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Reading Between the Lines of the Financial Stability Plan, Part II

In a series of announcements, the Department of the Treasury ("Treasury") and the federal banking agencies have offered significant guidance on the operation of the Capital Assistance Program ("CAP"), one of the principal elements of the Financial Stability Plan announced on February 10, 2009. *See Reading Between the Lines of the Financial Stability Plan*, 21st Century Money, Banking & Commerce Alert® (Feb. 12, 2009).

CAP has two aspects:

Institutions with over $100 billion in assets. Through a "stress test," the government will be allowed to identify the "worst case" potential capital needs of the 19 largest banking organizations in the country (which control about two-thirds of the total assets of the US banking system). Institutions in this category that are deemed to need additional capital will effectively be given the choice of obtaining private capital or accepting an investment by the Treasury in mandatorily convertible preferred stock ("Convertible Preferred").

All other institutions. CAP will allow smaller banking institutions to address concerns they may have about the adequacy of their total capital and, more particularly, their tangible common equity (an increasing focus of investors and credit rating agencies), by applying to participate in the program. If accepted, the Treasury will purchase their Convertible Preferred. While it appears that smaller institutions that apply will not be subject to a stress test, all smaller institutions should expect that their banking regulators will closely scrutinize the adequacy of their capital if they decide not to participate in CAP or to raise additional private capital on their own. Institutions that participated in the Capital Purchase Program ("CPP"), as well as those that did not, may apply. The Treasury has stated that eligibility for CAP participation by smaller institutions will be consistent with the criteria and the deliberative process established to determine eligibility under the CPP.

The key features of the Treasury's investment are as follows:

- *Convertible Preferred*. Institutions participating in CAP will have six months to raise private capital to fill any capital needs identified by the stress test (or as otherwise determined). After six months, the Treasury will purchase Convertible Preferred to fill any gap remaining, in an amount between 1% and 2% of an institution's risk-weighted assets. With the approval of its primary federal banking regulator, an institution also may issue Convertible Preferred to redeem preferred stock it issued under the CPP. As a result, total investment by the Treasury in Convertible Preferred could reach as high as 5% of an institution's risk-weighted assets. The Convertible Preferred will pay a 9%

dividend, will be non-voting, and, if not redeemed earlier, will mandatorily convert after seven years into common stock. The Convertible Preferred may be redeemed only with (i) the proceeds of an issuance of common stock or (ii) additions to retained earnings. The Convertible Preferred may be converted in whole or in part from time to time by the issuer, with the approval of its primary federal banking regulator. After the mandatory conversion date, the Treasury will be required to use reasonable efforts to sell annually 20% of the total common stock it held as of the conversion date. If any additional capital is required, it may be provided by the Treasury through its Targeted Investment Program, which is intended to maintain market stability and would involve additional terms and conditions.

- *Warrants*. Alongside the Convertible Preferred, the Treasury will receive 10-year warrants to purchase common stock in an amount equal to 20% of the dollar amount of the Convertible Preferred.

Institutions that participate in CAP will be subject to strict executive compensation limitations as well as a range of other limitations and requirements. To the extent that Convertible Preferred is converted into common stock, the Treasury may become a significant or controlling stockholder of an institution. The Treasury has indicated that it will publish a set of principles regarding how it will use its common stock voting rights prior to closing any transactions under CAP.

CAP will take government involvement in private financial institutions to new levels. Institutions will have to weigh this factor as they consider whether to accept government funds under CPP, to seek private equity, or to try to continue under their current capital structure.

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