

# Goodbye CPP, Hello CAP: The Risks and Benefits of Treasury's Newest Capital Infusion Program

If your bank is looking to raise capital -and has been stymied by the frozen debt markets-Treasury's [new CAP program](#) may be an alternative. The good news: Unlike the CPP program, you'll be able convert the preferred shares into common equity shares, and the warrant coverage is better than anything you'll find privately. The bad news: Those same conversion and warrant exercise provisions will dilute your existing common shares, which may make it more difficult to raise common stock in the future.

Plus the money is more expensive (9% for CAP vs. 5% for CPP). And there are a host of restrictions most banks will find onerous:

- You must submit a plan that details how you intend to use the capital to increase lending above levels that would have been possible without the government help.
- Recipients must submit monthly reports to Treasury, which will be made public, that show your bank's lending broken out by category. You must include the number of new loans made and how many asset-backed and mortgage-backed securities were purchased.
- Forget repurchasing shares or pursuing cash acquisitions of healthy firms until you repay the government.
- Don't even think of paying quarterly stock dividend payments. Any dividend in excess of \$0.01 per share requires Treasury's approval.
- Add to that the executive compensation and corporate governance limits that already affect CPP recipients.

"At the end of the day, I don't think there will be a rush to apply for the CAP," says attorney Angelee Harris of Manatt, Phelps & Phillips, in Costa Mesa, Calif. "I think when you look at it, it's more expensive," she says. The additional strings attached to getting the money, particularly the inability to pay dividends, will deter most of her banking clients.

Joseph M. Harenza, CEO and managing director of the Griffin Financial Group in Reading, Pa, says "uncertainty is the major issue" for not applying. Harenza say there are too many unanswered questions about the potential of stress tests and "Big Brother" government regulations. He is also worried about rules Congress may impose in the future.

Treasury, for instance, has not yet indicated how it will use its common stock voting rights under the CAP program, though the government says it will publish "a set of principles governing its use of these rights prior to closing any transactions." Depending on how much preferred stock is converted to common stock, Treasury

could end up as a significant shareholder in some banks.

Treasury describes the CAP program as access "to contingent common equity provided by the U.S. government as a bridge to private capital in the future."

As part of CAP, the country's 19 biggest bank holding companies (assets of \$100 billion or more) are each undergoing stress tests now. If regulators determine that a bank does not have enough of a capital buffer to survive severe economic conditions, they will give it six months to raise the money privately. Then the bank can get a CAP infusion. Banks will have little recourse to argue with the stress test conclusions. The government notes that the [stress tests](#) are "subject to the same framework used for bank examinations or bank holding company inspections."

Harris says she wonders if Treasury intentionally tightened the rules for CAP recipients "to motivate the banks" to raise the money privately.

Treasury notes in a [white paper](#) on the program that any additional capital required as a result of the stress test "does not represent a new capital standard and is not expected to be maintained on an ongoing basis." The government capital is limited to a minimum of 1% of the institution's total risk weighted assets and to a maximum of 2% of total risk-weighted assets (plus any amount of CAP preferred shares needed to redeem shares held under CPP). Any bank that needs more capital than the limit will be labeled as an institution in need of "exceptional assistance."

Struggling smaller banks can't access the new capital at all if they don't pass regulator scrutiny, whether through a stress test or other capital examination. It isn't clear yet whether regulators will require stress tests for banks whose assets are below \$100 billion. Government documents indicate that such banks will merely be subject to the "deliberative process" established for the CPP program, now referred to as TARP 1.

Harenza says he is advising bankers to talk to regulators and figure out alternatives to raising capital, rather than applying for the CAP money. Suspend your dividends, enhance your dividend reinvestment program, "look at other ways," he suggest. "On balance, I don't see a lot of community banks screwing around with this unless they don't have a choice," he says.

Still, he notes, "there's just no capital out there right now." He says the government program allows financial institutions to convert the government's shares to common equity at a decent price (90% of the average closing price for the 20-day trading period ending Feb. 9, 2009). "Tangible common equity is what these guys are looking for," he notes. "It's highly desirable and almost impossible to get."

The CAP program also allows banks that have participated in the CPP program to exchange their existing TARP shares for new ones "with supervisory approval."

Attorney Lawrence Kaplan of Paul Hastings in Washington, D.C. says the CAP program might make sense for banks that didn't file for CPP and now need government money. If you made a decision in November not to apply and your situation has changed, he says somewhat hesitantly, "perhaps it's an opportunity."

The deadline for [applying to the CAP program](#) is May 25.

Key differences between CPP and CAP

<p>Use of the Money: Under CPP, banks did not have to detail how they would use the money. The CAP program requires applicants to submit a plan for how the capital will preserve and strengthen their lending capacity.</p>
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<p>Preferred Stock: Under CPP, the stock was perpetual life. It pays a 5% annual dividend, increasing to 9% after</p>
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five years. CAP money pays a cumulative 9% dividend, compounding quarterly.

Conversion: CPP capital did not convert. CAP capital converts to common stock after 7 years. It is convertible into common equity at a 10% discount to the average closing price for the 20-day trading period ending Feb. 9, 2009.

Mortgage Foreclosure Mitigation: CPP did not require banks to participate in mortgage foreclosure mitigation programs, but CAP does.

Dividends: CPP recipients needed Treasury approval to increase their dividends. CAP recipients cannot pay more than a penny for dividends on common stock without Treasury approval.

Warrants: The price was 15% of CPP preferred, but 20% of CAP preferred. Exercise price under CPP was the market price for the common stock; it is 90% of the common stock price under CAP.

*Source: The Los Angeles law firm of Manatt, Phelps & Phillips*

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