

## A WEEK OF DEVELOPMENTS FOR THE U.S. FINANCIAL SYSTEM

February 28, 2009

To Our Clients and Friends:

This has been a week filled with regulatory pronouncements and developments for the U.S. financial system. On February 23, 2009, amid growing market concern, the U.S. Department of the Treasury (the “Treasury”) and the federal banking agencies issued a joint statement, pronouncing that the U.S. government stands firmly behind the banking system.

On February 24, 2009, the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued guidance on the payment of dividends, stock redemptions and stock repurchases by bank holding companies, including those receiving public funds.

On February 25, 2009, the Treasury and the federal banking agencies released the parameters of the capital assessment or stress test exercise for the major U.S. banking organizations and the details of a convertible preferred security to be purchased by the Treasury under the Capital Assistance Program (“CAP”) to supplement the original announcement of these measures made on February 10, 2009.

On February 26, 2009, the Obama Administration submitted its 2010 budget blueprint to Congress, including a reserve of \$250 billion for losses arising from the possible deployment of an additional \$750 billion in assistance to the financial system.

On February 27, 2009, the Treasury announced that subject to certain conditions, it would participate in a Citigroup proposal to convert a portion of its preferred stock to common equity alongside other preferred holders.

This memorandum discusses each of these developments.

### FEBRUARY 23 JOINT STATEMENT

Amid a mounting chorus of concern for the financial health of major U.S. financial institutions and the risk of nationalization, the Treasury and the federal banking agencies on February 23, 2009, issued a joint statement, pronouncing that “[t]he U.S. government stands firmly behind the banking system during this time of financial strain” and reiterating the determination of the U.S. government “to preserve the viability of systemically important financial institutions so that they are able to meet their commitments.” The latter statement in particular seems designed to reassure the markets that the U.S. government will not permit systemically

important financial institutions to fail. The joint statement also referred in broad outline to the terms of the CAP that were to be released on February 25, 2009. In response to recent calls for clarification of the government's intent with respect to financial institutions that might require further federal assistance, the joint statement affirmed that "[b]ecause our economy functions better when financial institutions are well managed in the private sector, the strong presumption of the Capital Assistance Program is that banks should remain in private hands." Subsequent events in the week would serve to place this statement in higher relief.

#### FEDERAL RESERVE GUIDANCE

The Federal Reserve, in a supervisory letter issued on February 24, 2009, updated and significantly expanded prior guidance on the payment of dividends and the repurchase or redemption of capital instruments by bank holding companies. The supervisory letter indicates that the Federal Reserve now expects a bank holding company to consult with the Federal Reserve before: (i) declaring and paying a dividend that could raise safety and soundness concerns (*e.g.*, declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid); (ii) redeeming or repurchasing regulatory capital instruments when the bank holding company is experiencing financial weaknesses; or (iii) redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase would occur.

With respect to dividend payments, the supervisory letter indicates that, as a general matter, a bank holding company should "eliminate, defer or severely limit" its dividends if: (i) the bank holding company's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the bank holding company's prospective rate of earnings retention is not consistent with the bank holding company's capital needs and overall current and prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. But significantly, the supervisory letter also states that paying a dividend that exceeds earnings for the period for which the dividend is being paid may rise supervisory concerns and hence prior regulatory consultation is now required.

With respect to redemptions and repurchases of capital instruments, the supervisory letter notes that prior approval from or consultation with the Federal Reserve is already required in some instances under existing regulations (*e.g.*, for the redemption of perpetual preferred or trust preferred securities included in Tier 1 capital). The supervisory letter further states that a bank holding company experiencing financial weakness or at significant risk for developing financial weakness should consult with the Federal Reserve before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration.

The supervisory letter also includes guidance on dividend payments by bank holding companies participating in the Treasury's Capital Purchase Program ("CPP") and other government capital programs. Bank holding companies are discouraged from using the proceeds of the CPP or other government capital programs to pay dividends on trust preferred securities or to repay debt obligations. If the financial condition of the bank holding company deteriorates significantly, the supervisory letter indicates that it may be appropriate for the company to cease paying dividends on its preferred and trust preferred securities. This guideline was apparently issued in anticipation of the actions that would be taken later in the week with respect to Citigroup.

## CAP

On February 25, 2009, the Treasury released the details of the convertible preferred security to be available under the CAP. At the same time, the federal banking agencies issued guidance on the capital assessment process that would be required for major U.S. banking organizations. The CAP is a successor and supplement to the \$350 billion CPP, which was originally implemented by the Treasury in October 2008 under the provisions of the Emergency Economic Stabilization Act of 2008. The CAP builds and expands upon the CPP. The first element of the CAP, as articulated by the Treasury, is a forward-looking capital assessment "to determine whether any of the major U.S. banking organizations need to establish an additional capital buffer during this period of heightened uncertainty." The second element of the CAP is access for "qualifying financial institutions" (a term defined under the CAP in a manner substantially similar to the term as defined under the CPP) to a form of contingent common equity to be provided by the Treasury "as a bridge to private capital in the future."

## Capital Assessment

Under the capital assessment (popularly known as the "stress test"), the federal banking supervisors are undertaking a coordinated capital "planning" exercise with each of the 19 major U.S. banking organizations with assets exceeding \$100 billion. The exercise will involve a forward-looking capital assessment to estimate the range of possible future losses and the resources of each such institution, including pre-provision net revenue and allowance for loan losses, to absorb losses over a two-year period. Each institution will be required to analyze potential firm-wide losses, including in its loan and securities portfolio, as well as from off-balance sheet commitments and contingent exposures, such as implicit and explicit liquidity and credit commitments. Institutions with trading assets of \$100 billion or more will be required to estimate potential trading-related losses under the stress test scenarios.

The stress test assessment will cover two economic scenarios: a baseline scenario and a more adverse scenario. The baseline scenario is based on an average of private-sector economic forecasts and projects GDP growth to be -2% in 2009 and 2.1% in 2010, an unemployment rate of 8.4% for 2009 and 8.8% for 2010, and house price declines of 14% in 2009 and 4% in

2010. The more adverse scenario reflects a deeper and longer recession than in the baseline scenario and assumes 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 house price declines of 22% in 2009 and 7% in 2010. The federal banking agencies will determine the amount of regulatory capital necessary for each institution to hold to remain well capitalized under the more adverse scenario.

An institution that the federal banking agencies conclude requires additional capital will enter into a commitment to issue a convertible preferred security (“Convertible Preferred”) to the Treasury under the CAP. The institution will have up to six months to raise private capital to meet the capital requirement and will be able to cancel the capital commitment under the CAP without penalty if it is able to raise private capital.

#### Contingent Common Capital - Convertible Preferred

The CAP Convertible Preferred will be available to the 19 institutions undergoing the forward-looking capital assessment as well as any other “qualifying financial institution” (“QFI”).<sup>1</sup> The Treasury has indicated that eligibility for the CAP will be consistent with the criteria and deliberative process established for QFIs under the CPP.

The issuance of the Convertible Preferred will meet the “Qualified Equity Offering” test under the CPP, allowing the proceeds of the Convertible Preferred to be used with supervisory approval to redeem the preferred shares sold to the Treasury under the CPP and to reduce the number of shares of common stock underlying the warrants issued under the CPP.

The amount of Convertible Preferred to be issued will be between 1% and 2% of the risk-weighted assets of the QFI, plus an additional amount of Convertible Preferred to the extent used to redeem the preferred shares sold under the CPP. With the approval of the appropriate federal banking agency, an institution may seek “exceptional assistance” and issue Convertible Preferred in an amount in excess of the above solely at the discretion of the U.S. Treasury. Exceptional assistance may be subject to additional terms and conditions.

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<sup>1</sup> *Qualifying Financial Institution means (i) any U.S. bank or U.S. savings association not controlled by a Bank Holding Company (“BHC”) or Savings and Loan Company (“SLHC”), (ii) any top-tier U.S. BHC, and (iii) any top-tier U.S. SLHC which engages solely or predominately in activities that are permitted for financial holding companies under relevant law. QFI shall not mean any BHC, SLHC, bank or savings association controlled by a foreign bank or company. For purposes of this program, “U.S. bank,” “U.S. savings association,” “U.S. BHC” and “U.S. SLHC” means a bank, savings association, BHC or SLHC organized under the laws of the United States or any state of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa or the Virgin Islands.*

The Convertible Preferred will convert under three circumstances: (1) mandatorily seven years after issuance; (2) in whole or in part at any time at the option of the QFI with the approval of its primary federal banking agency; or (3) at the option of the holder upon specified corporate events, such as certain sales, mergers or changes of control of the QFI.

In each instance the conversion price will be 90% of the average closing price for the common stock for the 20-day trading period ending February 9, 2009 (“Conversion Price”). The Conversion Price can be reduced by up to 45% if any required shareholder consent is not obtained within 18 months.

The dividend rate on the Convertible Preferred will be 9% per annum, compounded quarterly, but will increase to 20% per annum on the six-month anniversary of the issue date if any required consent of the QFI shareholders is not obtained by that date.

The QFI may redeem the Convertible Preferred at any time with the approval of its primary federal banking agency. The Convertible Preferred will be redeemable at par (plus accrued and unpaid dividends) for the first two years. Thereafter, the Convertible Preferred will be redeemable for par (plus accrued and unpaid dividends) or the as-converted value, whichever is greater. The QFI must pay the redemption price from additions to retained earnings or with cash proceeds from common stock issuances which result in aggregate gross proceeds to the QFI of not less than 25% of the issue price of the Convertible Preferred. Following the redemption in whole of the Convertible Preferred, the QFI may repurchase the warrants and any common stock then held by the Treasury at fair market value.

For so long as any Convertible Preferred or any common stock issued under the CAP is owned by the Treasury, dividends on the common stock of the QFI will be limited to \$0.01 per share per quarter unless the Treasury consents to a higher amount. During this period, the QFI will require the Treasury’s consent for any repurchases of equity securities or trust preferred securities subject to certain exceptions.

The Convertible Preferred will have no voting rights prior to conversion, other than standard class voting rights on the authorization or issuance of shares ranking senior, on amendments to the rights of the Convertible Preferred, and on any merger, exchange or similar transaction which would adversely affect the rights of the Convertible Preferred. If dividends are not paid in full on the Convertible Preferred for six dividend periods, the Convertible Preferred will have the right to elect two directors.

Upon conversion of the Convertible Preferred, the Treasury will have voting rights associated with the common stock. The Treasury has said that it will publish a set of policies governing its use of these voting rights. The Treasury has also said that investments made under the CAP will be placed in a separate trust set up to manage the government’s investments in

financial institutions. The objective of the trust will be to protect and create value for the taxpayer as a shareholder over time.

The Treasury will receive warrants for shares of common stock having an aggregate market value based on the Conversion Price equal to 20% of the Convertible Preferred amount. The initial exercise price and price for determining the number of shares of common stock subject to the warrants will be the Conversion Price, subject to customary anti-dilution adjustments.

The term of the warrants will be ten years. The warrants will be immediately exercisable in whole or in part. As in the CPP, the warrants will not be subject to any restrictions on transfer and the Treasury will agree not to exercise voting power with respect to any shares of common stock issued under the warrants. If a QFI does not have sufficient available common stock to reserve for issuance upon conversion of the Convertible Preferred and the exercise of the warrants or if shareholder approval is required under applicable stock exchange rules, the QFI will be required to call a meeting of its shareholders as soon as practicable after the date of the investment to obtain the required shareholder approval.

By participating in the CAP, the QFI agrees to comply with the executive compensation requirements of the Emergency Economic Stabilization Act of 2008, as recently amended by the American Recovery and Reinvestment Act of 2009.<sup>2</sup>

The QFI will also be subject to enhanced transparency and accountability conditions. Prior to receiving capital under the CAP, the QFI must submit a plan showing how it intends to use the capital to preserve and strengthen its lending capacity. Any QFI receiving capital will be required to submit monthly reports detailing its lending broken out by category, along with an estimate of what its lending would have been absent the CAP. All information disclosed to the Treasury will be publicly available online.

## 2010 BUDGET BLUEPRINT

The 2010 budget blueprint released by the Obama Administration on February 26, 2009, includes a \$250 billion “contingent reserve for further efforts to stabilize the financial system.” This contingent reserve is an estimate of the net cost to the government of future financial support. The budget document indicates that estimates of the value of the financial assets acquired by the federal government to date suggest that the government will recover approximately two-thirds of the money spent on purchasing the assets. The contingent

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<sup>2</sup> For a discussion of the amendments made by the American Recovery and Reinvestment Act of 2009, please see *Brave New World: New Executive Compensation Restrictions for Companies Participating in the Troubled Asset Relief Program (TARP)*, Debevoise & Plimpton LLP Client Update, February 17, 2009.



reserve of \$250 billion thus reflects the estimated net cost to the government of \$750 billion in additional asset purchases. This reserve does not represent a specific budget request at this time.

#### CITIGROUP EXCHANGE PROPOSAL

On February 27, 2009, Citigroup announced a plan to convert through a series of exchange offers up to \$52.5 billion of its existing preferred and trust preferred stock into common stock. The conversion is designed to increase Citigroup's tangible common equity without any additional U.S. government investment.

Citigroup has said that it will offer to exchange common stock for up to \$27.5 billion of its preferred securities and trust preferred securities at a conversion price of \$3.25 a share. The U.S. government has indicated that it will match this exchange dollar-for-dollar, up to a maximum of the \$25 billion of preferred stock issued under the CPP at the same conversion price. The conversion of the privately placed preferred securities and the Treasury's CPP preferred securities will be based on their liquidation preference. The conversion of the publicly issued preferred securities will be based on an as yet unspecified percentage of their face value.

Any remaining Citigroup preferred stock issued under the CPP that is not converted into common stock, as well as all other Citigroup preferred stock owned by the U.S. government (*i.e.*, the \$20 billion of preferred stock issued to the Treasury under the Targeted Investment Program and the \$7 billion of preferred stock issued to the Treasury and the Federal Deposit Insurance Corporation in connection with the guarantee of certain Citigroup assets), will be converted into trust preferred securities with an 8% cash dividend that will be structurally senior to the existing preferred stock.

Assuming the maximum eligible conversion, the U.S. government would own 36% of Citigroup's outstanding common stock. Citigroup's existing common shareholders would own approximately 26% of the outstanding common stock with the common stock that would be exchanged for non-government owned preferred stock accounting for the remaining 38%. Subject to applicable legal requirements, it is anticipated that the Treasury will hold the interim securities and the common stock in a trust.

Participating holders of publicly issued preferred stock and trust preferred stock will receive shares of Citigroup's common stock in the exchange. The Treasury and participating holders of privately placed preferred stock will receive interim securities and warrants. The interim securities will convert into common stock after shareholder approval to increase Citigroup's authorized common stock. If such approval is not obtained within six months after issuance of the interim securities, the warrants will give the holders the right to purchase Citigroup's

common stock for \$0.01 per share and the interim securities will pay a 9% dividend that will increase by 2% every quarter until it reaches 19%.

Citigroup has undertakings from the holders of approximately \$12 billion of the privately placed preferred stock that they will participate in the exchange. The Treasury's participation is conditioned upon at least \$11.5 billion of the privately placed preferred stock participating in the exchange.

In connection with the exchange, Citigroup will suspend all dividends on both its preferred stock (other than its trust preferred stock) and common stock. The Citigroup board of directors will also be reconstituted so that a majority of its 15 members will be independent directors.

Please feel free to contact us with any questions.

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