

Client Advisory

Treasury's New Capital Assistance Program to "Stress Test" and Provide Billions to Banks

On February 25, the United States Treasury (UST) took action again to make billions of dollars of capital available to banks and thrifts that need or want to bolster their capital ratios.¹ The new program, known as the Capital Assistance Program (CAP), is in addition to the Capital Purchase Program (CPP) whereby the UST has provided almost \$200 billion to U.S. financial institutions since October 2008. The CAP consists of two core elements. First, bank regulators will perform a coordinated forward-looking capital assessment, or "stress test," to determine whether any participating institution needs to establish an additional capital buffer to withstand potential losses caused by a significant worsening of the economy. Second, any eligible institution that fails the stress test will be required to either raise additional private capital or to offer mandatorily convertible preferred shares to the UST.

Each of the 19 U.S. banking institutions that has consolidated assets in excess of \$100 billion will be required to participate in the stress tests, and may access the CAP immediately as a means to establish any required additional capital buffer. Any U.S. banking institution with consolidated assets below \$100 billion will be able to participate in the CAP on a voluntary basis, as long as it is a "Qualified Financial Institution" (QFI) and is "publicly traded."² A QFI is:

- (i) a U.S. bank or U.S. savings association that is not controlled by a Bank Holding Company (BHC) or a Savings and Loan Holding Company (SHLC); or
- (ii) a top-tier U.S. BHC; or
- (iii) a top-tier U.S. SLHC which engages solely or predominately in activities that are permitted for financial holding companies under relevant law.

The UST will determine eligibility and allocations for each QFI after consultation with such institution's federal banking regulator. The deadline for submission of applications for the CAP is May 25, 2009.³

Stress Tests

In order to receive any capital injections from the UST pursuant to the CAP, each participating QFI will be subjected to a one-time stress test by banking supervisors to estimate expected losses at such QFI over the next two years, assuming a "baseline" economic scenario and a more severe "adverse" scenario. The baseline scenario assumptions are based on the average of the economic projections published in February 2009 by Consensus Forecasts, the Blue

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¹ Guidelines for the program are available on the UST's website at <http://www.treasury.gov/press/releases/tg40.htm>, and include a white paper, a term sheet and answers to a set of frequently asked questions.

² "Publicly traded" means a company (1) whose securities are traded on a national securities exchange and (2) which is required to file periodical reports with the SEC or its primary federal bank regulator.

³ The UST will not release the names of QFIs that apply for the CAP or those which are not approved, although details of any completed transaction will be published. If requested by a QFI, the UST may allow certain portions of any application to be treated confidentially.

Chip survey and the Survey of Professional Forecasters. Under this scenario, it is assumed that (i) GDP will decline 2% in 2009 and increase 2.1% in 2010, (ii) unemployment will be 8.4% in 2009 and 8.8% in 2010, and (iii) housing prices will fall 14% in 2009 and 4% in 2010. The adverse scenario reflects a deeper and longer recession than in the consensus baseline, and under that scenario it is assumed that (i) GDP will fall 3.3% in 2009 and rise only 0.5% in 2010, (ii) unemployment will be 8.9% in 2009 and be 10.3% in 2010, and (iii) housing prices will decline 22% in 2009 and 7% in 2010.

Supervisors will use the results of the stress tests to determine the amount of additional capital, if any, which such QFI needs in order to be able to continue lending and to absorb the potential losses that could result from a more severe decline in the economy than projected. Each such QFI will have six months to raise that capital from private sources, but to the extent it is unable to do so, it will be required to access the capital by offering mandatorily convertible, cumulative preferred shares (Convertible Preferred) to UST.⁴

Terms of Convertible Preferred Shares

The following are the main terms of the Convertible Preferred to be issued to the UST pursuant to the CAP:

- Each QFI may issue and sell to the UST Convertible Preferred in an amount equal to not less than 1% of its risk-weighted assets and not more than 2% of its risk-weighted assets plus any additional amount of Convertible Preferred to the extent the additional proceeds are used to redeem preferred shares sold under the CPP or the UST's Targeted Investment Program.⁵
- The Convertible Preferred will mandatorily convert to common stock at the "Conversion Price" after seven years, and optional conversion may occur earlier (i) at the option of the QFI at any time, with approval of the QFI's primary federal banking agency, and (ii) at the option of the Convertible Preferred holder upon specified significant corporate events (including certain sales, mergers or changes in control of the QFI.) The "Conversion Price" is 90% of the average closing price for the QFI's common stock for the 20 trading day period ended February 9, 2009, subject to customary anti-dilution adjustments, and to three successive penalty reductions, each of 15% of the initial Conversion Price, on the six-, 12- and 18-month anniversaries of the issue date if any needed stockholder approval to authorize QFI common shares underlying the Convertible Preferred or the Warrants (described below) has not been obtained by those anniversaries.
- The Convertible Preferred will have a cumulative dividend rate of 9% per annum, compounding quarterly, but the rate will balloon to 20% if certain required stockholder approvals are not received within six months.
- The Convertible Preferred will be entitled to Tier 1 regulatory capital status and will rank senior to common stock and pari passu with existing preferred shares other than those which by their terms rank junior to any existing preferred shares.
- The Convertible Preferred will be non-voting (except for class voting rights on authorizing or issuing shares ranking senior to the Convertible Preferred, amendments to the rights of the Convertible Preferred, or significant matters such as mergers that would adversely affect the rights of the Convertible Preferred), however, if dividends are not paid on the Convertible Preferred in full for six dividend periods, whether or not consecutive, the holders of the Convertible Preferred will have the right to elect two directors; this right will end when full dividends have been paid for four consecutive periods. Also, upon conversion of the Convertible Preferred, the UST will have the voting rights of the QFI's common stock.
- The issuance by a QFI of the Convertible Preferred will qualify as a "Qualified Equity Offering" under the CPP if the proceeds from the sale of the Convertible Preferred redeem the old Preferred Shares and warrants issued under the CPP.

⁴ Any QFI may apply for CAP funds from the UST immediately at the conclusion of the stress test to be certain of its access to UST funds, but delay funding for six months in order to have as much opportunity to raise private funds as possible.

⁵ A QFI may issue Convertible Preferred in excess of the investment limit with the approval of the appropriate federal banking agency, but would then be deemed to require "exceptional assistance," which would restrict even further the form and amount of executive compensation permitted for that QFI. The UST, in its sole discretion but in consultation with the appropriate federal banking agency, will determine whether to provide such "exceptional assistance."

Restrictions on Redemptions, Dividends and Repurchases

Redemptions. At any time, Convertible Preferred may be wholly or partially redeemed, with the QFI's primary federal banking agency's consent, solely with the proceeds of one or more issuances of common stock for cash which results in aggregate gross proceeds to the QFI of not less than 25% of the issue price of the Convertible Preferred, or additions to retained earnings. Convertible Preferred redeemed within the first two years of issuance are redeemable at par, plus any accrued and unpaid dividends, and afterwards at the greater of par plus accrued and unpaid dividends and the as-converted value. After the redemption in whole of the Convertible Preferred held by the UST, a QFI may repurchase the warrant and any common stock then held by the UST at fair market value.

Dividends on Junior Securities. For as long as any Convertible Preferred is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Convertible Preferred,⁶ or common shares, nor may the QFI repurchase or redeem any such shares, unless all accrued and unpaid dividends for all past dividend periods on the Convertible Preferred are fully paid. Also, for so long as any Convertible Preferred or common stock of the QFI issued under the CAP is outstanding and owned by the UST, dividends declared and paid on the common stock may not exceed \$0.01 per share per quarter without the UST's consent.

Repurchases. For so long as any Convertible Preferred or common stock issued under the CAP is outstanding and owned by the UST, any repurchases of equity securities or trust preferred securities will require the UST's consent (subject to certain exceptions similar to those for the CPP). In addition, there shall be no share repurchases if prohibited as described in the paragraph above.

Mandatory Sale

After the mandatory conversion date, the UST will make reasonable efforts to annually sell common stock equal to at least 20% of the total common stock owned by the UST on the mandatory conversion date until the UST owns none of the QFI's common stock. After the conversion of the Convertible Preferred into the QFI's common stock, the QFI may, with its primary federal banking agency's consent, repurchase any common stock held by the UST at a price equal to the greater of the Conversion Price and the market price of the common stock on the date of repurchase.⁷ Any such repurchases must be made with the proceeds of an issuance of common stock for cash or additions to retained earnings. Afterwards, the QFI may repurchase the warrants described below (and any common stock issued upon their exercise) then held by the UST at fair market value.

Warrant Terms

The UST will also receive warrants (Warrants) to purchase common stock of the QFI with an aggregate market value equal to 20% of the aggregate redemption price of its Convertible Preferred on the date of investment. The initial exercise price for the Warrants will be the Conversion Price, subject to the same three penalty reductions for delayed stockholder approval as the Convertible Preferred Conversion Price penalty reductions described above.

The Warrants will have a term of 10 years, and are immediately exercisable and fully transferable. If the UST exercises the Warrants, it will agree not to vote the common stock it receives in connection with that exercise.

If the QFI's common stock is no longer listed or traded on a national securities exchange, or any required approval of the QFI stockholders has not been received within 18 months after the issuance date of the Warrants, the Warrants will be exchangeable, at the UST's option, for senior term debt or another economic instrument of the QFI.

If the QFI does not have enough available authorized shares of common stock to reserve for issuance upon conversion of the Convertible Preferred and exercise of the Warrants and/or stockholder approval is required for such issuance under applicable stock exchange rules, the QFI will call a meeting of its stockholders as soon as practicable after the date of a CAP investment to increase the number of authorized shares of common stock and/or comply with such exchange rules, and to take any other measures deemed necessary by the UST to convert the Convertible Preferred or exercise the Warrants.

⁶ But pari passu preferred shares may receive dividends pro rata with the Convertible Preferred.

⁷ Such market price to be calculated based on the average closing price during the 20 trading day period beginning on the day after notice of repurchase is given.

Transferability of Preferred Shares, Warrants and Underlying Common Stock

None of the Convertible Preferred, the Warrants or the underlying common stock of the QFI will be subject to any contractual restrictions on transfer. Each QFI will be required to file a shelf registration statement covering the Convertible Preferred, the Warrants and the common stock underlying the Warrants as promptly as practicable after the date of any investment, and if necessary, take all action to cause such shelf registration statements to be declared effective as soon as possible. In addition, each QFI will grant to the UST piggyback registration rights for the Convertible Preferred, the Warrants and the underlying common stock, will apply to list the underlying common stock on the same national securities exchange as the QFI's common stock, and will take other reasonable steps requested by the UST to facilitate transfer of those shares.

Executive Compensation

Each QFI and its covered officers and employees will be subject to the rules, regulations and guidance of the UST with respect to executive compensation, transparency, accountability and monitoring, as published and in effect at the time of the investment closing. These rules include the executive compensation restrictions imposed by the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA) that was signed into law by President Obama on February 17. These rules are broad and comprehensive and include (i) restrictions on bonuses and incentive compensation, (ii) prohibitions on certain severance payments, (iii) recoupment of certain bonus and incentive compensation, (iv) limits on incentives for excessive risk taking, (v) limits to deductions for compensation, (vi) requirements regarding luxury expenditures, (vii) provisions regarding stockholder "Say-on-Pay," and (viii) requirements to provide compliance certifications regarding all of the foregoing items.⁸ These rules may require modification or waivers of existing contracts and severance arrangements, and are subject to further change by the UST. Specific rules implementing the recent amendments by the ARRA to EESA, which would be applicable to the CAP, are expected to be published by the UST soon.

Katten's TARP Task Force

Katten Muchin Rosenman LLP's multidisciplinary TARP Task Force advises clients on the U.S. Treasury's Troubled Asset Relief Program created under the Emergency Economic Stabilization Act of 2008. Katten's TARP Task Force advises clients on how to structure their participation in the TARP Capital Assistance Program and the Capital Purchase Program, and advises clients on determining how the executive compensation rules apply to them and structuring their compensation arrangements appropriately. Katten's TARP Task Force also advises clients with respect to all aspects of other TARP-related programs, such as the Term Asset-Backed Securities Lending Facility (TALF) whereby the Federal Reserve provides leveraged loans collateralized by newly issued consumer asset-backed securities, and the Private-Public Investment Fund whereby the government will provide assistance to private-sector entities to purchase troubled assets.

⁸ For detailed information regarding these executive compensation requirements, please see Katten's client advisory on the topic, available at <http://www.kattenlaw.com/stimulus-act-expands-executive-compensation-restrictions-for-tarp-recipients-02-26-2009/>.

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