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News Bulletin

March 2, 2009

Details on the New Federal Financial Stability Programs: CAP replaces CaPP, Stress Tests and amended TLGP

This week, regulators detailed a number of Financial Stability Plan programs. Economic assessments will be conducted on the 19 largest financial institutions – those with $100 billion or more of assets. Capital in the form of mandatory convertible preferred securities will be made available to financial institutions identified through economic assessments, or upon approved applications, through the new Capital Assistance Program (CAP). Eligible institutions will be able to issue FDIC-guaranteed senior unsecured mandatory convertible debt under an extension of the Federal Deposit Insurance Corporation's (FDIC) temporary liquidity guarantee program (TLGP).

Below we discuss each program. Many questions remain unanswered for financial institutions and market participants; additional information will become available as regulators begin the economic assessments and the programs move into the implementation phase.

For links to the publicly-available information regarding these programs and 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.

Background

On October 14, 2008, two programs were announced to address concerns that the financial crisis was depleting capital levels at financial institutions and that the freeze in the interbank lending market was creating liquidity issues.

First, the U.S. Department of the Treasury (Treasury) announced the Capital Purchase Program (CaPP) under the Emergency Economic Stabilization Act's (Stabilization Act) Troubled Asset Relief Program. Under CaPP, eligible institutions applied for capital investments from Treasury in the form of senior preferred stock.[1] The CaPP has been widely used, with over 400 institutions receiving Treasury capital as of February 24, 2009.[2] Although described as a volunteer program to support healthy financial institutions, CaPP has been criticized for the lack of transparency into the use of proceeds by participating institutions. The structure of Treasury's investment has created complexity for participants. For example, although the Treasury investment provides participating institutions Tier 1 capital, credit rating agencies have discounted the equity credit attributable to Treasury's investment premised on the assumption that Treasury would divest the preferred shares as soon as practicable.

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[1] The Capital Purchase Program offered terms tailored to the capital structure of the financial institutions, including different structures for publicly-held institutions, privately-held institutions and S corporations. Participation in CaPP, with limited exception, also required issuance to Treasury of warrants, the terms of which were similarly tailored to the nature of the participating institution.

[2] A copy of the February 24, 2009 transaction report is available at http://www.treasury.gov/initiatives/eesa/docs/transaction_report_02-24-09.pdf.

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As a result, rating agencies do not view the capital as "permanent" and financial institution participants do not achieve the full benefits of having issued the securities. Additionally, structuring the investment as preferred stock creates challenges for both Treasury and the issuing financial institution. Although Treasury receives registration rights, there is no existing or secondary market for Treasury's class of preferred stock. This creates pricing and liquidity challenges. The new CAP addresses some of these concerns.

Second, the FDIC announced the TLGP, including a debt guarantee program, which has been widely used. Under the debt guarantee program, participating entities can issue senior unsecured debt with an FDIC guarantee. The TLGP limits the issuance of FDIC guaranteed debt to 125% of the debt outstanding on September 30, 2008 that was scheduled to mature by June 30, 2009. The guarantee terminates on the earlier of the maturity of the debt or June 30, 2012. Given the expiration of the guarantee on June 30, 2012, the majority of the guaranteed debt issued matures no later than June 30, 2012. The FDIC, concerned with the ability of participating entities to roll maturing debt into new debt, expanded the program to guarantee debt that mandatorily converts into common stock. The FDIC's goal is to provide "additional flexibility to obtain funding from investors with longer-term investment horizons." As we discuss below, there are a number of factors financial institutions should consider when evaluating this new program.

For more information on the Capital Purchase Program and the TLGP, please see our related Client Alerts,[3] available at Financial Crisis Legal Updates and News.

Capital Assistance Program (CAP)

CAP is a two-part program: special economic assessments of major banking institutions; and a Treasury program to provide additional capital to eligible institutions through the purchase of mandatory convertible preferred securities. The CAP capital investment program does not terminate or replace the earlier Treasury capital program – CaPP. Similar to the phased-in implementation of the CaPP, CAP is currently available only to publicly-held institutions; additional programs for institutions that are privately-held or organized as subchapter S corporations or in mutual form are expected at a later date. Participation in the special economic assessment may result in an institution needing CAP funds; however, participation in CAP is elective. A qualifying financial institution (not participating in the special economic assessment) may apply for CAP. For ease of reference, we use CAP when discussing the Treasury capital investment program.

CAP provides participating institutions capital through the sale to Treasury of mandatory convertible preferred securities. As required by the Stabilization Act, Treasury also receives a warrant from participants. The warrant is designed to protect the U.S. taxpayer's investment by ensuring that Treasury benefits from any increase in the value of the institution's common stock. While the new program is substantially similar to the earlier program, it includes new features that may benefit potential participants and additional requirements that respond to some of the criticisms raised by members of Congress and the media.

The key change from CaPP to CAP is the change in the format of Treasury's investment—from senior preferred stock to mandatory convertible preferred stock. As we discuss below, proceeds from participation in the new CAP can be used to redeem a prior Treasury investment through CaPP. Institutions considering participating in CAP should consider, among other things: required consents and approvals; authorized stock; possible anti-dilution adjustments triggered by the issuance of a convertible instrument; possible anti-dilution adjustments triggered by the issuance of a new warrant to Treasury; and overall cost of capital associated with exchanging the Treasury CaPP securities for new CAP securities.

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[3] Client Alerts on the Capital Purchase Program and TLGP include New Liquidity and Capital Alternatives for Financial Institutions: Treasury's TARP Capital Purchase Program; FDIC's Temporary Liquidity Guarantee Program, Update to Treasury's Capital Purchase Program, CaPP: Private Bank Program, FDIC Approves Temporary Liquidity Guarantee Program Final Rule, CaPP: Subchapter S-Corporations and FDIC to Extend TLGP; FDIC-guaranteed Debt Exempt from SEC and OCC Registration. Additional resources, including summary reference guides, and links to government resources are available at Financial Crisis Legal Updates and News.

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CAP also requires enhanced reporting from participating institutions. The additional reporting requirements address concerns regarding the lack of transparency into the uses of taxpayer funds by institutions that were CaPP participants and a lack of "metrics" to gauge the success of Treasury's rescue efforts.

CAP was implemented, in part, "to support lending to creditworthy borrowers." To ensure that Treasury and other oversight bodies can assess CAP's success, CAP applicants are required to submit a plan for how CAP proceeds will be used to increase lending above the level that would have been possible without government support. Thereafter, participating institutions must provide regular reports on their lending activities. These reports will be made publicly available. Although we expect many participants will use the CAP proceeds to redeem the outstanding CaPP securities, we expect those institutions will be required to disclose additional lending activities made possible as a result of receiving government capital.

Exchange of Capital Purchase Program Preferred Stock

For three years after issuance, the senior preferred stock issued to Treasury under the CaPP may be redeemed only with the proceeds of a "qualified equity offering." A qualified equity offering, as defined under CaPP, is limited to an offering of Tier 1 perpetual preferred or common stock. CAP modifies the terms of CaPP by providing that the sale of CAP securities to Treasury is a qualified equity offering, but only to the extent that the proceeds are used to redeem CaPP securities. As a result, participation in CAP can be used to exchange the CaPP senior preferred stock for CAP mandatory convertible preferred stock. Institutions may prefer to have outstanding an instrument that converts to common stock rather than Treasury's senior preferred stock, which carries a 5% annual coupon for the first five years, increasing to 9% thereafter.

There has been no guidance issued regarding the methodology for "exchanging" or "tendering for" the Treasury's existing senior preferred stock and replacing it with new mandatory convertible preferred stock.

Executing a qualified equity offering has additional benefits for CaPP participants, including reducing the number of shares underlying the CaPP warrant issued to Treasury. Once a CaPP institution obtains proceeds from one or more qualified equity offerings equal to 100% of the CaPP investment, the number of shares underlying Treasury's CaPP warrant is reduced by half. Proceeds from a new CAP transaction may be counted toward this required amount, but only to the extent they are used to redeem CaPP preferred stock. However, if an institution participates in CAP, but does not use the proceeds to redeem the CaPP senior preferred securities, there will be no adjustment to the number of shares underlying the CaPP warrant.

A qualifying financial institution that participates in CAP will be required to issue a new warrant to Treasury. An institution evaluating its participation in this new program should calculate the value/cost of issuing a new warrant and compare that to the value/cost associated with the old CaPP warrant.

Proceeds from a CAP sale may also be used to redeem preferred stock sold to Treasury under the Targeted Investment Program.[4]

As we discuss above, although the CaPP senior preferred stock is Tier 1 capital for regulatory purposes, credit rating agencies have discounted the equity credit attributable to the security. This discount is based on the assumption that Treasury and the issuing institution expect that security to be redeemed as quickly

[4] To date only two banking institutions have participated in the Targeted Investment Program. Additional information about Treasury's Targeted Investment Program is available at http://www.treasury.gov/initiatives/eesa/.

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as practicable. The structure of the senior preferred, including the step-up in interest rate, encourages redemption. Rating agency treatment of the CAP mandatory convertible preferred is unknown at this time.

Eligible Institutions

Institutions eligible to participate in CAP are "Qualifying Financial Institutions" or QFIs. These include any of the following U.S.[5] institutions:

1. any bank or savings association not controlled by a bank holding company or savings and loan holding company;

2. any top-tier bank holding company; or

3. any top-tier savings and loan holding company which engages solely or predominately in activities that are permitted for financial holding companies under relevant law.

In each case Treasury, in consultation with the primary federal banking regulator, will determine eligibility for an institution. Entities controlled by a foreign entity are not eligible. This definition did not change substantially from the definition of QFI for CaPP.

Program Specifics

We set forth below some of the details of the program.

- Applications: As with CaPP, applications are made to the financial institution's primary federal banking regulator who will make a recommendation to Treasury. Although detailed information has not been provided on the criteria for the program, only "viable" institutions will be approved.
- Use of Proceeds: The application must contain a plan for how the capital will be used to preserve and strengthen lending capacity, including how lending will increase over what would have been possible without government support.
- Reporting: Participants are required to submit monthly lending reports that will be posted on the financial stability website, www.financialstability.gov.
- Investment Amount: No less than one percent of risk-weighted assets and no more than the sum of (1) two percent of risk weighted assets, (2) the amount needed to redeem CaPP preferred stock and (3) the amount needed to redeem preferred stock under the Targeted Investment Program.
- Exceptional Assistance: If a financial institution requires, and is approved to receive, capital in excess of the investment amount described above, the additional capital would be considered "exceptional assistance." This characterization would trigger additional executive compensation restrictions, as announced on February 4, 2009 by Treasury,[6] and may result in separately negotiated agreements relating to corporate governance or other matters.

[5] A U.S. institution is one that is organized under the laws of the United States or any state of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa, or the Virgin Islands.
[6] A copy of Treasury's release on executive compensation is available at http://www.ustreas.gov/press/releases/tg15.htm.

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Mandatory Convertible Preferred

Features of the mandatory convertible preferred to be purchased by Treasury include:

- Tier 1 capital for holding companies
- Ranks senior to common stock and *pari passu* with existing preferred stock other than junior preferred stock
- Liquidation preference of $1,000 per share, subject to the institution's authorized preferred shares and the alternative of a higher liquidation preference held by a depositary issuing depositary receipts
- Convertible into common equity at a 10% discount to the average closing price for the 20-trading day period ending February 9, 2009 (the day prior to the release of the Financial Stability Plan), subject to standard anti-dilution provisions
- Conversion price is subject to reduction (15% each six-months following issuance, up to 45%) if any required shareholder approval is not obtained
- Upon conversion, accrued and unpaid dividends are payable in cash or common stock, at the election of the institution
- Manditorily converts after 7 years, and earlier at the issuer's option, subject to approval of the primary federal banking regulator
- Convertible at the holder's option upon specified corporate events, including certain sales, mergers or changes of control
- Pays a 9% annual dividend, compounding quarterly; if any required shareholder approval is not obtained within six months after issuance, dividend rate will increase to 20% per annum until shareholder approval is obtained
- Redeemable with consent of primary federal banking regulator with the proceeds of a cash sale of common stock; provided the gross proceeds from the stock sale must be at least 25% of the CAP mandatory convertible preferred issuance price
    - Redeemable at par for the first two years, plus accrued and unpaid dividends
    - After the first two years, redeemable at the greater of par plus accrued and unpaid dividends and the as-converted value
    - Upon redemption in full, the institution can redeem outstanding warrants and any common stock held by Treasury at fair value
- Redeemable after conversion with consent of primary federal banking regulator with the proceeds of a cash sale of common stock or additions to retained earnings. The purchase price will be the greater of the conversion price and the average 20-trading day closing price beginning the day after notice of repurchase is given to Treasury

Warrants

Participating institutions will issue a warrant to Treasury at the time of the CAP investment. Terms of the warrant are outlined below.

- Warrant to purchase a number of shares of common stock having an aggregate market value equal to 20% of the mandatory convertible preferred amount on the date of investment

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- Exercise price for the warrant and market price for determining number of shares of common stock underlying the warrant will be 90% of the average closing price for the 20-trading day period ending February 9, 2009
- Term of 10 years
- Immediately exercisable
- Treasury will agree not to exercise voting control with respect to any shares of common stock received upon exercise of the warrant
- If the common stock is no longer listed or traded on a national securities exchange, or any required shareholder consent is not obtained within 18 months of the closing date, the warrant will be exchangeable at the option of Treasury into senior debt or another instrument
- Following repurchase in full of the mandatory convertible preferred and/or common stock, institution can repurchase the warrant and any related common stock at fair market value

Corporate Governance and Executive Compensation

CAP participating institutions are subject to the executive compensation and corporate governance requirements of the Stabilization Act, as amended by the American Recovery and Reinvestment Act of 2009. Because the amendments are retroactive, they will apply to CaPP participants as well as CAP participants. Although Treasury released regulations under the Stabilization Act, regulations have yet to be released under the Recovery Act amendments. Please see our Client Alert discussing the new executive compensation restrictions, available at Financial Crisis Legal Updates and News.

Additionally, the terms of the program impose the following limits and restrictions:

- If at any time the institution fails to pay accrued dividends on the mandatory convertible preferred, then no dividends may be declared or paid on junior preferred shares, *pari passu* preferred shares – unless paid on a pro rata basis with mandatory convertible preferred dividends, or common shares; nor may any share repurchases occur
- Dividend on common stock cannot exceed $0.01, unless Treasury consents
- Treasury consent required for repurchases of equity securities or trust preferred securities, for so long as Treasury holds any mandatory convertible preferred shares or common stock; provided that this restriction is subject to market exceptions similar to those in the CaPP
- Prior to conversion, voting rights limited to authorization or issuance of senior ranking shares, amendment to rights of mandatory convertible preferred or merger, exchange or similar transaction that would adversely affect the mandatory convertible preferred
- Following conversion, voting rights as a holder of common stock
- If full dividends are not paid for any six dividend periods, Treasury will have the right to elect 2 directors until such time as all accrued and unpaid dividends are paid and the right to elect directors will terminate thereafter when dividends are paid in full for four consecutive dividend periods
- Shelf registration statement for the mandatory convertible preferred, warrant and underlying common stock for each must be filed as soon as practicable following the investment date
- Institution will agree to take additional efforts to facilitate the transfer of the securities, which may include grant of piggyback registration rights, listing securities on a national securities exchange or appointment of a depositary to hold shares and issue depositary receipts

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Treasury announced its intention to publish a set of principles it will apply when exercising its voting rights under securities acquired through CAP. The principles will be available prior to the first closing of a CAP transaction.

Treasury also disclosed its intention to sell each year, following the mandatory conversion date, 20% of each institution's total common stock owned.

Economic Assessments or "Stress Tests"

The second component to CAP is the assessment process major financial institutions will undergo in the coming days and weeks. These assessments are expected to be completed by the end of April 2009. The 19 largest banking institutions, those with assets in excess of $100 billion as of December 31, 2008, will be included in the process. According to information published by the Federal Reserve Board, these institutions represent approximately two-thirds of the nation's bank holding company assets. The limited information available about the stress tests has been published through FAQs.[7]

The program is designed to address ongoing public concern that the nation's banking system cannot withstand the current economic environment or any further weakening of the economy. Banking regulators will test the ability of banking institutions' balance sheets to withstand two thresholds of economic decline over a projected two-year period; a baseline scenario and a more adverse scenario. For example, the baseline scenario assumes a decline in home values of 14% in 2009 and 4% in 2010 and the more adverse scenario assumes a decline in home values of 22% in 2009 and 7% in 2010. Assessments at each institution will include management's estimates for revenue, risk management and ability to raise capital in the future, among other factors. By publishing the standards for the assessments and disclosing the results of the CAP investments, Treasury and the banking regulators seek to enhance investor confidence in the banking system.

Test results will identify whether, in each scenario, the institution would require additional capital. Although initial descriptions of the assessment stated that the assessment would not create new capital levels for participating institutions, recent releases refer to a "necessary additional buffer" and participation by any institution that "requires additional capital." Although the FAQs indicate that bank holding companies are currently expected to "hold capital above minimum regulatory capital levels, commensurate with the level and nature of the risks to which they are exposed," the published information leaves little room for doubt that the major banking institutions are being held to a higher standard.

If a need for additional capital is identified, the institution must enter into a commitment to receive a CAP investment within six months. During that six-month period, the institution can obtain private capital in lieu of a Treasury capital investment.

TLGP's Debt Guarantee Program for Mandatory Convertible Debt

On February 27, 2009 the FDIC Board approved an interim final rule to extend the TLGP to provide an FDIC guarantee for mandatory convertible debt. TLGP currently provides participating entities the ability to issue senior unsecured debt backed by an FDIC-guarantee. Under the program, the FDIC guarantees timely payment of interest and principal, backed by the full faith and credit of the United States. Participation in the program was determined as of December 5, 2008 when eligible entities notified the FDIC of their intent to participate. In very limited cases an entity could become an eligible entity after December 5, 2008,[8] but entities eligible as of December 5, 2008 that did not elect to participate cannot do so now.

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[7] The "FAQs – Supervisory Capital Assessment Program" is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090225a1.pdf.

[8] Institutions that did not fall within the definition of "eligible entities" under the FDIC's TLGP rules until after December 5, 2008, for example, because they were chartered after that date, could apply to the FDIC for classification as an "eligible entity" under the TLGP.

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Mandatory Convertible Debt—Defined

The interim final rule amends the definition of "senior unsecured debt" to include "mandatory convertible debt." Mandatory convertible debt is defined as senior unsecured debt that is required by its terms to convert into common stock of the issuer on a fixed and specified date, which must be on or before June 30, 2012. The debt can convert earlier if the issuer fails to make a timely payment under the instrument or upon merger or consolidation where the surviving institution is not the issuer.

Issuance Cap Unchanged

As noted above, participating entities are able to issue FDIC-guaranteed debt up to an issuance cap. The amendments do not increase the cap or change its calculation. Although mandatory convertible debt is now included within the definition of senior unsecured debt, the calculation of the issuance cap has been amended to specifically exclude any outstanding mandatory convertible debt in the calculation.

Additionally, given the success of the debt guarantee program, issuers may have issued FDIC-guaranteed debt up to their issuance cap, leaving them unable to utilize the new features of the program. Even those issuers with available issuance capacity will need to consider carefully the benefits and limitations of the new program.

Approval Required

FDIC approval is required to issue guaranteed mandatory convertible debt under the program. Depending on the structure of the proposed mandatory convertible debt, additional bank regulatory applications and notices will be necessary[9] and the application to the FDIC must include a confirmation that the participating entity has made all applications and notices required under the Bank Holding Company Act, Home Owners' Loan Act, Change in Bank Control Act and with the primary federal banking regulator. Applications to issue guaranteed mandatory convertible debt must be received by the FDIC no later than June 30, 2009.

Disclosure and Fees

Provisions of the debt guarantee program rules requiring disclosure have been amended to include specific disclosure language for guaranteed mandatory convertible debt: The expiration date of the FDIC's guarantee is the earlier of the mandatory conversion date or June 30, 2012. The assessment for the guarantee of mandatory convertible debt will be calculated based on the number of days until conversion: 180 days or less has a 50 bp assessment, 181-364 days has a 75 bp assessment and 365 days or greater has a 100 bp assessment.

Comment Period

The interim final rule will be subject to a 15 day comment period after publication in the Federal Register. Given the application deadline of June 30, 2009, there will be a limited amount of time after publication of a final rule for participating entities to evaluate the benefits of the new TLGP features.

Other Considerations

Although the FDIC extended the TLGP to provide participating entities assistance in obtaining funding from investors with longer time horizons than June 30, 2012, the issuance of mandatory convertible debt may pose other issues for institutions. The FDIC-guaranteed mandatory convertible debt will not provide Tier 1 capital until

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Additionally, grandfathered savings and loan holding companies engaging in certain non-financial activities could request classification as an "eligible entity" by the FDIC.

[9] For example, if conversion of the mandatory convertible debt into common stock will result in a holder owning 10% of a national bank's outstanding voting common stock, prior notice to the Office of the Comptroller of the Currency is required under the Change in Bank Control Act.

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conversion into common stock. Institutions will need to evaluate their anticipated capital needs, debt funding plans as well as the accounting treatment for a convertible instrument. An institution also should consider the potential dilutive effect associated with the issuance of a mandatory convertible debt security. If an institution anticipates issuing a mandatory convertible debt security, and it is a participant in the CaPP, it may be subject to certain limitations on "repurchase" transactions, which, under ordinary circumstances might have been used to offset potential dilution. An institution also should consider whether, from a capital structure perspective, the issuance of a mandatory convertible debt security will be helpful. For example, it is not clear how rating agencies will view the issuance of a mandatory convertible debt security. An institution also may wish to consider the effect of an issuance on tangible common equity and other similar ratios.

Institutions may also want to consider a beneficial feature differentiating TLGP from the Treasury programs—the TLGP does not require compliance with the executive compensation and corporate governance restrictions discussed above.

Conclusion

Permitting institutions to exchange their existing Capital Purchase Program Treasury investments for mandatory convertible preferred 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, such as the CAP mandatory convertible preferred qualify for Tier 1 capital. Statements that the FDIC-guaranteed mandatory convertible debt will not qualify for Tier 1 capital treatment prior to conversion is likely to significantly diminish its appeal to financial institutions.

There are a number of matters that issuers should consider. In the intervening time (since 2006/2007), the accounting guidance for convertible securities has been revised, which bears 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.

Market commentators, research analysts and rating agencies have been particularly focused on the "tangible common equity" position of our financial institutions. Traditionally, mandatory convertible instruments have been seen as boosting tangible common equity. The instrument currently available for issuance under the TLGP's debt guarantee program, however, would have an adverse impact on tangible common equity. On the other hand, the CAP terms as outlined by Treasury are similar to the terms of mandatory convertible instruments that have previously been offered by financial institutions with beneficial impact to tangible common equity.

Financial institutions will be considering carefully the executive compensation and corporate governance limitations under the various government programs as well as which program provides the best opportunity to transition from government investment to fully private ownership.

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