become bank holding companies through the conversion of their industrial bank subsidiaries to bank status. This action brings the last two remaining independent investment banks under Federal Reserve Board regulation and marks a final end to the 75-year-long Glass-Steagall era.

In approving the applications, the Federal Reserve Board authorizes the New York Fed to provide increased liquidity support to the applicants by extending credit to the companies' US broker-dealer subsidiaries, as well as to the broker-dealer subsidiary of Merrill Lynch, against all types of collateral that may be pledged by depository institutions for discount window advances or by primary dealers under the Primary Dealer Credit Facility. The Federal Reserve Board also authorizes the New York Fed to extend credit to the London-based broker-dealer subsidiaries of Goldman Sachs, Morgan Stanley and Merrill Lynch against collateral eligible to be pledged under the Primary Dealer Credit Facility.

Back in March of this year, when the financial crisis had yet to reach the crescendos of recent weeks, the Treasury Department announced its Blueprint for a Modernized Financial Regulatory Structure. Among other proposals, the Treasury's Blueprint called for legislative action to make the Federal Reserve Board the nation's "market stability regulator," with authority to take corrective actions as needed to ensure overall financial market stability, in lieu of its traditional role as regulator of state member banks, bank holding companies, and financial holding companies. In light of recent events, however, it appears that the Federal Reserve Board has deemed it necessary to accede to the market stability regulator role without waiting for Congressional action, and without sacrificing any of its traditional responsibilities.

This expanded role of the Federal Reserve Board and the New York Fed should be attributed not only to the need for emergency actions to prevent a further breakdown in the US financial markets, but also to the changing nature of the US financial system generally and the sheer size and market impact that its leading players have attained. Any Congressional restructuring of the US financial regulatory structure to come in the wake of the financial crisis will have to address these new realities.

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