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FINANCIAL SERVICES REGULATORY & ENFORCEMENT UPDATE

Treasury Department Announces Specifics of Capital Assistance Program

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On February 25, 2009, the United States Department of the Treasury (Treasury) released details of the Capital Assistance Program (CAP). The CAP will provide equity capital to eligible qualifying financial institutions (QFIs) in the form of mandatorily convertible preferred securities (i.e., preferred stock that will convert to common stock after seven years, but that may be converted into common stock at any time after issuance at the option of the QFI). This program is intended to provide QFIs with additional, high-quality capital in order to restore confidence in the US banking system and ensure the continued ability of US financial institutions to provide loans in the face of a weaker-than-expected economic environment and of larger-than-expected actual and potential losses. The CAP is a major component of the Financial Stability Plan (FSP) announced by Treasury on February 10, 2009, that will utilize the remaining TARP funds and may well require additional appropriations.[1]

In announcing the CAP, Treasury released a term sheet for the mandatorily convertible preferred shares for publicly traded institutions,[2] which includes details about eligibility criteria, characteristics of the convertible preferred shares, conversion into common stock, and Treasury's right to warrants for the purchase of common stock of participating QFIs. In addition, Treasury released the application form and guidelines for participating in the CAP, as well as an FAQ document. Term sheets are expected to be released later for financial institutions that are organized as subchapter S corporations or in mutual form or that are not publicly traded.

The CAP has two components. The first is a forward-looking capital assessment, or "stress-test," that will evaluate the capital adequacy of a QFI under two alternative economic scenarios: a baseline, or expected, economic scenario, and a more adverse economic scenario. The second is access to additional high-quality capital through the sale of mandatorily convertible preferred stock to Treasury as a "bridge" to private capital in the future. The federal banking regulators have also released an FAQ document for the stress-test.

As currently formulated, only the 19 QFIs with consolidated assets in excess of $100 billion[3] will undergo the stress-testing. The capital assessment will evaluate the

assets and capital position of a QFI by calculating the possible losses if economic conditions degrade more than generally expected. This exercise will allow supervisors to determine whether an additional capital buffer is needed for the QFI to comfortably absorb losses and continue lending, even assuming significant deterioration in the broader economy.

In addition to the 19 QFIs that have been selected for stress-testing, the CAP is open to all interested publicly traded QFIs. A QFI that desires to participate in must submit a CAP application to its primary federal bank regulatory agency. The CAP application, while similar to the prior Capital Purchase Program (CPP) application, is a separate application that now explicitly requires more information than was required for the original CPP application, including information on any pending or currently negotiated mergers, acquisitions, or other capital raisings, and the expected consummation date. QFIs wishing to participate in the CAP must submit their applications by no later than 5 p.m. (ET), May 25, 2009. QFIs approved for participation will have up to six months to close the transaction after receiving preliminary Treasury approval; this reflects Treasury's willingness to permit a QFI time to raise private capital and obviate the need for CAP participation. The 19 QFIs subject to stress-testing need not wait for the conclusion of those assessments before applying.

Eligibility Criteria

As noted above, participation in the CAP is restricted to QFIs. For purposes of the CAP, a QFI is: (i) any US bank or savings association that is not controlled by a bank holding company (BHC) or savings and loan holding company (SLHC); (ii) any top-tier US BHC; and (iii) any top-tier US SLHC that engages solely or predominately in activities permitted for financial holdings companies under Section 4(k) of the Bank Holding Company Act.[4]

As was the case with the CPP, in order to qualify as a "US" bank, savings association or holding company for purposes of the QFI definition, an institution must be organized under the laws of the United States or any state of the United States, and cannot be controlled by a foreign bank or company. In addition, for entities seeking to qualify as QFIs by becoming BHCs or SLHCs, to be eligible for the CAP, an application to form the holding company must have been *approved* (not just submitted) by January 15, 2009. Prior participation in the CPP program is not required to access the CAP funds, nor are existing participants in the CPP precluded from obtaining additional funds under the CAP.

As under the CPP, the final determination of CAP eligibility will be made by the Treasury in consultation with the applicant's primary federal regulator.

Supervisory Capital Assessment Program

Each of the 19 QFIs with assets in excess of $100 billion will be required to analyze potential firmwide losses — including in its loan and securities portfolios, off-balance sheet commitments and contingent liabilities — under two defined economic scenarios over a two-year time horizon.[5] These scenarios are intended to represent a

baseline scenario and a more adverse scenario, assuming the following economic data:[6]

	BASELINE SCENARIO	ADVERSE SCENARIO
REAL GDP		
2009	-2.0	-3.3
2010	2.1	0.5
UNEMPLOYMENT RATE		
2009	8.4	8.9
2010	8.8	10.3
HOUSE PRICES		
2009	-14	-22
2010	-4	-7

Federal financial regulators will review the loss and revenue forecast of each of these QFIs and, based upon this review, will determine whether the institution has a sufficient capital buffer to ensure that it can keep lending to creditworthy borrowers in the event that adverse economic conditions persist or deteriorate further. This assessment of capital adequacy will consider many factors, including: the inherent risks of the institution's exposures and business activities; the quality of its balance sheet assets and its off-balance sheet commitments; the firm's earning projections; and the firm's expectations regarding economic conditions and the composition and quality of its capital (e.g., focusing on an institution's tangible common equity, rather than its level of Tier 1 capital). The federal banking regulators currently plan to finish conducting these capital assessments by the end of April.

If a QFI is determined to require additional capital, it will enter into a commitment to issue a CAP convertible preferred security to Treasury in an amount sufficient to meet the institution's determined capital need. Significantly, however, in a departure from the CPP, QFIs will be given six months to raise the necessary capital from private sources. If successful, the institution would be able to cancel the capital commitment without penalty. If unsuccessful, the institution must access the capital made available by the Treasury under the CAP.

Mandatorily Convertible Preferred Stock

A participating QFI will be permitted to issue mandatorily convertible preferred shares ("CAP Shares" or "Convertible Preferred") to Treasury in any amount between one percent and two percent of its risk-weighted assets, plus any additional amount used to redeem senior preferred shares sold under the CPP ("CPP Shares" or "Senior Preferred").[7] A QFI must receive the approval of its primary federal regulator to exceed this limit, and will then be deemed as needing "exceptional assistance." The full consequences of receiving exceptional assistance have not yet been made clear, but the CAP term sheet notes that QFIs receiving exceptional assistance "may be subject to additional terms and conditions," and the CAP FAQs note that "QFIs falling under the 'exceptional assistance' standard may have bank-specific negotiated agreements with the Treasury Department." As with the CPP, CAP Shares will qualify as Tier 1

capital and will rank senior to common stock and *pari passu* with existing preferred shares (other than preferred shares which by their terms rank junior to any other existing preferred shares).

Conversion. All CAP Shares *must* convert to common stock after seven years. The CAP Shares may be converted to common stock in whole or in part at any time, at the option of the QFI, subject to approval of the QFI's primary federal regulator. The conversion price will be 90 percent of the average closing price for the QFI's common stock for a 20-trading-day period ending on February 9, 2009, subject to later reduction in the event certain stockholder approvals are required and not received and subject to customary anti-dilution adjustments.

After the mandatory conversion date (i.e., at the seven-year mark), Treasury must use reasonable efforts to sell on an annual basis an amount of common stock equal to at least 20 percent of its QFI common stock holdings. In addition, the QFI will have the right to repurchase any common shares held by the Treasury using proceeds from an issuance of common stock or with additions to retained earnings.

If a QFI either (i) does not have sufficient available authorized shares of common stock to reserve for conversion of Convertible Preferred shares or for the exercise of the warrants (discussed below) or (ii) must receive shareholder consent for issuing common stock under these circumstances, it must call a shareholder meeting and receive the permissions necessary to convert the CAP Shares or exercise the warrants. Failure to receive such consent within six months of issuing the Convertible Preferred shares will result in a decreased conversion price and an increased dividend payment.

Dividends. Convertible Preferred shares will pay cumulative dividends at an annual rate of nine percent, compounded quarterly.[8] Under the CPP, dividends are capped at five percent for the first five years, increasing to nine percent thereafter.

Under both the CPP and the CAP, a participating QFI is barred from declaring or paying a dividend on junior preferred shares, on preferred shares ranking *pari passu* with the senior preferred, or on common shares, unless the QFI has satisfied its dividend obligations with respect to the CAP or CPP Shares. However, under the CAP, common dividends are limited to $0.01 per share per quarter unless the Treasury consents to a higher amount. By contrast, under the CPP, there is no set limit on common dividends, only the requirement that for the first three years, the Treasury must approve any dividend increase.

Redemption. At any time, CAP Shares may be redeemed, in whole or in part, with proceeds from the issuance of common stock for cash (if those proceeds exceed 25 percent of the issue price of the CAP Shares), or from retained earnings. Any redemptions must be approved by the QFI's primary federal regulator.

By comparison, under the original terms of the CPP, Senior Preferred shares could not be redeemed within the first three years, unless repurchased with proceeds from

the sale of qualifying amounts of perpetual preferred or common stock, but after three years, the QFI could redeem any or all of the CPP Shares without needing regulatory approval. This term sheet provision has been effectively modified by the American Recovery and Reinvestment Act of 2009, which amended section 111 of the Emergency Economic Stabilization Act of 2008 (EESA) to allow QFIs to repay the Treasury for any type of TARP assistance without regard to the source of those funds and without needing to comply with a waiting period.

Under both the CAP and the CPP, shares are redeemed at par, plus accrued and unpaid dividends. In addition, after redemption, the QFI then has the right to repurchase any other security held by Treasury at fair market value.

Transferability. Shares issued under the CAP will not be subject to any contractual restrictions on transferability. Treasury will have the ability to hold or sell these shares, and participating QFIs will be required promptly to file a shelf registration statement covering the CAP Shares and to grant Treasury piggyback registration rights for the shares. The term sheet also requires participating QFIs to take any reasonable steps requested by Treasury to facilitate transfer of the shares, including in particular making reasonable efforts to list the shares on a national securities exchange. These provisions are identical to those under the CPP.

Voting Rights. Like Senior Preferred shares under the CPP, Convertible Preferred shares under the CAP will not have voting rights, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the senior preferred shares, (ii) any amendment to the rights of senior preferred shares, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the senior preferred shares. Under both programs, if dividends are not paid in full for six dividend periods, Treasury will have the right to elect two directors: this right will terminate when dividends have been paid for four consecutive dividend periods.

However, upon conversion of the CAP Shares, Treasury will receive the voting rights associated with those common shares. Treasury indicated in the CAP term sheet that it will publish a set of principles governing its use of these rights prior to purchasing any CAP Shares.[9] Presumably, to the extent that Treasury chooses to restrict its common voting rights under these "principles," any self-imposed restriction on voting rights would not pass with the shares if sold by Treasury to a third party.

Warrants

As part of its purchase of CAP Shares, Treasury also will receive a warrant to purchase a participating QFI's common stock, with an aggregate market value, based on the Convertible Preferred conversion price, equal to 20 percent of the amount of Treasury's investment in the QFI's Convertible Preferred. The initial exercise price on the warrants will be the Convertible Preferred conversion price, again subject to later reduction in the event certain stockholder approvals are required and

not received and subject to customary anti-dilution adjustments. The warrants will be immediately exercisable, in whole or in part, for ten years. Unlike common shares received through the conversion of CAP Shares, Treasury will not exercise any voting rights with respect to any common shares issued to it upon the exercise.

The terms of these warrants are similar to those provided by QFIs under the CPP, except that under the CPP program, the warrants only have an aggregate market value of 15 percent of the CPP Shares.

Executive Compensation Limits

QFIs that receive CAP funds are subject to executive compensation limits from two different sources: Treasury guidelines released on February 4, 2009, and the executive compensation provisions in section 111 of EESA, as amended by the American Recovery and Reinvestment Act of 2009. The Treasury guidelines impose different restrictions depending upon whether the QFI is deemed to have received "exceptional assistance." EESA's compensation provisions apply uniformly to all QFIs, except that its bonus restrictions apply to different numbers of a QFI's employees based on the total amount of TARP funds received by the institution. Presumably, Treasury will attempt to rationalize these two regimes in issuing regulations required by the recent amendments to section 111 of EESA.[10]

The Treasury guidelines only apply to QFIs that receive CAP funds, while the amended EESA provisions apply to any institution that received funds from any TARP program (i.e., both CPP and CAP). The restrictions from both the guidelines and EESA apply to QFIs as long as the Treasury holds any of their equity under the CAP.

Salary and Bonuses. Treasury guidelines limit "senior executives"[11] from receiving in excess of $500,000 total annual compensation, including bonuses, with the exception that additional compensation may be given in the form of restricted stock. Any restricted stock paid to senior executives can only be sold after a set period of time, or after all of the QFI's equity has been repurchased from the Treasury. However, participating QFIs that do not receive exceptional assistance through CAP can waive this salary limitation by disclosing details of the compensation packages to shareholders and, if requested by Treasury, by subjecting the compensation to a non-binding "say on pay" shareholder resolution.

EESA does not limit total compensation, but like the Treasury guidelines, it does limit bonuses to restricted stock. In addition, the value of the bonus cannot exceed one-third of the employee's annual compensation. This restriction applies to a number of a QFI's highest-compensated employees, which is determined based on the total amount of TARP funds the QFI receives. In addition, EESA prohibits compensation plans that create incentives for the five most highly compensated employees to take "unnecessary and excessive risks" while the institution holds TARP funds.

Golden Parachutes. Under Treasury guidelines, the top 10 most highly

compensated executives of a QFI receiving exceptional assistance are prohibited from receiving any golden parachute payment, while the next 25 executives are prohibited from receiving any golden parachute payment greater than one year's compensation upon severance from employment. Otherwise, only the top five executives in a QFI are prohibited from receiving golden parachute payments. EESA imposes a prohibition on golden parachute payments for the top 10 most highly compensated employees.

Claw-Back Provisions. Treasury guidelines require QFIs to have policies that claw back bonuses and incentive compensation from any of the top 25 most highly compensated senior executives if they are found to have "knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay." EESA contains a similar claw-back provision for bonuses given to the top 25 highest-paid executives that are found to have been based on statements of earnings later found to have been "materially inaccurate."

Additional Points to Consider

Going forward, as a result of Treasury's FSP, entities that participate in Treasury programs like the CAP will be subjected to additional scrutiny and public disclosure requirements. Although Treasury has yet to provide significant guidance as to how these requirements will operate, the following points presented in the FSP are worth considering for well-capitalized QFIs that are contemplating applying to participate in the CAP:

- Recipients of exceptional assistance, or of CAP funds, are expected to show how "every dollar of capital they receive" is enabling them to preserve or generate new lending compared to what would have been possible without the government's assistance.
- All recipients of assistance are expected to submit a plan for how they intend to use that capital to preserve and strengthen their lending capacity. The FSP indicates that this plan is to be submitted during the application process, and that these reports will become public upon completion of the capital investment.
- Each recipient must submit monthly reports to Treasury detailing by category how many new loans the recipient provided to businesses and consumers, and how many asset-backed and mortgage-backed securities the recipient purchased. The report must also include a description of the lending environment in the communities and markets they serve as well as a comparison to their most rigorous estimate of what their lending would have been in the absence of government support. For public companies, similar reports will be filed on a Form 8-K simultaneous with the filing of their Form 10-Q or 10-K reports.
- All information disclosed or reported to Treasury by recipients of capital assistance will be posted on FinancialStability.gov.

- All recipients of capital investments will be required to participate in mortgage foreclosure mitigation programs consistent with Treasury guidelines.
- Treasury has indicated that all recipients of capital assistance will be restricted from pursuing cash acquisitions of healthy firms until the government investment is repaid. Exceptions will be made for explicit supervisor-approved restructuring plans.

Endnotes

1 On October 3, 2008, then-President Bush signed into law the Emergency Economic Stabilization Act of 2008 (EESA), which granted Treasury the authority to allocate up to $700 billion to the Troubled Assets Relief Program (TARP). Approximately $200 billion of TARP funds were used in the Capital Purchase Program (CPP), which provided capital to QFIs by purchasing senior preferred shares and warrants for common stock. The application deadline for the CPP for publicly traded institutions passed on November 14, 2008, with many QFIs choosing to participate, but financial institutions have continued to see capital levels erode through markdowns of illiquid assets and downward pressure on prices of common equity. For a more complete analysis of the CPP, please see our October 16, 2008, release entitled "US Treasury Announces TARP Capital Purchase Program; IRS Issues Related Tax Guidance," available at: http://www.mayerbrown.com/publications/article.asp?id=5736&nid=6.

2 "Publicly traded" means a company (1) whose securities are traded on a national securities exchange and (2) required to file, under the federal securities laws, periodic reports with either the Securities and Exchange Commission or its appropriate Federal banking agency.

3 These QFIs will be selected based on data reported for the fourth quarter of 2008 to the Board of Governors of the Federal Reserve System on Form FR Y-9C, Consolidated Financial Statements for Bank Holding Companies.

4 Treasury indicated in footnote 2 to the "Treasury White Paper" that accompanied the announcement of the CAP that "eligibility for capital under the CAP is consistent with the criteria and process established for identifying [QFIs] in the [CPP]." However, unlike the CPP, the term sheet definition of QFI under the CAP does not expressly include all US banks and those savings institutions controlled by a US SLHC that does not engage solely or predominately in activities that are permitted for financial holding companies. Thus, whereas the CPP was expressly open to all FDIC-insured depository institutions regardless of whether they were owned by a holding company, the CAP term sheet does not expressly define QFI as broadly, thus creating some uncertainty about the eligibility of stand-alone insured depository institutions themselves.

5 QFIs with less than $100 billion in assets will not be required to undergo a stress-test to access CAP funds.

6 The baseline scenario figures are based on averages derived from projections published by Consensus Forecasts, the Blue Chip survey, and the Survey of Professional Forecasters in February. The adverse scenario figures represent a projection of a deeper and longer recession than in the baseline.

7 Issuance of the mandatorily convertible preferred shares will be a "qualified equity offering" under the CPP, to the extent the proceeds from the sale of Convertible Preferred shares are used to redeem Senior Preferred shares. This allows QFIs to exchange CPP Shares for CAP Shares.

8 If shareholder approval, as described above, is not received, the dividend rate increases to 20 percent per year until such approval is given.

9 All CAP Shares and any resulting QFI common stock will be held by a separate entity within the Treasury, the Financial Stability Trust.

10 The statutory language is unclear concerning whether certain compensation restrictions contained in EESA are now in effect or will not take effect until the Securities and Exchange Commission and/or the Treasury issue implementing regulations required by the statute.

11 The Treasury guidelines do not define this term. However, in 31 CFR § 30.2 Q-2, "TARP Capital Purchase Program," Treasury provided the following definition of senior executive officer (SEO) under section 111 of EESA:

(a) General definition. A SEO means a "named executive officer" as defined in Item 402 of Regulation S-K under the federal securities laws (17 CFR § 229.402) who: (1) is employed by a financial institution that is participating in the CPP while the Treasury holds an equity or debt position acquired under the CPP; and (2)(i) is the principal executive officer (PEO) (or person acting in a similar

capacity) of such financial institution (or, in the case of a controlled group, of the parent entity); (ii) the principal financial officer (PFO) (or person acting in a similar capacity) of such financial institution (or, in the case of a controlled group, of the parent entity); or (iii) one of the three most highly compensated executive officers of such financial institution (or the financial institution's controlled group) other than the PEO or the PFO.

For more information about the CAP, please contact one of the authors of this Client Update listed below, any other member of the Financial Services Regulatory & Enforcement group, or your regular Mayer Brown lawyer.

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