

FINANCIAL SERVICES ALERT

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SPECIAL EDITION

Treasury Unveils the Capital Assistance Program

Today the Treasury announced the terms for the Capital Assistance Program ("CAP"), which is the new capital assistance program that was announced as part of the Financial Stability Plan on February 10th. For further discussion of the Financial Stability Plan, see the February 11, 2009 *Alert*. The CAP consists of two core elements, a supervisory assessment and access to a government capital investment. Participation in the CAP is required for the largest U.S. banking institutions -- those with assets of more than \$100 billion -- which are not foreign-controlled. U.S. banking organizations with assets of less than \$100 billion may also voluntarily participate in the CAP. Applications to participate in the CAP, including those by the large banking organizations who are required to participate in the supervisory assessments, must be submitted by May 25, 2009.

Stress Tests. Under the CAP, the federal banking agencies (the "Agencies") are conducting forward-looking assessments, or "stress tests," to evaluate the capital needs of participating banking organizations by analyzing the expected losses under certain conditions and the resources available to absorb those losses should economic conditions be more adverse than generally expected. The CAP assessments will be done on an interagency basis as a coordinated supervisory exercise to ensure they are carried out in a timely and consistent manner.

The Agencies have constructed two economic scenarios for banking organizations to use to estimate expected losses over the next two years. The first, or "baseline," scenario represents a consensus outlook and is based upon the most recent economic forecasts. The second, or "more adverse," scenario reflects a deeper and longer recession than the baseline scenario. As factors, the Agencies will provide the real GDP growth, civilian unemployment rate and residential home price assumptions for 2009 and 2010 to be used in the baseline and more adverse scenarios. For the baseline scenario, this will be a GDP growth rate of -2% in 2009 and 2.1% in 2010, an unemployment rate of 8.4% for 2009 and 8.8% for 2010, and a residential home price index change of -14% in 2009 and -4% in 2010. For the more adverse scenario, this will be a GDP growth rate of -3.3% in 2009 and 0.5% in 2010, an unemployment rate of 8.9% for 2009 and 10.3% for 2010, and a residential home price change of -22% in 2009 and -7% in 2010. The banking organizations must analyze their loan and securities portfolios, off-balance sheet commitments and contingencies, and, for firms with trading assets in excess of \$100 billion, potential trading-related losses, to determine expected future losses under each scenario. The scenarios will account for internal resources available to absorb losses, including pre-provision net revenue and reserves.

Capital Ramifications. Based on the results of this analysis, the Agencies will determine the amount of regulatory capital necessary for each institution to hold today in order to

remain well-capitalized under the more adverse scenario. In making this determination, the Agencies will consider the inherent risks of the banking organization's exposures and business activities, the quality of its balance sheet assets and its off balance sheet commitments, its earning projections, and the composition and quality of its capital.

The Treasury understands that some firms may be asked to hold more capital than they might otherwise be required to hold to remain well-capitalized, however, it believes this is necessary to restore confidence in the stability of the financial system and the creditworthiness of borrowers, which will result increased lending. The Treasury stressed that the capital provided under the CAP does not represent a new capital standard and is not expected to be maintained on an ongoing basis. Rather, capital is being made available under the CAP to help banking organizations absorb larger than expected future losses, should they occur, and to support lending to creditworthy borrowers during the economic downturn.

Should the assessment indicate that an additional capital buffer is warranted, banks will have six months to raise capital privately or access the capital made available from the Treasury under the CAP. In light of the current challenging market environment, the Treasury is making government capital available immediately through the CAP to eligible banking institutions to provide this buffer.

Share Issuances, Redemptions and Limitations. With supervisory approval, banks will be able to request capital under the CAP in addition to their existing preferred stock issued under the Capital Purchase Program ("CPP") and also will be allowed to apply to exchange their existing CPP preferred stock (or existing preferred stock issued under the Targeted Investment Program ("TIP")) for preferred shares newly issued under the CAP. Capital provided under the CAP will be in the form of a preferred security that is convertible into common equity at a 10% discount to the price prevailing prior to February 9, 2009, and carries a 9% dividend yield (the "CAP Preferred Shares"). Banking organizations may convert the CAP Preferred Shares to common equity at their discretion with the approval of their governing Agency.

The Treasury, or any other subsequent holder of the CAP Preferred Shares, also has the option to convert the CAP Preferred Shares upon certain events, such as certain sales, mergers or changes of control. After seven years, the CAP Preferred Shares automatically will convert to common equity if not redeemed or converted before that date. The CAP Preferred Shares may be redeemed, subject to the approval of appropriate Agency, at any time with the proceeds of one or more common stock issuance for cash which result in aggregate gross proceeds to the banking organization of at least 25% of the issue price of the CAP Preferred Shares. For the first two years, the CAP Preferred Shares are redeemable at par, plus any accrued and unpaid dividends. After the first two years, the CAP Preferred Shares will be redeemable at the greater of (1) par plus accrued and unpaid dividends or (2) the as-converted value. Following a redemption, the redeeming banking organization may repurchase any warrants or common stock held by the Treasury at fair market value.

The total amount of CAP Preferred Shares banking organizations generally may issue is between 1% and 2% of their risk-weighted assets plus any amount used to redeem preferred shares issued under the CPP or the TIP. If necessary, banking organizations may issue CAP Preferred Shares in excess of this amount with regulatory approval, which will be at the sole determination of the Treasury in consultation with the appropriate Agency. Any assistance

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will be deemed “exceptional assistance” and the banking organization receiving such exceptional assistance may be subject to additional terms and conditions, including additional executive compensation restrictions.

Recipients of capital under the CAP will be subject to the executive compensation requirements of the Emergency Economic Stabilization Act of 2008, as recently amended by the American Recovery and Reinvestment Act of 2009. The Treasury stated it will shortly be releasing rules to implement these amendments. Please see the February 17, 2009 *Alert* for further discussion of these restrictions.

Recipients will also be subject to restrictions on paying quarterly common stock dividends, repurchasing shares, and pursuing cash acquisitions. Banking organizations with CAP Preferred Shares outstanding may not pay dividends or redeem shares unless they are current with their dividends on the CAP Preferred Shares. Further, for as long as a banking organization has CAP Preferred Shares outstanding, common stock dividends may not exceed \$0.01 per share per quarter without the Treasury’s consent. The Treasury’s consent is also required for repurchases of equity securities or trust preferred securities for the period in which the CAP Preferred Shares are outstanding.

As part of the application process, banks must submit a plan for how they intend to use this capital to preserve and strengthen their lending capacity – specifically, to increase lending above levels relative to what would have been possible without government support. Banks receiving capital will be required to submit to Treasury monthly reports on their lending broken out by category. These reports will be posted on <http://financialstability.gov/>.