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Throwing Off the TARP—Implications of Repaying Uncle Sam

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In October 2008, the U.S. Treasury launched the Capital Purchase Program (CPP) under the Troubled Asset Relief Program (TARP), pursuant to which the Treasury has invested nearly $200 billion in over 500 financial institutions.[1] Almost from the start, the boards and managements of many TARP-recipient institutions have focused on when and how to get out from under Uncle Sam's umbrella.

The stress test results have now been released, and Secretary Geithner has said that adequately capitalized financial institutions "will have the opportunity to repay" their TARP capital. Conventional wisdom has been that many institutions will rush to repay the government capital. Repurchasing this capital would appear to secure several clear advantages, including the opportunity to repurchase the related warrants at low valuations, the elimination of TARP-related restrictions on executive compensation and the reduction of government influence on governance and management.

"We never believed the investment of taxpayer funds was intended to be permanent . . . [w]e view it as our duty to return the funds."
—Goldman Sachs Group, Inc. CFO David Viniar on the company's April 14, 2009 earnings release conference call

There are several issues, however, that should be considered in determining whether to redeem TARP capital. The board and management of TARP recipients should consider whether repayment will require raising new capital today and the cost of that capital, the financial institution's future capital needs and the potential sources of capital and the likelihood of continued government, shareholder and public scrutiny of compensation practices even after the TARP repayment.

The first part of this bulletin briefly describes the conditions to repayment and the requirements regarding the source of funds for repayment. The second part discusses issues that the board and management of financial institutions that received TARP capital should consider in determining whether to repay the Treasury.

CONDITIONS TO REPAYMENT AND SOURCES OF FUNDS

"The critical thing we care about is whether the system as a whole is in a position where it has the capacity to support the credit that recovery requires. That is the ultimate test."
—Treasury Secretary Timothy Geithner, responding to a question from Representative Jeb Hensarling at the Congressional Oversight Panel hearing on April 21, 2009

The terms of the contracts governing the CPP investments permit repayment only with the consent of the financial institution's primary Federal regulator and require repayment during the initial three-year period after issuance to be funded entirely with the proceeds of cash sales of Tier 1 perpetual preferred stock or common stock. The economic stimulus bill, however, directed the Secretary of the Treasury to permit a TARP recipient to redeem TARP capital, after consultation with its primary Federal regulator, without regard to the source of the funds or the lapse of any period of time.

The May 6th Joint Statement issued by Treasury Secretary Tim Geithner, Federal Reserve Chairman Ben Bernanke, FDIC Chairman Sheila Bair and Comptroller of the Currency John Dugan outlined several conditions to the repayment of TARP funds:

- "Supervisors will carefully weigh an institution's desire to redeem outstanding CPP preferred stock against the contribution of Treasury capital to the institution's overall soundness, capital adequacy, and ability to lend, including confirming that [bank holding companies] have a comprehensive internal capital assessment process."

[1] As of May 12, 2009, the Treasury had outstanding CPP investments of approximately $198 billion, net of repurchases of approximately $1.2 billion by 12 banks.

"To the extent we have people pay [TARP funds] back, we should welcome that. It goes into the Treasury."
—Barney Frank, in an April 24, 2009 interview with Reuters

- "All [bank holding companies] seeking to repay CPP will be subject to existing supervisory procedures for approving redemption requests for capital instruments."

- In order to repay, the 19 banks which underwent the stress testing process must demonstrate, based on their post-repayment capital structure, that at the end of 2010, assuming the adverse macroeconomic scenario employed in the stress tests, they will have a Tier 1 risk-based ratio of at least 6% and a Tier 1 common risk-based ratio of at least 4%.

- Additionally, these 19 banks must be able to demonstrate their "financial strength by issuing senior unsecured debt for a term greater than five years not backed by FDIC guarantees, in amounts sufficient to demonstrate a capacity to meet funding needs independent of government guarantees."

Previously, in testimony before the Congressional Oversight Panel on April 21, 2009, Secretary Geithner had said the "ultimate test" for repayment would be whether an individual bank's repayment would result in a reduction in the overall credit available to the economy.

Based on the above, it appears that, legally and practically speaking, the required source of funds for repayment of TARP funds will depend primarily on an institution's financial strength, capital adequacy and liquidity, as determined by the Federal Reserve (or Office of Thrift Supervision in the case of thrift holding companies). Moreover, the approval of the regulator for any redemption (as opposed to mere consultation) may be required under existing supervisory procedures (for example, under Federal Reserve regulations and policies, if the redemption would reduce consolidated net worth by 10 percent or more or have a "material effect" on the institution's capital base). Strong financial institutions with adequate capital and liquidity may be allowed to repay TARP capital with funds from any source, including cash on hand or retained earnings. Less well-capitalized financial institutions, however, may be required to adhere more closely to the original terms of the CPP and repay at least a substantial portion of the TARP funds with the proceeds of Tier 1 capital issuances.

"[TARP money was] just tough to keep, given all the changes. When you attach the conditions that had been added, the capital became kind of expensive."
—Russell Colombo, CEO of Bank of Marin, in an interview with Bloomberg News

BOARD AND MANAGEMENT CONSIDERATIONS

Cost of Capital and Future Capital Needs

The CPP preferred stock carries a 5% dividend for five years, making it a relatively cheap source of capital. If the repayment must be funded with new capital, then its cost and dilutive effect must be taken into account in deciding whether to repay. In addition, the board and management should consider their financial institution's potential capital needs in the future and the likely cost of that capital. For many institutions, the analysis of capital costs, needs and dilutive effects should be undertaken with the help of financial and legal advisors, especially in the case of smaller financial institutions. In particular, the board and management should consider the possibility that TARP repayment is followed by an unanticipated need to raise capital. Losses at financial institutions are expected to continue to mount, especially in commercial real estate and credit cards, and these losses will continue to erode capital. Raising capital under these conditions could be difficult and expensive. And although capital is potentially available under the Treasury's Capital Assistance Program, the cost of that capital is substantially higher than under the CPP.

Sources of Repayment

The board and management should consider the best means of repaying the TARP capital in light of the stress tests and their financial institution's overall capital position—*i.e.*, whether the TARP capital should be repaid with the proceeds of equity issuances, other financing, cash on hand or retained earnings, or a combination of sources. If it is necessary or desirable to raise new regulatory capital, the board and management should consider the cost and dilutive effect of new capital as compared to the TARP capital, whether to issue common or preferred stock (*e.g.*, many financial institutions will be expected or required to increase the percentage of their Tier 1

"Participation in the TARP has created a competitive disadvantage for TCF and we believe it is in the best interest of our stockholders to repurchase these shares."
—William A. Cooper, Chairman and CEO of TCF Financial, in TCF Financial's press release announcing that it received approval from the Treasury Department to repay its TARP funds

capital represented by common stock) and whether the capital should be raised publicly or privately. While tapping the substantial pools of capital from private equity funds and other private investors may be possible at higher valuations (and thus be less dilutive) than in a public offering, private capital may come with "strings attached". Repaying TARP capital with debt proceeds (to the extent allowed by government regulators), cash on hand or retained earnings may expose the financial institution to the risk of being inadequately capitalized in the event of future losses or writedowns.

Timing

Although financial shares have rallied significantly in the past two months, share prices are still depressed for many financial institutions. In the case of those institutions that will need to issue new Tier 1 capital instruments to redeem TARP capital, the board and management should consider whether waiting to issue new capital at a more attractive valuation would have a less dilutive effect on earnings per share than a large equity offering at today's depressed prices. On the other hand, the current favorable market window, reflected in the recent offerings by Goldman Sachs, Wells Fargo, Morgan Stanley and others, may not persist.

Warrants

Under the terms of the CPP, at any time following repurchase of the Treasury's senior preferred stock, publicly held financial institutions[2] have the right to repurchase the related TARP warrants at fair market value (determined by its board in good faith in reliance on the opinion of a nationally recognized independent investment banking firm, subject to an appraisal procedure in the event of disputes). The warrants are likely to be substantially out of the money at present and as a result their fair market value may be minimal despite their remaining term. In deciding whether to repay TARP capital and comparing the cost of TARP capital to alternative sources of capital today and in the future, boards and managements should consider the impact of repurchasing the warrants today under potentially favorable circumstances.

Funding Costs

As a condition to repayment of TARP capital, the 19 financial institutions subject to the stress tests must demonstrate their ability to issue five-year senior unsecured long-term debt without an FDIC guarantee. Presumably, the only means of demonstrating that ability is to actually raise the nonguaranteed debt. Depending on the amount of nonguaranteed debt required to be raised, increased funding costs could be an issue worth considering.

Competitive Disadvantages

Some of the rush to repay TARP funds appears due to the negative implications and competitive disadvantages resulting from being a TARP recipient. JPMorgan Chase CEO Jamie Dimon called the TARP capital a "scarlet letter". The board and management should consider the effect of continued government involvement on their financial institution's competitive position in terms of business generation and retention and recruitment of key personnel, especially where some or most of its competitors have repaid their TARP capital.

Compensation Restrictions

One clear advantage of the repayment of TARP funds is the elimination of the compensation restrictions imposed on TARP recipients by the economic stimulus bill. However, financial institutions can expect heightened regulatory, shareholder and public scrutiny of compensation practices to continue, which may result in informal limits even in the absence of formal ones. Moreover, some new regulations on compensation practices are almost certain to be part of the upcoming reform of the financial regulatory system, as has already been widely reported. Also, a financial institution which has repaid the TARP capital but still has outstanding FDIC-guaranteed

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[2] The right to repurchase the warrants applies only to publicly held financial institutions. In the case of privately held financial institutions, the Treasury exercised the warrants at the same time as the CPP investment and those institutions must repurchase the warrant shares in addition to the CPP preferred shares in order to completely repay their TARP capital.

"We'll have to make judgments about whether the quality of leadership of those institutions' boards is strong enough so that again our interests are met best . . our interests are not just as a shareholder, as an investor. We want to make sure the institutions are going to be strong enough so that we can get out, that private capital will come replace us over time."
—Treasury Secretary Timothy Geithner, in an interview with Charlie Rose on May 6, 2009, responding to a question about whether the government will be involved in management of banks in which the government has a significant ownership stake

debt is, as a practical matter, likely to remain under substantial pressure and scrutiny regarding compensation practices.

Government as Shareholder

In deciding whether or not to repay, boards and managements should consider the potential ramifications of continuing to have the government as a significant shareholder. Although Secretary Geithner has said that Treasury will "exert our influence only on core governance issues and not on day-to-day operations," it is foreseeable that the government will weigh in on a range of issues not historically subject to close regulation, including compensation practices, business lines and acquisitions and divestitures. It is also worth noting that the government's stated goal is to strengthen the banking system and increase lending to support economic recovery, with returns to shareholders perhaps being less of a priority. At the very least, the presence of the government as shareholder could influence a financial institution's decision-making process. In addition, there is at least a perception that being a TARP recipient adversely affects a financial institution's negotiating position with regulators.

Potential for Further Changes by the Government

The government has appeared to change its position on TARP repayment in the past and has not always spoken with a single voice. The board and management should weigh the considerations described above, some of which may lead to a deferral of TARP repayment, against the desirability for their financial institution to get out of TARP now before the terms and conditions of repayment are changed to make repayment more difficult or onerous.

Summary of Selected Pros and Cons

In summary, the board and management of financial institutions planning to repay TARP capital should weigh the following pros and cons, among other factors:

TARP Repayment – Selected Pros and Cons

Pros	Cons
• Signals strength and avoids competitive disadvantages	• TARP is relatively cheap capital
• May be opportune time to repurchase warrants at a low valuation	• Replacement capital may be more expensive and dilutive
• Reduces government influence on governance and management	• Continued economic weakness could result in unanticipated need to raise capital after TARP repayment
• Eliminates TARP-related compensation restrictions	• Compensation practices will continue to be scrutinized and perhaps regulated even after TARP repayment
• Might be advisable to do it now before conditions to repayment are changed	

Conclusion

While the TARP capital should be repaid eventually (and preferably within the first five years before the dividend rate goes up), the primary questions for boards and managements, as outlined in this bulletin, are when and how. We believe that it would be advisable for the board and management of TARP recipient institutions to begin analyzing the possibility of repayment in light of the institution's overall financial condition, capitalization and liquidity. In doing so, the board and management should carefully consider the best time and means of repayment in light of the factors discussed above. In particular, if it is necessary to raise new capital, consideration should be given to its cost and dilutive effect weighed against the benefits of repayment. In addition, the potential impact of future losses, additional capital needs and funding costs should be analyzed thoroughly before repaying the TARP capital.

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

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