

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

October 15, 2008

Table of Contents

Equity Investments	2
Senior Executive Compensation Restrictions.....	5
The Regional Bank Program	6
FDIC Liquidity Guarantee	8
FDIC Deposit Insurance	9
Other Recent Developments	9
TARP Implementation.....	9

In the wake of intense pressure in the global credit markets and continued turmoil in the stock markets, the US Treasury Department, in coordination with other G-7 governments, yesterday expanded its plan to restore confidence in the US banking system. Wielding the extraordinary discretion recently granted to it by Congress, the US government announced a plan to inject \$250 billion of capital directly into the US banking system, to guarantee the short-term debt of most US banks and thrifts and to eliminate FDIC insurance limits for non-interest bearing accounts. Under the plan, the Secretary of the Treasury, the Chairman of the FDIC and the Chairman of the Federal Reserve Board yesterday jointly announced the following:

Treasury will invest
\$250 billion in the US
banking system

- » Treasury will use the full \$250 billion it currently has available under the Troubled Asset Relief Program (“TARP”) to purchase preferred stock and warrants for common stock of the nine US bank holding companies that are systemically important and of other healthy regional and community banks;
- » The FDIC will use its emergency powers to guarantee through June 30, 2012 certain senior unsecured debt issued by eligible banking institutions; and
- » The FDIC will provide unlimited insurance through 2009 for non-interest bearing deposit accounts, a move primarily designed to protect the payroll and working capital accounts of small and medium-sized businesses.

This memorandum analyzes the implications of these developments and the federal government’s evolving response to the financial crisis.

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

Preferred Stock Terms

- » **Nonvoting, cumulative perpetual preferred stock**
- » **Treated as Tier 1 capital**
- » **Subscription amounts: minimum of 1% of risk-weighted assets; maximum of lesser of 3% of risk-weighted assets and \$25 billion**
- » **Senior to common stock and *pari passu* with existing senior preferred stock**
- » **5% dividend; step-up to 9% after 5 years**
- » **No increase in common stock dividends for 3 years without Treasury approval unless preferred stock has been fully redeemed**
- » **No payment of common dividends if preferred stock dividends have not been paid in full**
- » **Treasury has right to elect two directors if preferred stock dividends unpaid for any 6 quarters**
- » **No restrictions on Treasury's transfer**

Equity Investments

Preferred Stock. When TARP was created just twelve days ago, it seemed to be aimed primarily at the purchase of troubled real estate-related assets. But the plain language of the legislation, supported by certain remarks on the congressional floor during the debates, permits Treasury, after notice to Congress, to purchase other “financial assets” if necessary to promote financial stability. When it became apparent that a large capital investment was needed to restore confidence in the US banking system, Treasury decided to use the first tranche of the TARP program to buy preferred stock and warrants for common stock of US banking institutions.

The capital injection of \$250 billion will be available to all qualified financial institutions on identical terms, although the timing of the investments will be faster for the nine systemically important US bank holding companies. The amount of preferred stock that Treasury may purchase from any qualifying financial institution must equal at least 1% of its risk-weighted assets and not more than the lesser of (i) \$25 billion and (ii) 3% of its risk-weighted assets.

Qualifying financial institutions are US bank holding companies, certain US savings and loan holding companies and certain stand-alone US banks and thrifts. Otherwise qualifying financial institutions that are “controlled” by foreign banks or companies are excluded.

An initial \$125 billion will be allocated among the nine US bank holding companies that the banking regulators have designated as systemically important and that have already agreed to participate. According to media sources, they are Bank of America/Merrill Lynch (\$25 billion), Citigroup (\$25 billion), JPMorgan (\$25 billion), Wells Fargo (\$25 billion), Goldman Sachs (\$10 billion), Morgan Stanley (\$10 billion), Bank of New York Mellon (\$2-3 billion) and State Street (\$2-3 billion).

The preferred stock will be perpetual and cumulative, except that it will be noncumulative if issued by a bank that does not have a holding company, will rank senior to common stock and *pari passu* with existing senior preferred stock, and will have a coupon rate of 5% that will step up to 9% after five years. It is redeemable at par plus accrued dividends after three years, although it can be redeemed earlier with the proceeds of certain replacement equity offerings equal to at least 25% of the issue price of the preferred stock. As usual, the

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

Warrant Terms

- » **10-year warrant to purchase common stock**
- » **Immediately exercisable and transferable by Treasury**
- » **Exercisable for common stock with a value at preferred stock purchase date equal to 15% of liquidation value of preferred stock**
- » **Exercise price equal to value of common stock at the time the preferred stock is purchased**
- » **Warrant amount cut in half if funds raised in Tier 1 or common stock offerings before December 31, 2009 equal or exceed issue price of senior preferred**
- » **Under the terms of the warrants, Treasury will agree not to vote any common stock it receives on exercise of the warrants**

redemption will require the approval of the financial institution's primary federal banking regulator.

The preferred stock will be nonvoting except for customary consents and the right to elect two directors if the dividend is not paid for six quarters, whether or not consecutive. The right to elect directors will end when full dividends have been paid for four consecutive dividend periods. In contrast to customary market terms, Treasury's right to elect two directors will be in addition to any directors elected by holders of the other classes of preferred stock. Dividends on common stock and *pari passu* preferred stock will generally not be permitted unless dividends are paid on the preferred stock purchased by Treasury.

Qualifying financial institutions will agree that, unless the preferred stock has been redeemed, they will not increase their common stock dividends or buy back their common stock, subject to certain exceptions, for a period of three years. These terms are more onerous than the norm for capital market preferred securities, but much less onerous than some had feared. We understand that the preferred stock should be accounted for as equity under GAAP and the Treasury term sheet states that it will be treated as Tier 1 capital for regulatory capital purposes.

Warrants. Treasury will receive warrants to purchase a number of shares having an aggregate market price — determined based on a 20-trading day trailing average price at the time of issuance — equal to 15% of the amount of the preferred stock being purchased. This price will range from \$450 million to \$3.75 billion for the nine large systemically important US bank holding companies. The per-share exercise price of the warrants will be equal to the same 20-trading day average price. The amount of the potential dilution from the warrants is limited to a maximum of 10-15% for the smallest of the nine large bank holding companies.

Under the terms of the warrants, Treasury will agree not to vote any common stock it receives on exercise of the warrants. It remains to be seen how Treasury will implement this agreement not to vote any common stock. Qualifying financial institutions generally may prefer, however, that Treasury agree to attend meetings and, by voting on the same basis as other shareholders, neutralize its vote to ensure there is a quorum in shareholder meetings. Treasury will have the right to sell the common stock to the public via a resale shelf registration statement by means of registration or piggyback rights.

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

Under New York Stock Exchange and NASDAQ rules, the warrants cannot give the right to purchase shares in an amount exceeding 19.9% of the issuer's common stock outstanding at the time the warrants are issued unless there is shareholder approval, or an exception to the general rule is invoked, which seems unlikely. Based on publicly available information, this should not present an issue for the large institutions, but could be an issue for some regional and community banks. If a qualifying financial institution is required to obtain shareholder approval under the relevant exchange rules or under state law to authorize a sufficient number of shares for the settlement of the warrants and does not do so, the exercise price will be reduced by up to 45%, in 15% increments every six months. This "penalty" resulting from the absence of shareholder approval may itself create a problem under NASDAQ rules.

The warrants will include customary antidilution requirements. If any required shareholder consent is not obtained within 18 months, or if the qualifying financial institution is no longer publicly traded, the warrants will be exchangeable for senior debt or another security acceptable to

Treasury. This may result in the warrants being treated as liabilities under US GAAP, resulting in volatility in the earnings of participating institutions on account of marking the warrants to market.

Encouragement of Private Investment. The preferred securities will not rank senior to existing preferred stock and will not contain terms prohibiting the issuance of additional preferred or common equity that is *pari passu* or junior to it. In short, the preferred stock will be issued on terms much like those obtainable in the capital markets, other than the dividend step-up and the director and executive compensation restrictions and corporate governance standards discussed below. This should reduce, but perhaps not entirely eliminate, the fear many had expressed that government equity would crowd out private investment. As a further incentive to raise equity in the capital markets, any qualifying financial institution that raises perpetual preferred stock or common stock qualifying as Tier 1 regulatory capital before December 31, 2009, in an amount equal to 100% of the issue price of the preferred stock purchased by Treasury, will have the number of shares underlying the warrants reduced by 50%.

Yesterday's actions, by setting forth the contours of Treasury's investment, are designed to encourage private investment

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

Removing Potential Tax Obstacles. The IRS published two notices yesterday clarifying the tax treatment of the preferred stock and warrants that Treasury will acquire. One notice clarifies that Treasury's purchases under TARP will not be treated as "Federal financial assistance" under Section 597 of the Internal Revenue Code. Without this clarification, there would have been some concern that the price paid by Treasury for preferred stock and warrants could be treated as taxable income to the qualifying financial institutions. A second notice prevents preferred stock, warrants and common stock that Treasury holds following the exercise of warrants from counting towards an "ownership change" under Section 382 of the Code. An "ownership change" generally results in limitations on a company's use of its net operating loss carryforwards and certain other tax attributes, including "built-in" losses that are realized after an "ownership change." Treasury has previously published other notices "turning off" certain aspects of Section 382 in ways that encourage equity investment and facilitate acquisitions of banks. Both from a policy perspective and in certain technical respects, yesterday's notices are consistent with the previous ones. Yesterday's notices indicate that their guidance is subject to change, but any such changes will not apply on a retroactive basis.

Timing. The deadline to elect to participate in the TARP equity purchase program is November 14, 2008.

Senior Executive Compensation Restrictions

Treasury officials have been interpreting TARP to give Treasury a range of discretion in refining the executive compensation rules applicable under different programs and, therefore, observers were particularly curious to see the executive compensation restrictions that Treasury would impose on qualifying financial institutions participating in the capital infusion program. Treasury chose a middle of the road approach, imposing restrictions less stringent than those applicable to failing institutions from which Treasury might purchase troubled assets, but more stringent than the rules applicable to institutions selling troubled assets in Treasury auctions.

Nevertheless, the restrictions under the capital infusion program, which have already been accepted by the nine systemically important bank holding companies after their private meetings with Treasury, will require careful consideration by the many regional and community banks that will be deciding between now and November 14, 2008, whether to participate. A qualifying financial institution must modify existing compensation arrangements to

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

conform with the mandated restrictions and the qualifying financial institution's senior executives must waive any claims against the government as a result of the imposition of these restrictions. These restrictions require qualifying financial institutions to:

- » ensure that senior executive compensation does not encourage excessive risk taking;
- » impose a clawback on compensation paid to a senior executive based on financial results or performance metrics later proved to be materially inaccurate;
- » limit severance benefits to any senior executive to not more than three times the executive's average taxable compensation for the prior five years; and
- » agree not to deduct annual compensation to any senior executive in excess of \$500,000.

In the first instance, there will be corporate governance and business judgment issues for the board and management as they think through the process by which they will decide whether or not to participate

All the limitations above will apply to the CEO, CFO and the next three most highly compensated executive officers of each qualifying financial institution.

The severance benefit restriction limits payments that are contingent upon the involuntary termination of a senior executive, or upon the bankruptcy, liquidation or receivership of the qualifying financial institution, to an amount not exceeding three times the executive's average taxable compensation for the last five years. Thus, for qualifying financial institutions that participate in the capital infusion program, the rules place a limit on, but do not absolutely prohibit, severance payments, as Treasury plans to do in cases involving Treasury purchases of troubled assets directly from systemically significant failing institutions.

The Regional Bank Program

The \$125 billion not allocated to the nine systemically important bank holding companies will be offered to other US banking institutions, including regional

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

and community banks, according to a plan the details of which have yet to be announced. Regional and community banks that are “controlled” by a foreign bank or company are excluded. It is clear that many regional and community banks are in need of capital. The FDIC has 150 banks on its watch list, the highest number since the savings and loans crisis of the late 1980s.

The standardized voluntary program raises a number of considerations for the remaining qualifying financial institutions, especially regional and community banks, that might participate. In the first instance, there will be corporate governance and business judgment issues for the board and management as they think through the process by which they will decide whether to participate. Later on, there will be corporate governance and control issues as they consider the investor relations and other implications of dealing with a passive governmental investor, their free float and, possibly other significant minority investors. There may also be a need for a shareholder vote if the qualifying financial institution is listed and the warrants are for more than 19.9% of the common stock or the company does not have sufficient authorized shares under its charter.

Perhaps most importantly to regional and other banks who may be considering participating in this additional \$125 billion direct investment program, Treasury has not yet made clear which institutions can participate and, if so, at what allocation, if the offer is oversubscribed. So far, Treasury has offered little indication as to the answers to these questions, other than the Secretary’s comments that all “healthy” eligible institutions would be welcome to participate. Developments in the coming days will no doubt provide further clarity on this issue.

Treasury has announced its intention to be a passive investor and that its investment will be minority and non-controlling. One hopes, especially with respect to regional banks, that the Federal Reserve will take into account the existence of Treasury as a shareholder in further revising its views of what is a minority, “non-controlling” investment from the private sector. The goal of encouraging side-by-side private sector investment in regional and community banks would be well served by further flexibility in the Federal Reserve’s control rules.

TARP Equity Upside. The direct capital infusions announced yesterday do not eliminate the equity upside provisions in the TARP program, so any qualifying financial institutions that later sell troubled assets to TARP will be required to

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

provide Treasury with additional equity upside if they receive more than \$100 million under TARP or are party to further direct purchases. It is reasonable to assume that this upside will generally be in the form of warrants with terms like those described above.

The direct capital infusions announced yesterday do not eliminate the equity upside provisions in the TARP program

Bank Failures. As noted above, we understand that the capital injections are only for healthy institutions. Comments by Treasury make it clear that they expect further bank failures, largely at the regional level, despite the capital injections which are reserved for healthy banks and the implementation of TARP. This implies further consolidation among regional banks or deposit purchases by systemically important banks.

FDIC Liquidity Guarantee

The FDIC will guarantee both senior unsecured debt and the unsecured portion of secured debt issued by eligible entities on or before June 30, 2009. The eligible entities are practically all US banking entities, including FDIC-insured banks and thrifts, US bank holding companies, and certain US savings and loan holding companies. This insurance is designed to deal with liquidity, not capital, concerns as senior unsecured debt does not count as regulatory capital for banks.

The insurance program is optional, and all eligible entities will be covered by the program during its first 30 days; after that time, eligible entities must opt out if they do not wish to participate. We believe that eligible entities wanting to participate in the program will likely announce their intent not to opt out to their counterparts and the general public well before the expiration of the mandatory 30-day period. Each of the nine systemically important US bank holding companies receiving funds under the TARP Capital Purchase Program have agreed to participate.

The guarantee cannot exceed 125% of the debt outstanding as of September 30, 2008 that is scheduled to mature before June 30, 2009. The guarantee would cover eligible debt through June 30, 2012, giving eligible entities a strong incentive to issue debt maturing on or prior to that date. Banks taking part in the insurance program will be “subject to enhanced supervisory oversight to prevent rapid growth or excessive risk-taking.” An annualized fee of 75 basis

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

points on the face amount of debt issued under the program applies after the mandatory first 30 days. The FDIC's guarantees under the program do not count against the \$700 billion available to Treasury under the TARP "revolver."

FDIC Deposit Insurance

The FDIC is also providing unlimited insurance for non-interest bearing deposit accounts, mainly payment processing accounts such as payrolls, until December 31, 2009. All FDIC-insured banks and thrifts will be covered by this increased insurance during the first 30 days of the program, after which they may opt out. After those first 30 days, a 10 basis point surcharge on the bank's or thrift's existing insurance premiums will be imposed for accounts in excess of the existing deposit insurance limit of \$250,000.

According to remarks by the FDIC Chairman, this additional insurance was established to avoid closing otherwise viable banks because of deposit withdrawals and to protect "smaller, healthy" banks that have lost payroll accounts to larger banks because of market uncertainties.

Other Recent Developments

In addition to the US government actions outlined above, yesterday the Federal Reserve issued further guidance on its Commercial Paper Funding Facility and Treasury submitted a request for public input on the establishment of its guarantee program for troubled assets under TARP. We will address these developments in separate client memoranda in the near future.

TARP Implementation

After the \$250 billion of TARP funds are issued under the plan announced yesterday, \$450 billion will remain available for the troubled asset purchases originally contemplated by the legislation. It is clear that Treasury is working around the clock to put into place the needed infrastructure for that program. Since the TARP program is a revolver, this amount could increase if not all \$250 billion is used for capital investments or if any of the equity stakes are sold down or redeemed within the TARP purchase period.

Once the key managers are hired and the infrastructure is in place, the pressure will be on for Treasury to show that program purchases can promptly restore confidence in the US banking system. A key factor in the success of TARP is

DAVIS POLK & WARDWELL

Emergency Economic Stabilization Act of 2008: US Government Capital Injections

going to be whether it is successful in balancing the tensions in its competing policy goals: putting a floor on declining real estate values, mitigating foreclosures for homeowners and facilitating a more liquid market for the mortgages and real-estate-related securities and derivatives on the balance sheets of many financial institutions. It is likely that Treasury's purchase program will focus close to the ground, *i.e.*, on whole mortgages and perhaps "other real estate" owned as a result of foreclosures, and on the more plain vanilla varieties of mortgage-backed securities. If these purchases achieve Treasury's stated goal of price discovery under more liquid market conditions, they may shed light on upper-tier securities such as CDOs and CDOs squared and on derivatives such as credit default swaps on mortgage-related securities. One wonders what this would reveal in terms of capital adequacy, particularly in the case of banks that have not been marking to market the mortgages they hold.

Below are hyperlinks to selected federal agency releases issued yesterday:

- » [Term Sheet for TARP Capital Purchase Program](#)
- » [Treasury Press Release on TARP Capital Purchase Program](#)
- » [Fact Sheet on FDIC Temporary Liquidity Guarantee Program](#)
- » [Treasury Executive Compensation Rules](#)

We will continue to monitor developments and issue additional newsflashes and memoranda as facts dictate.

