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U.S. Treasury's Capital Purchase Program for Mutual Banks and MHCs

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Overview

- Capital infusion from U.S. Treasury Department under TARP Capital Purchase Program (CPP).
- 4th and 5th tranches of CPP (SEC Reporting / Non-Public QFIs and S Corps).
- As of April 20th more than 500 QFIs have taken $198.9 billion; ranging from $300k -$25 billion; and $198.4 million has been repaid.
- Investment in form of Subordinated Debt (30 year, non-voting, 7.7%-13.8%) or Preferred Stock (plus Warrants).
- Amount available: 1-3% of risk weighted assets up to $25 billion.
- Based on Treasury's public term sheets.
- Available to: 1) Mutual Banks, 2) 2-Tier MHCs Public, 3) 2-Tier MHCs Private, and 4) Single-Tier MHCs.

Prior CPP Securities Structure

Public Company CPP:

- "Exploding Rate" preferred stock (5% dividend for 5 years, 9% thereafter).
- 10 year warrant for common stock with value of 15% of preferred stock.

Private Company CPP:

- In order to avoid government ownership of common stock of private company, warrant covers preferred stock equal to 5% of investment.
- Warrant preferred at 9% dividend.
- Warrant exercised immediately, resulting in after-tax cost (assuming 5 year redemption) of 6.45%.

Reasons For Mutual / MHC CPP Structure

- Mutuals (banks and holding companies) cannot issue equity securities - result, debt is used instead of preferred stock.
- MHCs in 2-Tier structure have ability to issue equity like other stock banks and holding companies – result, preferred stock is used.
- Interest on debt is tax deductible - result, UST "tax effected" the interest rate (5% to 7.7% and 9% to 13.8%) on the debt.
- Tier 2 capital treatment for mutual banks is function of no holding company and other factors.

Eligibility / Issuer

- Any U.S. bank holding company or savings and loan holding company or U.S. bank or thrift.
- Cannot be owned or "controlled" by foreign entity.
- MHCs - Must apply to federal regulator by May 7.
- Mutual Banks – Must apply to federal regulator by May 14.
- No need to reapply unless material change in risk weighted assets from original application.
- UST determines after consulting with primary federal regulator - "troubled" or "4" rated banks likely to be denied.

Four Types of “Mutual” Issuers

1) Mutual Banks

2) Single Tier MHCs (Private)

3) 2-Tier MHCs (Private) – Not exchange listed

4) 2-Tier MHCs (Public) – Exchange listed

Mutual Banks - "Senior Securities"

Type:	Subordinated Debentures ($1,000 par, per note) and Warrants for subordinated debt.
Ranking:	Senior to any equity instrument, junior to deposits and general and secured creditors.
Maturity:	30 years.
Rate:	7.7% first 5 yrs, 13.8% thereafter.
Capital:	Tier 2 – only helps risk-based ratios.

Mutual Banks - “Senior Securities”

Voting:	Non-Voting BUT class voting for issuance of equity / capital instruments; amendments or transactions adversely affecting rights.
	UST may elect 2 directors if 6 payments missed.
Redemption:	100% of par, plus any accrued/unpaid interest.
	Subject to approval of federal regulator.
Repayment:	Immediate upon receivership.

Mutual Banks - "Senior Securities"

Repurchases: For first 10 years - No repurchases of any equity /capital securities without UST consent (except for benefit plans consistent with past practice) unless Senior Securities and Warrants are redeemed or transferred to 3rd party.

No repurchases unless accrued and unpaid interest is paid.

After 10 years, no repurchases unless all Senior Securities and Warrants have been redeemed or transferred to third parties.

Mutual Banks - “Senior Securities”

Dividends:	No dividends unless accrued and unpaid interest on Senior Securities has been paid.
	For first 3 years – No increase in regularly paid dividends on equity / capital securities without UST’s consent.
	After year 10 - No dividends on equity/capital securities (or repurchases) until all Senior Securities and Warrants are redeemed.
Deposits:	From year 3 to 10 – UST consent for “extraordinary dividends” on deposit accounts (payments in excess of the stated rate.
Transfer:	Freely transferable by UST. UST will use commercially reasonable efforts not to transfer if it will result in SEC reporting by issuer.

Mutual Banks - Terms of Warrants

Rate:	13.8% payable quarterly.
Amount:	5% of Senior Securities.
Exercisable:	Immediately; UST intends to exercise immediately on "cashless" basis – increases cost.
Redemption:	Redeemable after Senior Securities redeemed.
Reduction:	If QFI receives gross proceeds of 100% of Senior Securities in "Qualified Equity Offering" by 12/31/09 then Warrants are reduced by 50%
Transfers:	Freely transferable.

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Single Tier MHCs - "Senior Securities"

Type:	Subordinated Debentures ($1,000 par, per note) and Warrant (5% of Senior Securities) issued by MHC.
Terms:	Essentially same as mutual bank Senior Securities.
Differences:	Tier 1 capital.
	Interest Deferral – may defer up to 20 quarters with interest accruing and compounding. If interest is deferred, no dividends may be paid on equity/capital securities (could be oversight).
	Immediate repayment upon receivership of major bank subsidiary or more than 20 quarters of deferrals.

Interest on Senior Securities-Mutuals and Single-Tier MHCs

- 7.7% - First 5 years.
- 13.8% - After 5 years (Objective – encourage repayment).
- Payable quarterly.
- Tax deductible.
- May defer up to 20 quarters. Term sheet does not allow mutual bank deferral.
- Interest cumulates and compounds for deferrals.

Example-Senior Securities for Mutuals and Single-Tier MHCs

Bank with $500M risk weighted assets, 3% participation:

- $15 million senior securities (15,000 of $1,000 Notes).
- $750,000 warrants/notes (750 of $1,000 Notes).
- Must repay $15,750,000.
- 5 year weighted interest rate: 9.22%
  (assumes all securities are redeemed at 5th year)

2-Tier MHCs (Non-Public) - Preferred/Warrants

Type:	Preferred Stock and Warrants for preferred.
Ranking:	Senior to common stock, pari passu to existing preferred unless explicitly junior in terms.
Maturity:	Perpetual.
Rate:	5% first 5 yrs, 9% thereafter, cumulative.
Capital:	Tier 1.
Voting:	Non-Voting unless issuance of equity senior to preferred, amendments or any transaction adversely affecting rights of preferred stock.
	UST may elect 2 directors if 6 payments missed.

2-Tier MHCs (Non-Public)-Preferred/Warrants

Deferral:	None.
Redemption:	100% of issue price, plus accrued dividends. Subject to approval of federal regulator.
Repayment:	No comparable receivership provision.
Transfer:	Freely transferable unless transfer causes SEC reporting by issuer.
Repurchases:	First 10 years - No repurchases of any equity securities or trust preferred without UST consent (except for benefit plans consistent with past practice).

2-Tier MHCs (Non-Public)-Preferred/Warrants

Dividends,
Repurchases: No dividends on or redemptions of junior preferred / common stock unless Preferred Stock is paid and current.

First 3 years – No increase in dividends on common stock unless UST consents.

Years 4 to 10 – No increase in dividends on common stock more than 3% unless UST consents.

After 10 years: No dividends on or repurchases of common stock until redemption.

All dividend / repurchase limitations lifted upon redemption or transfer to 3rd party.

2-Tier MHCs (Non-Public) - Terms of Warrants

Type:	Right to purchase Warrant Preferred Stock for $0.01 per share, with 5% liquidation preference.
Terms:	10 year term, other rights / restrictions same as Preferred Stock except 9% cumulative dividend.
Exercisable:	Immediately; UST intends to exercise immediately – increases cost.
Redemption:	Redeemable after Preferred stock redeemed.
Reduction:	If QFI receives gross proceeds of 100% of Preferred Stock in "Qualified Equity Offering" by 12/31/09 then Warrants are reduced by 50%.
Transfers:	Freely transferable unless causes SEC reporting.

2-Tier MHCs (Public)–Senior Preferred/Warrants

Terms: Basically same as Preferred Stock and Warrants for MHCs (Non-Public) except:

Warrant is for purchase of amount of common stock equal to 15% of Senior Preferred Stock, with exercise price based on 20 day trading price.

UST not intending to exercise Warrant immediately.

QFI must file SEC shelf registration statement covering the Senior Preferred as promptly as practicable.

2-Tier MHCs (Public)–Senior Preferred/Warrants

Terms: QFI will hold a stockholder vote or take any other measures required to permit the issuance of the common stock underlying the Warrant.

If QFI no longer listed on an exchange then may substitute OR cannot get the vote of stockholders within 18 months then Subordinated Debt will be substituted (or some other economic equivalent as determined by UST).

Restrictions Applying To All QFIs

American Recovery and Reinvestment Act of 2009 (ARRA)

Imposes additional restrictions on any TARP recipient.

In addition to dividend and repurchase restrictions, ARRA imposes additional restrictions while TARP securities (not Warrants) are outstanding and held by UST:

1) Executive compensation restrictions.

2) Related party restrictions.

3) Regulatory reporting requirements.

Executive Compensation Restrictions

General Rule: No payment or accrual of any bonus, retention award or incentive compensation to certain officers depending on size of TARP investment:

$25M or less – highest paid.
$25-250M – 5 highest paid.
$250-500M – senior officers + 10 next highest paid.
$500+ - senior officers + 20 next highest paid.

Exceptions: Restricted stock awards up to 1/3 of annual compensation that do not fully vest during TARP period and bonuses under employment contracts made before February 11, 2009.

Issues: Definition of "incentive compensation," effect on SERPs and pensions.

Executive Compensation Restrictions

General Rule: No "golden parachute" severance payments for senior executives and next 5 highest paid.

Not 280G standard – means NO payment for any reason upon departure of officer.

Accrued and vested benefits (pensions and SERPs) generally not restricted.

UST regulations clarifying restrictions not yet issued.

Executive Compensation Restrictions

General Rule: No "unnecessary or excessive risk taking."

Benefit plans cannot encourage unnecessary or excessive risk or manipulation of earnings.

General Rule: "Clawback" of incentive compensation paid to senior executives and next 20 highest paid if based on financial statements that are "materially inaccurate."

Not size related.

General Rule: $500,000 deduction limit, deductions not allowed for compensation paid in excess of $500,000.

Executive Compensation Restrictions

General Rule: Limitation on luxury expenses, must adopt company-wide policy limiting excessive or luxury expenses, certain area must be covered by policy.

General Rule: Board Compensation Committee. Must establish committee of independent directors to review all compensation plans, must meet at least 2x a year.

General Rule: CEO and CFO must provide written certification of compliance with requirements.

General Rule: Stockholder vote on executive compensation. Must permit separate non-binding vote to approve executive compensation. Does not overrule Board or imply any additional fiduciary duties.

Executive Compensation Restrictions

- Must modify or terminate all benefit plans, arrangements and agreements that do not comply. (Need both company and executive agreement)

Regulatory Restrictions and Reporting

- FDIC – New directive to maintain records regarding lending and use of proceeds.
- OTS – New holding company "source of strength" agreement required.
- Business/capital plan may be required in the event of redemption.
- SIG TARP requires description of use of funds.

Affiliate Transaction Restrictions

- Applies while senior securities outstanding.
- Applies to new "transactions" ($120,000+) with "related parties" (executive officer, director, 5% holder, immediate family). (See SEC Reg. S-K Item 404).
- Terms and conditions must be at least as favorable as those for unaffiliated third parties.
- Must be approved by audit committee or independent directors, if no independent directors – must be approved by board and records maintained.

Application Process

- Must apply by May 7, 2009 or May 14, 2009.
- Apply to holding company regulator AND federal regulator of largest bank.
- If previously applied, no need to reapply.
- Application does not commit company/bank to issue.
- Processing time for approval has been varied.
- Will have 30 days from approval to commit to issue.

Capital Alternatives

- Holding company debt – market has tightened except for refinancings covered by DGP.

- Trust preferred – market is effectively closed.

- Common stock:
  - Valuations are low
  - MHC Market non-existant

Final Analysis / Considerations

- Is cost justified?
- How much leverage is necessary?
- Post-investment monitoring of funds.
- Should review, modify and certify compensation arrangements.
- What is effect on mergers, sales, attracting new capital?
- Potential risk of additional restrictions.

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