

Financial Services and Products ADVISORY

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Repurchases of Senior Preferred Stock Held by Treasury: A Critical Decision for CPP Participants

The repurchase of senior preferred stock sold to the U.S. Treasury Department under the Capital Purchase Program (CPP) is coming to the forefront as a critical and possibly unavoidable decision for every banking organization that has participated in the CPP. The importance of this decision was underscored late last week when, after the Federal Reserve released the results of the stress tests for the 19 largest U.S. banking organizations, many of the nine that are not required to raise capital announced (or reiterated) plans to repurchase the senior preferred stock.¹

Basic Considerations for a Repurchase

In much the same way that the stress test results have distinguished the conditions of the 19 largest bank organizations in the United States, the ability to repurchase senior preferred stock offers an opportunity for a banking organization to demonstrate its strength relative to non-repurchasing competitors. A repurchase will signal to shareholders that they do not face any near-term dilution and to potential new investors that the institution is on the upswing. Further, a full repurchase will lift compensation restrictions at an institution and enable it to attract talent from competitors with CPP senior preferred still outstanding.

CPP participants that would be eligible to make repurchases may choose not to do so for valid business reasons—indeed, the reasons for which the CPP originally was designed. The senior preferred stock remains a relatively inexpensive and non-dilutive source of capital to grow a banking institution organically or through acquisitions. If repurchases become more frequent, however, a non-repurchasing CPP participant should consider laying out publicly the strategy behind its retention of the CPP funds.

The requirements for a repurchase are largely regulatory in nature and should be part of any decision of whether to undertake a repurchase. This advisory describes and analyzes the several prerequisites or guidelines that Treasury and the Federal Reserve have in place. As an aid to decision making, we include at the end of the advisory a list of issues that a prospective repurchaser, particularly mid-sized institutions, should be ready to address. To expedite consideration of whether or not to repurchase, the board and management of a CPP participant should be aware of three threshold requirements that can be evaluated almost immediately:

¹ The relationship between possible repurchases of senior preferred stock issued to Treasury and the stress test results and decisions of last week is an important one. The stress test methodology and results are discussed in our companion advisory, also released today, [Supervisory Capital Assessment Program Results and Their Meaning for Other Financial Institutions](#).

- The institution must be sufficiently capitalized and its subsidiary banks well-capitalized immediately after the proposed repurchase.
- The subsidiary bank(s) should have a composite CAMELS rating and a component management rating of 1 or 2. Institutions with a 3-rated bank may also be eligible but face a stiffer challenge.
- After the repurchase, common stock should be the dominant form of Tier 1 capital, and the amount of perpetual preferred stock should exceed the amount of hybrid instruments.

Evolution of Repurchase Requirements

The repurchase of instruments issued under the CPP has always been an important part of the program. Treasury's intent, of course, is that every participant eventually will repurchase the senior preferred stock and warrants it has issued. The standard CPP Securities Purchase Agreement allows for repurchases at any time—but only if the issuer has raised an equivalent amount of Tier 1 capital of the same quality and the issuer's regulator has recommended that Treasury approve the repurchase.²

As part of the preferred stock transactions, Treasury also received warrants in the issuing banking firm. The repurchase of these warrants differs in the standard Purchase Agreement, depending on whether the issuing firm is publicly or privately held.

Many CPP participants were strongly encouraged, if not effectively required, by the regulators of the subsidiary banks to issue senior preferred stock to Treasury. As the business restrictions that accompanied the issuance of senior preferred stock became clearer, and since many participants felt that they had obtained capital they did not need, industry sentiment for relaxation of the repurchase conditions grew.

Congress responded to these concerns in section 7001 of the American Recovery and Reinvestment Act (ARRA), which lifted the across-the-board requirement that a repurchaser raise Tier 1 capital in at least the same amount.³ Treasury issued further guidance on February 26, 2009,⁴ and has continuously provided additional guidance, most recently updated on May 8, 2009.⁵ As of May 5, 2009, 12 institutions had repurchased their senior preferred stock.

² Because the senior preferred stock has been issued almost exclusively at the holding company level, the relevant regulators are the Federal Reserve (bank holding companies) and the Office of Thrift Supervision (savings and loan holding companies).

³ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 520 (2009). Section 7001 amended § 111 of the Emergency Economic Stabilization Act of 2008 (12 U.S.C. § 5221) to include § 111(g), which provides that Treasury shall permit a CPP recipient to repay Treasury “without regard to whether the financial institution has replaced such funds from any other source or to any waiting period....” *Id.*

⁴ Guidance available at <http://www.financialstability.gov/docs/PPP/PPP-FAQs.pdf>.

⁵ Treasury's updated guidance on the CPP program, including discussions related to a firm's repayment, is available at <http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html>. Additional information is also provided in Treasury's FAQs sheet, available at http://www.financialstability.gov/docs/FAQ_CPP-CAP.pdf.

Current Treasury Policy on Repurchases

While section 7001 of ARRA effectively eliminated the replacement capital provision in the senior preferred stock purchase agreements, several Treasury policies remain:

- **Banking Agency Consultation.** Prior consultation with primary federal regulator—Federal Reserve for all bank and financial holding companies, OTS for savings and loan holding companies.
- **Amounts.** At least 25 percent of outstanding CPP preferred stock must be repurchased.
- **Warrants.** Publicly traded firms have the option whether or not to repurchase outstanding and unexercised warrants. Should the firm choose not to repurchase the warrants, Treasury may liquidate registered warrants—but will provide the firm with the first opportunity to repurchase them before being offered to other investors. Warrants will be priced at “fair market value,” and a repurchasing firm will hire an independent advisor to provide a valuation, using standard industry practices, to Treasury. Treasury then will calculate independently its determination of the fair market value of the warrants. Should the two values differ, reference will be made to Section 4.9 of the Securities Purchase Agreement entered into between the firm and Treasury during the initial CPP investment to reach a mutually agreed upon fair market value.

Treasury immediately exercised the warrants issued by privately held institutions and in the process received additional preferred shares. Treasury has required that the two privately held repurchasing firms also repurchase these warrant preferred shares, in order to “fully” have repurchased Treasury’s CPP investment. These repurchases were made at the face value of the warrant preferred shares and represent an amount equal to five percent of Treasury’s investment. This requirement significantly increases the cost to privately held firms seeking to repay Treasury’s CPP investment.

Federal Reserve Rules and Policy

Apart from recent guidance on CPP repurchases, longstanding regulations and policies of the Federal Reserve identify three trigger points that may well apply to repurchases of CPP senior preferred stock. All three thresholds effectively require prior Federal Reserve approval before action is taken—a standard that, on its face, may be higher than Treasury’s “consultation” principle. The triggers are as follows:

- Repurchases (or any other actions) that would reduce consolidated net worth by 10 percent or more.⁶
- Repurchases of Tier 1 capital instruments that permit redemption at the option of the issuing firm.⁷
- Repurchases of Tier 1 or Tier 2 capital instruments before stated maturity—if redemption would have material effect on the repurchaser’s capital base.⁸ The Federal Reserve has not specified a metric for “material.”

⁶ See 12 C.F.R. § 225.4(b)(1).

⁷ See SR 09-4, available at <http://www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm>.

⁸ See 12 C.F.R. part 225, App. A § II.(iii).

In addition to the prior approval thresholds above, the Federal Reserve has explained more recently, in SR Letter 09-4, issued on March 27, 2009, how it will analyze repurchase requests. From these sources, four broad categories of supervisory concerns about repurchasers emerge. A prospective repurchaser may not ultimately be required to but should be prepared to respond to all of the following:

Overall Soundness. Although the Federal Reserve has not explained how it will analyze soundness in connection with a repurchase, soundness was a prerequisite to issue senior preferred stock under CPP in the first place, and essentially the same analysis should apply here. Moreover, soundness is a bedrock principle in all banking regulation. Based on other areas of bank regulatory attention we expect that repurchase eligibility would extend almost exclusively to any organization whose subsidiary banks all have both a composite CAMELS rating and a component management rating of 1 or 2.

Capital Adequacy. There are likely several elements to this category. The obvious starting point is a snapshot of an institution at the time of repurchase, including the three established thresholds above. The Federal Reserve may take other capital guideposts into account as well and that can be assessed with current information.

First, a banking firm should be able to show that, after the repurchase, common stock is the dominant form (i.e., more than 50 percent) of Tier 1 capital and that the amount of perpetual preferred stock in Tier 1 exceeds the amount of hybrid instruments in Tier 1.

Second, since a repurchase here almost certainly will result in a net reduction in capital during a quarter, a requester should be prepared to demonstrate that it will remain well-capitalized immediately after the repurchase.

Third, a principle for dividends is that the amount paid should not exceed net income for the past four quarters, net of dividends or other cash distributions to shareholders during that period. Whether the Federal Reserve would expand this policy to cover repurchases remains to be seen.

Looking forward, the Federal Reserve will assess a requestor's continuing capital position in several ways. An institution can expect to provide financial projections at least through the end of 2010 that show continuous well-capitalized status, even in an adverse scenario. The institution will have to demonstrate that it can raise additional common stock or other Tier 1 capital. The institution also should plan to demonstrate that its prospective rate of earnings retention is consistent with capital needs and overall current and prospective financial condition. Additionally, trends in capital levels and in net income after any dividends are likely to play an important role in the Federal Reserve's assessment.

Ability to Lend. This category appears to mean primarily the ability to obtain debt financing. Treasury has, for example, required that any of the 19 largest institutions planning to repurchase senior preferred stock must raise five-year unsecured debt that is not guaranteed by the FDIC.⁹ The amount of this debt is not specified but "should be sufficient to demonstrate a capacity to meet funding needs independent of government guarantees."¹⁰ The same requirement is not practical for most institutions outside the top 19, but a potential repurchaser should be prepared to show its ability to access the debt market. One straightforward measurement would be the current rating on any outstanding unsecured debt that is not guaranteed by the FDIC.

⁹ We note that any five-year paper is automatically not supported by the federal government; the one program to support such financing is the FDIC's Temporary Liquidity Guarantee Program, which covers unsecured debt with a maximum maturity of three years.

¹⁰ Joint Statement by Treasury, Federal Reserve, FDIC and OCC (May 6, 2009).

Three other factors are likely to play a role in the assessment of the ability to lend. First, since TARP and CPP were designed to stimulate lending, an institution should be in a position to show how its lending increased after receipt of CPP funds and how the repurchase is unlikely to result in diminished lending. Second, liquidity can be a limiting factor, and a prospective repurchaser should be able to demonstrate that it has (and will have) sufficient liquidity to maintain or expand its lending business. Of course, an organization with subsidiary banks that satisfy the overall soundness concerns above is likely to have shown adequate liquidity already. Third, earnings and earnings trends are typically an important determinant of expansion or contraction in lending operations; current and projected earnings should show that a repurchaser will be able at least to continue its lending business on the current scale.

Internal Capital Planning Process. Every banking organization already is required to have a robust set of procedures for managing capital adequacy. An institution's capital planning process should take into account several risks, and, in the current environment, liquidity risk should be a significant concern. In assessing the strength of capital planning, the Federal Reserve will look to several factors that the process should cover, including asset quality, the potential for unanticipated losses, liquidity and credit commitments, earnings capacity, cash flow, ability to serve as a source of strength for subsidiary banks, composition and quality of capital, and the ability to raise additional capital.

Conclusion

Whether or not to repurchase senior preferred stock from Treasury is a critical, yet complicated, decision for the board and management of every banking institution that issued such stock. Maintenance of capital sufficiency immediately after the repurchase is just the starting point. Applicants are likely to have to show continued sufficiency even under adverse conditions, as well as sufficient liquidity and risk management. Board and management assessments and conclusions on these and other elements of a repurchase will have to be documented carefully.

The Repurchase Decision – Matters for Board and Management Consideration

Conditions At or Immediately After Repurchase

- Is the subsidiary bank (or banks) well-capitalized?
- Does the holding company have sufficient capital?
- Is common stock the dominant form of Tier 1 capital?
- Does perpetual preferred stock exceed the amount of hybrid instruments in Tier 1?
- Will the repurchase reduce consolidated net worth by less than 10 percent?
- Is the amount of the repurchase less than net earnings over the last four quarters, or if not, do future earnings indicate an ability to cover the amount of the repurchase?
- Can the firm demonstrate the ability to issue debt not guaranteed by the FDIC, either through an issuance or through an objective measurement?
- Does the institution have a robust capital assessment process, and has its management of capital been free from supervisory comments?

Conditions in the Future

- Will the subsidiary bank (or banks) remain well-capitalized at least through December 31, 2010?
- Similarly, will the holding company maintain sufficient capital through December 31, 2010?
- Will the organization be able to raise Tier 1 capital and issue debt through December 31, 2010?
- Are the institution's earnings and liquidity trending upward?
- Has the institution increased its lending with the CPP funds and can it maintain that level of lending after the repurchase?

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