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News Bulletin

February 23, 2009

New Federal Programs Support the Banking System: Expect Mandatory Preferred and Mandatory Debt Issuance

Today, in a joint statement of support for the nation's banking institutions, the U.S. Department of the Treasury (Treasury), Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency and Office of Thrift Supervision announced plans to provide continued support to, and encourage private capital investment in, financial institutions. The statement notes that the major banking institutions have capital in excess of that required to be considered "well-capitalized," and participation in the new programs will ensure sufficient capital for the institutions to "support economic recovery" and "provide credit necessary for the stabilization and recovery of the U.S. economy." The plan includes at least two components, with detailed information to be announced later this week. First, Treasury's new capital assistance program will be detailed on February 25th. Then, on February 27th the FDIC Board will consider amendments to its temporary liquidity guarantee program's debt guarantee program.

Below please find a brief overview of today's announcements, including what we will be looking for as program details are released. For more information about the government intervention efforts in response to the financial crisis, please see our Client Alerts and resources at Financial Crisis Legal Updates and News.

Treasury's Capital Assistance Program (CAP)

- Capital needs of major financial institutions will be assessed under a new "stress test" by federal regulators under a program to be initiated February 25th *("Major" has not yet been defined, but we expect it may be extended beyond the $100 billion asset test announced on February 10, 2009.)*
- The "stress test" will not reflect new capital levels for financial institutions but will evaluate the ability of the institution to withstand unanticipated and severe losses in coming periods *(While the stress test is not expected to be used on an ongoing basis, we expect financial institutions will benefit from incorporating such a test into internal long-term risk management programs.)*
- Institutions identified as needing additional capital will have an opportunity to raise private capital *(Information on how long an institution will be given to raise private capital is expected in the program detail announcement, but institutions will need to consider their public disclosure obligations if faced with a finding that additional capital raising is recommended.)*
- CAP will provide bridge capital to financial institutions, if needed, before they can obtain private capital; CAP investments will be in the form of mandatory convertible preferred shares. *(The Capital Purchase Program preferred stock investments, by contrast, were seen as "lower quality" shorter-term capital by some, including by rating agencies.)*

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- Capital Purchase Program investments are eligible for exchange into the new CAP mandatory convertible securities *(Financial institutions will need to consider the benefits of converting to a "higher quality" capital investment against any accompanying enhanced restrictions under the CAP program, as well as their current capital structure and ability to issue mandatory convertible securities.)*

Despite a series of private investments in 2007 and early 2008, losses by private investors and volatility and instability in the banking sector have curtailed private investor interest in financial institutions. As noted below, inclusion of an FDIC guarantee for new capital instruments may provide the necessary inducement for new private investments.

FDIC's Guarantee Program

On Friday, February 27, 2009, the FDIC Board will consider an extension of the temporary liquidity guarantee program's debt guarantee program (TLGP) to include mandatory convertible debt instruments. The TLGP provides a guarantee of timely payment of interest and principal on certain newly issued financial institution debt instruments, backed by the full faith and credit of the United States. The guarantees cover the period from issuance through June 30, 2012.

To enhance the utility of the FDIC guarantee by financial institutions seeking private investment, the FDIC will need to consider:

- The duration of the guarantee – private investors will look for long-term government support for financial institutions
- Structuring flexibility to provide a capital instrument tailored to the current capital structure of the financial institution and meeting the investment needs of private investors
- Regulatory clarity – the regulation should provide market, rating agency, investor and legal certainty
- Ease of execution, and inclusion of straightforward guarantee provisions in standardized documentation for mandatory convertible securities, will facilitate timely implementation of the program

Conclusion

CAP and TLGP may provide financial institutions the ability to issue government guaranteed, low-risk capital instruments to private investors, free from the restrictions imposed by participation in other government programs. Currently, participation in the TLGP does not require compliance with the executive compensation requirements under the Emergency Economic Stabilization Act of 2008 and the related TARP programs.

Additionally, permitting institutions to exchange their existing Capital Purchase Program Treasury investments for mandatory convertible shares may further strengthen capital positions. Historically, financial institutions have relied on issuing mandatorily convertible debt securities for capital raising purposes. In 2006 and 2007, quite a number of financial institutions issued mandatory converts in private placements to institutional investors and sovereign wealth funds and offered mandatory converts in public offerings. Rating agencies typically have looked favorably on mandatory converts for purposes of allocating "equity credit." From a regulatory capital perspective, mandatorily exchangeable securities have qualified for Tier 1 capital. There are a number of matters that issuers should consider. In the intervening time (since 2006/2007), accounting for convertible securities has undergone certain changes, which bear a close review. Issuers also may wish to consider related transactions that will minimize the dilutive effect associated with the issuance of mandatorily convertible instruments; however, the choices may be limited in light of other government program restrictions. Financial institutions will be considering carefully the executive compensation and corporate governance limitations under each of the programs as well as which program provides the best opportunity to transition from government investment to fully private ownership.

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Details of the program will be released over the next several days. As with prior federal crisis response programs, we expect the releases will reflect significant input from industry participants, but will retain the flexibility to incorporate additional details as the initial transactions are structured. Given the strong preference of government and private sector participants to identify and implement a private, rather than public, solution, the reaction of private investors will be critical for success.

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