Two weeks after the US government first announced its Financial Stability Plan, the US Treasury Department and the Federal Reserve, on February 25, 2009, released more information about the Capital Assistance Program. The new information covers, among other things, one of the most talked about features of the Financial Stability Plan – the “stress test” for systemically important financial institutions.

This memorandum discusses the stress test and summarizes other aspects of the Capital Assistance Program, contrasting them where appropriate with those of the Capital Purchase Program established by former Treasury Secretary Paulson.

For a more in-depth discussion of other aspects of the Financial Stability Plan, see Davis Polk’s memorandum entitled “The Financial Stability Plan and its Impact on Financial Institutions and Private Capital” dated February 17, 2009. Davis Polk will continue to monitor new developments and issue further newsflashes and memoranda from time to time.
Capital Assessment – the “Stress Test”

Creating a Buffer to “Comfortably Absorb Losses”

Ahead of the announcement by the Federal Reserve, market participants had been speculating about the extent to which the “stress test” announced by Treasury as part of the Financial Stability Plan on February 10, 2009, now termed the “supervisory capital assessment program” (the “capital assessment”), would differ from the current reviews conducted by Federal banking regulators and banking institutions on a regular basis. The Federal Reserve’s term sheet dated February 25, 2009, as well as a White Paper issued by Treasury on the same day, clarify that the capital assessment to be conducted for each of the nineteen largest US banking institutions complements traditional capital assessments in several ways:

» it is a one-time coordinated interagency effort with a set end date;

» it uses certain “more adverse” economic assumptions;

» it focuses, among other aspects, on capital composition;

» it aims at creating a more substantive buffer that would help the institution to “comfortably absorb” losses during times of economic stress; and

» it does not represent a new capital standard and is not expected to be maintained on an ongoing basis.

Aside from ensuring that the institution itself can “comfortably absorb losses,” the additional capital buffer made available following the assessment would also serve to reduce the domino effect under which, according to Treasury, “a very small number of counterparties” may cause “otherwise viable institutions” to fail. Treasury distinguishes the approach from capital provided on a when-needed basis, claiming that with the forward-looking nature of the new capital assessment, “market participants will gain confidence from the major U.S. banking organizations having undergone a systematic disciplined exercise designed to prepare them for a more severe and protracted recession.”
Economic Scenarios:
Baseline and More Adverse Alternatives

<table>
<thead>
<tr>
<th>Economic Indicator</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Baseline</td>
<td>-2.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>More Adverse</td>
<td>-3.3%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Civilian Unemployment Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Baseline</td>
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<td>8.8%</td>
</tr>
<tr>
<td>More Adverse</td>
<td>8.9%</td>
<td>10.3%</td>
</tr>
<tr>
<td>House Prices</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Baseline</td>
<td>-14.0%</td>
<td>-4.0%</td>
</tr>
<tr>
<td>More Adverse</td>
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<td>-7.0%</td>
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</table>

Mandatory Assessment for Some. Under the program, the nineteen US banking institutions with assets of $100 billion or more, representing roughly two-thirds of aggregate US bank holding company assets, are required to participate in the capital assessment. There is no indication whether the capital assessment will also be applied to smaller institutions. Those institutions may nonetheless access the Capital Assistance Program, as described in more detail under “Capital Assistance” below.

Coordination among Regulators. The Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of Currency and the Office of Thrift Supervision will perform a coordinated assessment exercise on the major banking institutions for which they are the primary Federal regulators by evaluating such institutions’ expected losses and resources to absorb such losses over a two-year period to “ensure [that] each institution has the amount and quality of capital necessary to perform [its] vital role in the economy.” Interagency coordination is designed to ensure that capital assessments are carried out in a timely and consistent manner, considering that holding companies and their bank subsidiaries are supervised by different primary Federal regulators.

Timing. The supervisory agencies have begun the assessments and will complete them as soon as possible, but no later than the end of April 2009.

Mechanics of the Capital Assessment

Losses. Each major banking institution will be required to analyze its expected firm-wide losses in its loan and securities portfolios, as well as from any off-balance sheet commitments and contingencies, under two defined economic scenarios: a “baseline” scenario and a “more adverse” scenario, as shown in the sidebar.

» The “baseline” scenario represents a consensus view on the depth and duration of the recession and is based on the most recent forecasts on real GDP, civilian unemployment rate and house prices from professional forecasters.

» The “more adverse” scenario reflects a deeper and longer recession.
Factors in Assessing Capital Adequacy

Specific factors considered in assessing capital adequacy include:

- uncertainty about the potential impact on earnings and capital from current and prospective economic conditions;
- asset quality and concentrations of credit exposures;
- the potential for unanticipated losses and declines in asset values;
- off-balance sheet and contingent liabilities (e.g., implicit and explicit liquidity and credit commitments);
- the composition, level and quality of the institution’s existing capital;
- the ability of the institution to raise additional common stock and other forms of capital in the market; and
- “other risks that are not fully captured in regulatory capital calculations.”

Institutions with trading assets of $100 billion or more will be instructed to analyze their expected trade-related losses under the same two scenarios outlined above.

Resources. Each participating institution will also forecast internal resources available to absorb expected future losses, including pre-provision net revenue and reserves, and will report its estimates using a standardized template provided by the agencies.

Supervisory Process. The primary Federal regulator will meet with the senior management of each institution to review its loss and revenue forecasts, and ultimately will determine whether the institution needs an additional capital buffer. The sidebar lists further factors considered in the process. According to Treasury, the capital assessment will be part of the supervisory process and subject to the framework used for bank examinations or bank holding company inspections. Thus, rather than being able to challenge the outcome of a capital assessment, financial institutions will be given “ample opportunity for discussions [with] supervisory agencies regarding the loss estimates and earnings forecasts during the capital assessment process.” As a practical matter, this means that banking institutions have no formal recourse and must settle their differences with their primary banking regulator.
Capital Assistance

All institutions can apply to participate in the second element of the Capital Assistance Program, the issuance of mandatory convertible preferred securities to Treasury. It is designed to provide institutions with “contingent common equity funded by the U.S. government as a bridge to private capital in the future,” as may be necessary to “retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital.”

The Capital Assistance Program is designed to provide institutions with “contingent common equity funded by the U.S. government as a bridge to private capital in the future”.

It is unclear whether the funds appropriated under the Emergency Economic Stabilization Act of 2008 (“EESA”), and in particular the $350 billion requested and obtained by the government in January 2009 and since allocated to various programs under the Financial Stability Plan, will be sufficient to fund the Capital Assistance Program and the other core components of the Financial Stability Plan. President Obama, in a speech before Congress on February 24, 2009, hinted at the potential need for additional funds, and, in his 2010 budget, included a $250 billion placeholder for losses associated with additional financial rescue efforts, leading to press estimates that such losses would arise from the deployment of up to $750 billion in additional funds. Congress would have to pass legislation, however, before the government could expand financial rescue efforts beyond the amount authorized under EESA.

Treasury has provided details on some of the terms of the securities and the process involved in accessing the capital. Treasury has also shed light on the role the government perceives for itself and for private capital in recapitalizing banking institutions, while raising new questions as to how that relationship between the public and private sector will unfold.

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Private Capital Participation and Government Ownership

US government ownership of financial institutions is “not an objective” of the Capital Assistance Program. Accordingly, the program contains elements designed to minimize government ownership, keep the period of government ownership temporary and encourage the return of private capital to replace government investment. The program also addresses aspects of how Treasury intends to manage its stakes in banking institutions during any intervening period of government ownership, in particular where a “significant stake in a financial institution is an outcome.”

Private Capital Participation. The terms of the Capital Assistance Program reflect Treasury’s long-held view that private capital is important to long-term financial recovery. Accordingly, the nineteen largest banking institutions, if found during their capital assessment to require an additional capital buffer, will be given six months to raise private capital in the public markets in order to establish or contribute to this capital buffer prior to resorting to the Capital Assistance Program as a “last resort.” It remains to be seen whether the program, as currently set up, encourages private capital participation. At the very least, the government’s backstop could set a floor on share prices of the major banking institutions.2

Whether banking institutions will be able to raise private capital may in part depend on whether, when and to what extent the results of the capital assessment will be made available to investors and the public by Treasury or the institution itself. Banking institutions will have to carefully consider whether the requirement to raise additional capital as a result of a capital assessment needs to be disclosed under the securities laws and applicable listing requirements. Investor decisions also could be influenced by the prospects of investing alongside the government should the securities offering fail to raise sufficient proceeds to establish the mandated buffer. For instance, while the government holds convertible preferred or common stock of an institution under the Capital Assistance Program, restrictions on common stock

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dividends may influence the attractiveness of a private common stock investment.

**Government Ownership.** The government intends to “keep the period of government ownership as temporary as possible.” Several features of the convertible preferred are designed “to give banks the incentive to replace [government] capital with private capital or to redeem [government] capital when conditions permit.” These include, among others, favorable terms for redemption during the first two years. This is also evident in the ability to redeem convertible preferred with additions to retained earnings as well as a provision requiring the government to attempt to sell all of the common stock it owns within approximately twelve years.

All investments made under the Capital Assistance Program will be placed in a separate trust – the Financial Stability Trust – that will be established to manage the government’s investments in financial institutions, including, possibly, investments made previously under TARP such as Capital Purchase Program preferred shares. The objective of the trustees will be to “protect and create value for the taxpayer as a shareholder over time.” The trust will presumably be created under US state law, and the trustees, whether consisting exclusively of government agents or also including private market participants, will need to comply with the typical fiduciary duties and responsibilities of a trustee towards the beneficiaries of the trust, the taxpayers. Separate legal entities have been used to hold and manage government investments in European countries such as the UK and France, and may be a good way of maximizing the value of investments, while distancing regulatory oversight from ownership and perhaps aiding the government in taking a consistent stance towards its various investments.

**Accessing the Capital Assistance Program**

**Eligibility.** Eligibility requirements are meant to be consistent with the criteria of the Capital Purchase Program. Thus far, only the term sheet applicable to publicly traded institutions has been made available. Separate term sheets are expected to be made available for institutions that are not publicly traded or are organized as subchapter S corporations or in mutual form.
Issuance Scenarios. The Capital Assistance Program is “open immediately.” There are at least three scenarios in which institutions can issue mandatorily convertible preferred stock (“convertible preferred”) to Treasury under the Capital Assistance Program.

» Raising additional capital following the capital assessment. Following the mandatory capital assessment for US banking institutions with assets in excess of $100 billion, regulators will determine whether an institution requires an additional capital buffer. If so, the institution will enter into a commitment to issue convertible preferred to Treasury in an amount sufficient to meet its capital requirement. Each institution will be permitted up to six months to raise private capital in public markets to meet this requirement, and can cancel its Capital Assistance Program commitment without penalty. Institutions identified as needing capital may find that market pressures may force them to act more quickly than the six months permitted under the program. The institution will then issue convertible preferred to raise any additional capital necessary to meet its capital requirement. The language of Treasury releases thus far leaves open the possibility that such institutions will be able to obtain a capital “advance” prior to the completion of the mandatory supervisory assessment. For instance, Treasury’s press release states that “[e]ligible U.S. banking institutions with assets in excess of $100 billion . . . may access the CAP immediately as a means to establish any necessary additional buffer.”

» Raising additional capital with the approval of relevant Federal banking regulators. US banking institutions with assets below $100 billion and therefore not subject to a mandatory supervisory assessment will be eligible to obtain capital consistent with the criteria and the “deliberative process” established for identifying institutions qualified to participate in the existing Capital Purchase Program, i.e., pursuant to a process that is designed to provide capital to strong and solvent banking institutions.
Exchange of Capital Purchase Program securities with supervisory approval. Banking institutions of any size will be allowed to apply to “exchange” senior preferred shares sold under the Capital Purchase Program by redeeming such shares with the proceeds of an issuance of convertible preferred. Proceeds from the issuance of convertible preferred that are used to redeem the senior preferred shares sold under the Capital Purchase Program will count towards the proceeds that are required to be raised in order to reduce the number of shares of common stock underlying the warrants issued to Treasury under the Capital Purchase Program. Such proceeds may also be used to redeem preferred shares issued under the Targeted Investment Program, under which two banking institutions, Citigroup and Bank of America, have thus far issued preferred shares to Treasury.

Application. On February 25, 2009, Treasury published the application to request participation in the Capital Assistance Program. The application for the Capital Assistance Program is similar to that of the Capital Purchase Program. Detailed investment agreements and associated documentation will be posted shortly.

As part of the application process, banking institutions must submit a plan for how they intend to use the capital to be obtained under the Capital Assistance Program to preserve and strengthen their lending capacity – specifically, to increase lending above levels relative to what would have been possible without government support. Treasury will post these plans on www.FinancialStability.gov after the closing of the investment under the Capital Assistance Program. Treasury will also publish electronic reports detailing any completed transactions, including the name of the banking institution and the amount of the investment, within 48 hours of such closing. Treasury will not release the names of institutions who apply for the Capital Assistance Program or those which are not approved.

Executive Compensation, Transparency, Accountability and Monitoring. The banking institution and its covered officers and employees must agree to
comply with the rules, regulations and guidance with respect to conditions for assistance as published and in effect at the time of the closing of the investment. The current state of such conditions is described in our recent client memoranda “The Financial Stability Plan and its Impact on Financial Institutions and Private Capital” and “Compensation Provisions in the American Recovery and Reinvestment Act of 2009,” both dated February 17, 2009, as well as “‘Say on Pay’ Now a Reality for TARP Recipients” dated February 25, 2009. As part of such conditions, institutions that receive assistance under the Capital Assistance Program will be required to submit monthly reports to Treasury on their lending, broken out by category, which will be posted on www.FinancialStability.gov. These restrictions also include the executive compensation provisions of EESA, as recently amended by the American Recovery and Reinvestment Act of 2009. Treasury has stated that it will release rules to implement these amendments in the near future.
Terms of the Convertible Preferred and Warrants

Under the Capital Assistance Program, banking institutions will issue convertible preferred that are pari passu with the most senior preferred shares of the banking institution currently outstanding, and warrants. The convertible preferred consists of cumulative mandatorily convertible preferred stock, which converts automatically after seven years, and is also convertible earlier at the option of the issuer or the holder under certain circumstances. The convertibility features make the preferred stock a source of potential common equity, or “contingent equity.” The convertible preferred qualifies as Tier 1 capital for bank and thrift holding companies.

Based on information released by Treasury on February 25, 2009, the convertible preferred and warrants will include the following terms:

Subscription Amounts. Each qualifying institution may issue an amount of convertible preferred equal to not less than 1% of its risk-weighted assets and not more than 2% of its risk-weighted assets plus any amount of convertible preferred to the extent the proceeds are used to redeem senior preferred sold under the Capital Purchase Program and, if applicable, the Targeted Investment Program. Similar to the Capital Purchase Program, measurements of risk-weighted assets will be based on the information contained in the latest quarterly supervisory report filed by the banking institution with its primary Federal regulator, “updated to reflect events materially affecting the financial condition of the [banking institution] since the filing of such report.”

» An institution that needs capital in excess of this investment limit will be categorized as needing “exceptional assistance.” Treasury, in consultation with the appropriate Federal banking regulator, will determine whether an institution qualifies for “exceptional assistance” on a case-by-case basis. Such assistance will be provided pursuant to bank-specific negotiated agreements with Treasury that may include additional terms and conditions, which, based on previous statements of the current administration as well as the terms of past interventions, could include additional restrictions with respect to dividends,
executive compensation or corporate expenditures and possibly corporate governance.

» The Capital Assistance Program does not impose a fixed cap such as that imposed under the Capital Purchase Program, which limited the investment to $25 billion per institution.

**Convertibility.** Unlike the preferred shares issued under the Capital Purchase Program, the convertible preferred are convertible in whole or in part into shares of common stock at the banking institution’s option, subject to the approval of the issuer’s primary Federal banking regulator, “if needed to preserve lending in [a] worse-than-expected economic environment.”

» **Conversion price:** 10% discount to the average closing price for the common stock for the 20 trading day period ending February 9, 2009, subject to reduction in the event a stockholder approval is required and not received and subject to customary anti-dilution adjustments.

» Convertible preferred are convertible at the conversion price at the option of the holder upon “specified corporate events, including certain sales, mergers or changes of control” of the issuer.

» After seven years, the convertible preferred will automatically convert at the conversion price if not redeemed or converted before that date.

» Upon conversion, the issuer must also pay accrued and unpaid dividends at the issuer’s option in either cash or common stock, with shares valued at the closing price on the second preceding trading day.

**Dividends.** The convertible preferred will pay cumulative dividends at a rate of 9% per year, compounding quarterly, subject to increase in the event a stockholder approval is required and not received. This makes assistance under the Capital Assistance Program more costly than under the Capital Purchase Program, which carried a 5% dividend for the first five years prior to stepping up to 9% thereafter.

**Redemption.** Subject to the approval of the issuer’s primary Federal banking regulator, the convertible preferred may be redeemed, in whole or in part, with
the proceeds of one or more issuances of common stock for cash which results in aggregate gross proceeds to the issuer of not less than 25% of the issue price of the convertible preferred. In contrast to preferred stock under the Capital Purchase Program, the convertible preferred may also be redeemed with additions to retained earnings, but not with proceeds from the sale of Tier 1 qualifying perpetual preferred stock.

» During the first two years from issuance, the convertible preferred will be redeemable at par, plus any accrued and unpaid dividends.

» Beyond two years from issuance, the convertible preferred will be redeemable at the greater of (i) par plus any accrued and unpaid dividends and (ii) the as-converted value.

» The more favorable terms for redemption during the first two years provide an incentive for certain banking institutions to redeem early.

Repurchases of Capital Assistance Program Common Stock and Warrants.

» Following the redemption in whole of the convertible preferred held by Treasury, the issuer may repurchase the warrants and any common stock then held by Treasury under the Capital Assistance Program at “fair market value,” which is not defined in the term sheet.

» Following the conversion of the convertible preferred into common stock, the issuer has the right, subject to the approval of its primary Federal banking regulator, to repurchase any such shares of common stock at a price equal to the greater of the conversion price and the average closing price for the common stock for the 20 trading day period beginning on the day after notice of repurchase is given. Such repurchases must be made from the same sources available for redemption of the convertible preferred.

» Following the repurchase of all common stock held by Treasury as a result of conversion, the issuer may repurchase the warrant issued to Treasury under the Capital Assistance Program, and any common stock it holds upon exercise of the warrants, at “fair market value.”

Dividend Restrictions. For so long as any convertible preferred is outstanding and owned by Treasury or Treasury owns any common stock under the Capital Assistance Program, dividends declared and paid on the issuer’s common stock must be no greater than $0.01 per share per quarter unless Treasury consents to a higher amount. 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, or common shares (other than in the case of pari passu preferred shares, dividends on a pro rata basis with the convertible preferred), unless all accrued and unpaid dividends for all past dividend periods on the convertible preferred are fully paid.

**Restrictions on Repurchases.** For so long as Treasury owns any convertible preferred or common stock of the issuer, Treasury’s consent is required for repurchases of equity securities or trust preferred securities, subject to exceptions similar to those available under the Capital Purchase Program. Furthermore, for as long as any convertible preferred is outstanding, the issuer may not repurchase or redeem any junior preferred shares, preferred shares ranking pari passu with the convertible preferred or common shares, unless all accrued and unpaid dividends for all past dividend periods on the convertible preferred are fully paid.

**Restrictions on Cash Acquisitions.** Banking institutions that receive assistance under the Capital Assistance Program will be restricted in pursuing cash acquisitions. This restriction is consistent with the Financial Stability Plan term sheet, which indicated that institutions receiving capital assistance would be restricted from pursuing cash acquisitions of “healthy” firms until the government is repaid, subject to exceptions for “explicit supervisor-approved restructuring plans.” However, this restriction does not appear in the Capital Assistance Program term sheet or White Paper, so its extent and applicability remain unclear.

**Convertible Preferred Voting Rights.** The convertible preferred will be nonvoting except for customary consent and director appointment rights.

**Warrants.** Treasury will receive warrants to purchase a number of shares of common stock having an aggregate market price – based on the conversion price – equal to 20% of the amount of the convertible preferred being purchased. Under the Capital Purchase Program, Treasury received warrants to purchase a number of shares having an aggregate market price equal to 15% of the amount of the preferred stock being purchased. The initial per-share exercise price of the warrants will be equal to the conversion price, subject to reduction in the event a stockholder approval is required and not received and subject to customary anti-dilution adjustments.
applies for as long as the banking institution fails to timely receive any required stockholder consent, as discussed below. The warrants include customary anti-dilution requirements. If any required shareholder consent is not obtained within eighteen months, or if the issuer is no longer publicly traded, the warrants will be exchangeable for senior debt or another security acceptable to Treasury.

Shareholder Consent. Shareholder consent may be required under the relevant exchange rules or under state law to authorize a sufficient number of common shares for conversion of the convertible preferred and settlement of the warrants. Therefore, where necessary, the issuer covenants to call a meeting of its stockholders as soon as practicable.

Failure to obtain any required shareholder consent has the following adverse effects:

» the conversion price of the convertible preferred will be reduced by up to 45%, in 15% increments every six months;

» the dividend rate on the convertible preferred will increase to 20% per year if such consent has not been received within six months; and

» the exercise price on the warrants will be reduced by up to 45%, in 15% increments every six months.

Common Stock Voting. To the extent Treasury holds common stock as a result of conversion of the convertible preferred, Treasury will vote such shares. Treasury will publish a set of principles governing its use of any voting rights obtained upon conversion before closing any transaction under the Capital Assistance Program. In contrast, and consistent with the provisions of the EESA, Treasury will not exercise its voting power with respect to any common stock it holds upon exercise of the warrants.

Transferability. Banking institutions will file a shelf registration statement and grant piggyback registration rights to Treasury in relation to the convertible preferred, the warrants and their respective underlying common stock. In addition, if requested by Treasury, the issuer will use reasonable efforts to list the convertible preferred on a national securities exchange on which its
common stock is traded, and will appoint a depositary to hold the convertible preferred and issue depositary receipts.

**Mandatory Sale.** Consistent with Treasury’s goal to “keep the period of government ownership as temporary as possible,” after the mandatory conversion date, Treasury will make reasonable efforts to sell 20% of the common stock it owns each year until it owns no common stock.
If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

**Useful Links**

- [Treasury Press Release dated February 25, 2009](#)
- [Federal Reserve Press Release dated February 25, 2009](#)
- [Capital Assistance Program Term Sheet](#)
- [Capital Assistance Program White Paper](#)
- [Capital Assistance Program FAQs](#)
- [Application Guidelines for the Capital Assistance Program](#)
- [Forward-Looking Economic Assessments FAQs](#)

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This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.