

FINANCIAL SERVICES REGULATORY & ENFORCEMENT, GLOBAL FINANCIAL MARKETS INITIATIVE UPDATE

FDIC Adopts Interim Rule on Temporary Liquidity Guarantee Program

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On October 23, 2008, the Federal Deposit Insurance Corporation (FDIC) adopted an interim final rule (the Interim Rule) establishing the Temporary Liquidity Guarantee Program (TLG Program). The TLG Program consists of two primary components: (i) a Debt Guarantee Program, through which the FDIC will guarantee the payment of certain newly issued senior unsecured debt of participating entities; and (ii) a Transaction Account Guarantee Program, through which the FDIC will guarantee certain noninterest-bearing transaction accounts of participating depository institutions.

The Interim Rule became effective October 23, 2008, although coverage under the TLG Program began as of October 14, 2008. Eligible entities, which principally include FDIC-insured depository institutions, US bank and financial holding companies, and certain savings and loan holding companies, are automatically covered under the TLG Program at no cost until November 12, 2008. After that date, any eligible entity that has not affirmatively “opted out” will remain a participant in the TLG Program and be assessed fees for their continued participation.

Background

On October 14, 2008, the Board of Directors of the FDIC (FDIC Board) announced its plans to implement the TLG Program as one in a series of measures undertaken to increase liquidity in the national credit markets. Other such measures have included the injection of capital into certain US financial institutions under the Troubled Asset Relief Program and the establishment of commercial paper liquidity facilities by the Board of Governors of the Federal Reserve System (FRB). Despite these efforts, many insured depository institutions have responded to the market turmoil by retaining cash and tightening their lending standards, which has severely impaired both short-term and long-term funding markets. The TLG Program is intended to respond to the credit crisis by encouraging liquidity in the US banking system, thereby facilitating lending to creditworthy businesses and consumers.

Statutory Authority

The Federal Deposit Insurance Act (FDI Act) authorizes coordinated action by the federal government in circumstances involving systemic risk to the US financial system. Upon a recommendation of systemic risk by the

FDIC Board, with the written concurrence of the FRB, Treasury (in consultation with the President) is authorized to make a formal determination of systemic risk to the US financial system. Such a determination authorizes the FDIC to take action to avoid or mitigate serious adverse effects on economic conditions and financial stability.

Following issuance of the appropriate recommendations by the FDIC and FRB, Treasury made a formal determination of systemic risk on October 13, 2008. The FDIC announced the TLG Program the following day.

Eligibility for Participation in the TLG Program

Subject to restrictions that may be imposed by the FDIC in consultation with the other federal financial regulators, the following entities are eligible for participation in the TLG Program:

- Any “insured depository institution,” as that term is defined in section 3(c)(2) of the FDI Act, except that for purposes of the Debt Guarantee Program it does not include an “insured branch” of a foreign bank;
- Any US bank holding company (BHC) or financial holding company (FHC), provided that the holding company has at least one chartered, insured, and operating bank or savings association within its holding company structure;
- Any US savings and loan holding company (SLHC) that either (i) engages only in activities that are permissible for FHCs under section (4)(k) of the Bank Holding

Company Act (BHCA) or (ii) has at least one insured depository institution subsidiary that is the subject of an application that was pending on October 13, 2008, pursuant to section 4(c)(8) of the BHCA; and

- Certain affiliates of insured depository institutions that affirmatively seek designation as an eligible entity and are approved by the FDIC after consultation with the appropriate federal banking agency.

Some observations regarding eligible institutions are in order. First, the last group of eligible entities provides the FDIC with “catchall” authority, in consultation with its sister bank regulatory agencies, to extend the benefits of the TLG Program to certain affiliates of depository institutions. Second, the definition of “insured depository institution” would cover certain “non-bank banks,” such as industrial banks and credit card banks. Finally, the Interim Rule does not require an entity to have been a bank holding company as of any specific date. Therefore, entities that acquire a bank and become a bank holding company after October 13, 2008, may still be eligible to have their debt guaranteed under the TLG Program, although advance consultation with the FDIC on this point is advisable.

Opt-Out Provisions

Eligible entities that wish to opt-out of the TLG Program must inform the FDIC of that decision by November 12, 2008, or they will be automatically enrolled. Entities that choose to participate may also notify the FDIC of their decision any time before the deadline. An eligible entity may elect to opt-out of the Debt Guarantee Program, the

Transaction Account Guarantee Program, or both. All entities within a US BHC or SLHC structure are required to make the same decision with respect to participation in each component.

If an entity elects to opt-out of the FDIC's guarantee of the newly-issued senior unsecured debt or the noninterest-bearing transaction accounts, the guarantee for the specific program(s) will expire at the earlier of November 12, 2008, or the time FDIC receives notice of the eligible entity's decision to opt-out. Decisions to opt-out will be made publicly available on the FDIC web site.

The Debt Guarantee Program

Under the Debt Guarantee Program, the FDIC will temporarily guarantee all non-contingent newly issued senior unsecured debt, up to prescribed limits, issued by participating entities from October 14, 2008, through June 30, 2009. The FDIC will guarantee such debt until the earlier of the maturity date of the instrument or June 30, 2012, at which point all guarantee coverage will terminate; thus, debt with a maturity date after June 30, 2012, will lose its guaranteed status as of that date. Any unpaid balance of debt guaranteed through the Debt Guarantee Program will be paid by the FDIC upon the failure of an issuing depository institution or the filing of a bankruptcy petition by an issuing holding company.

Qualifying Debt Instruments. The guarantee extends to a broad variety of senior debt instruments. These instruments include purchased federal funds, promissory notes, commercial paper, unsubordinated unsecured notes, certificates of deposit and

Eurodollar deposits standing to the credit of a bank, and bank deposits in an international banking facility of an insured depository institution. For purposes of this specific definition, a "bank" includes either an insured bank or a supervised foreign bank.

The FDIC has warned that the purpose of the Debt Guarantee Program is not to encourage innovative, exotic or complex funding structures, or to protect lenders who make high-risk loans in hopes of high returns. Accordingly, senior unsecured debt covered by the Debt Guarantee Program excludes, among other instruments, obligations from guarantees or other contingent liabilities, derivatives, derivative-linked products, debt paired with any other security, convertible debt, and capital notes. The Debt Guarantee Program does not apply to debt that is contractually subordinated to other debt of the entity, nor does it apply to loans extended to a participating entity's affiliates or "institution-affiliated parties" (e.g., officers and directors).

Disclosure and Compliance

Requirements. In order for debt to qualify for the guarantee, any documentation of the debt instrument must be clearly identified on its face as "guaranteed by the FDIC," and the guarantee must be properly disclosed to creditors. Participants in the Debt Guarantee Program will be subject to information requests by the FDIC and periodic on-site compliance reviews, and they must agree to be bound by FDIC decisions regarding management of the TLG Program. Moreover, participation in the Debt Guarantee Program does not exempt a participating entity from compliance with any other applicable laws, including federal securities

disclosure and registration requirements “that would be applicable if the entity or liability were not included in the program.”

Limits on Guaranteed Debt. The amount of debt to be guaranteed by the FDIC will be limited to a total of up to 125 percent of the par or face value of an entity’s senior unsecured debt that is outstanding as of September 30, 2008, and that is scheduled to mature before June 30, 2009. On a case-by-case basis, the FDIC, in consultation with the appropriate federal banking agency, may raise or lower this 125-percent limit.

Participating entities will be prohibited from issuing guaranteed debt in excess of this maximum amount once the maximum amount of guaranteed debt has been exhausted, but they will remain free to issue non-guaranteed debt in any amount and with any maturity. In addition, participating entities may, upon notice to the FDIC and before November 13, 2008, issue non-guaranteed debt with maturities beyond June 30, 2012, subject to additional fee assessments. Participating entities that issue debt that is represented as being guaranteed, and which exceeds the lawful guaranteed amount, will be subject to a penalty assessment of 150 basis points, and may be subject to administrative enforcement action, including the assessment of civil money penalties.

Payment of Claims

Insured Depository Institution Debt. With respect to the debt of a participating insured depository institution, the FDIC’s payment obligation arises upon an institution’s failure.

The FDIC will use its standard receivership claims process to process guarantee requests and expects that many debt holders will be paid on the business day immediately following the institution’s failure. The FDIC will be subrogated to the rights of any creditor it pays under the program.

Holding Company Debt. With respect to the debt of a participating holding company, the FDIC’s payment obligation arises when the holding company files for bankruptcy protection. At that time, the FDIC will make payment to the debt holder for the principal amount of the debt plus interest to the date of the bankruptcy filing. However, the FDIC does not expect to make immediate payment on the guaranteed amount for debt asserted against a bankruptcy estate. Instead, it will wait until the claim for the unsecured senior debt has been determined to be an allowed claim against the estate not subject to reconsideration. To receive payment, the holder of the unsecured senior debt must assign its rights, title and interest in the debt to the FDIC and transfer its validated claim in bankruptcy to the FDIC.

The Transaction Account Guarantee Program

The Transaction Account Guarantee Program will temporarily provide a full guarantee for funds held at FDIC-insured depository institutions in “noninterest-bearing transaction accounts” above the existing US\$250,000 deposit insurance limit. Coverage under the Transaction Account Guarantee Program became effective on October 14, 2008, and continues through December 31, 2009, for participating entities.

Qualifying Accounts. The Interim Rule defines a noninterest-bearing transaction account as a transaction account with respect to which interest is neither accrued nor paid and on which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal. This includes traditional demand deposit checking accounts, but excludes negotiable order of withdrawal (NOW) accounts or money market deposit accounts (MMDAs). Although the Transaction Account Guarantee Program is intended primarily to apply to transaction accounts held by businesses, it applies to all such accounts held by any depositor. In the Interim Rule, the FDIC asked for comment on whether coverage should be extended to NOW accounts held by sole proprietorships, non-profit religious, philanthropic, charitable organizations and the like, or governmental units for the deposit of public funds if the interest paid is *de minimis*.

Disclosure Requirements. All insured institutions are required to post signage in their main and branch office lobbies disclosing whether they are participating in the Transaction Account Guarantee Program or whether they have opted out. Participating entities also must disclose that noninterest-bearing transaction accounts at the entity are fully insured by the FDIC.

Sweep Accounts. The Interim Rule generally treats funds swept or transferred from a noninterest-bearing transaction account to another type of deposit or nondeposit account as being in the account to which the funds were transferred. However, funds swept from a noninterest-bearing transaction account to a noninterest-bearing

savings account will be treated as being in a noninterest-bearing transaction account and therefore covered by the guarantee.

Payment of Claims. As guarantor of deposits held in noninterest-bearing transaction accounts, the FDIC's obligation to make payment arises upon the failure of a participating insured depository institution. In most cases, the FDIC expects to make the entire amount of a qualifying transaction account available to the depositor on the business day following the failure of a participating institution. In the event of payment by the FDIC under the Transaction Account Guarantee Program, the FDIC will be subrogated to all rights of the depositor against the institution.

Fees for Participation in the TLG Program

Eligible entities that do not opt-out of the TLG Program will be assessed fees for their continued participation beginning on November 13, 2008. Under the Debt Guarantee Program, all eligible debt issued by participating entities from October 14, 2008, through June 30, 2009, will be charged an annualized fee equal to 75 basis points multiplied by the amount of debt issued, and calculated for the maturity period of that debt or June 30, 2012, whichever is earlier. Under the Transaction Account Guarantee Program, insured depository institutions will be assessed on a quarterly basis an annualized 10 basis point assessment on balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of US\$250,000.

Public Comment

Pursuant to section 553(b)(B) of the Administrative Procedure Act and based on a finding of good cause by the FDIC, the Interim Rule was adopted without conforming to the typical notice and comment requirements of a final agency rule. However, the FDIC has established a 15-day comment period, which begins upon publication of the Interim Rule in the Federal Register. The FDIC has also specifically requested comment on whether coverage of the Transaction Account Guarantee Program should be expanded beyond noninterest-bearing transaction accounts.

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