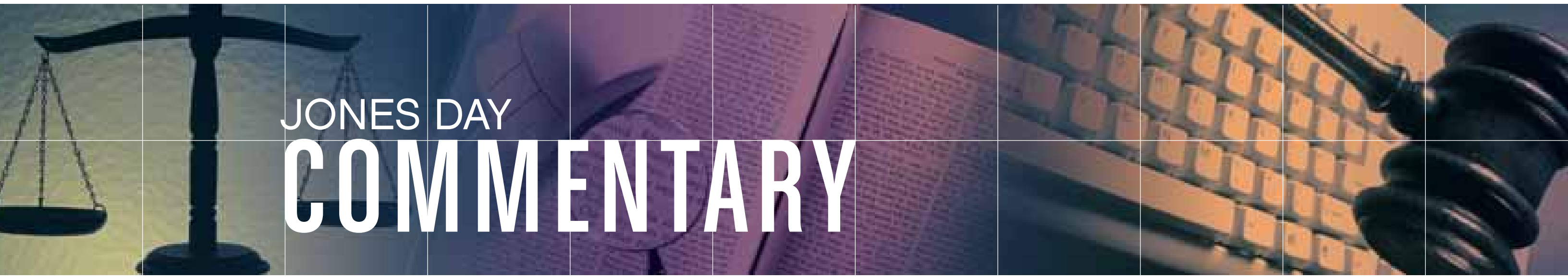
MARCH 2009



THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: STRESS TEST FOR U.S. BANKING ORGANIZATIONS

On February 10, 2009, the Treasury Department outlined its new Financial Stability Plan ("FSP"). The FSP has various elements including a "Stress Test." The Stress Test was described as a forward-looking, comprehensive test assessing whether major financial institutions have the capital necessary to continue to lend and to absorb the potential losses that can result from a more severe decline in the economy than projected. Banks that take, and presumably pass, the Stress Test would be provided access to a capital buffer by the Treasury to absorb losses and serve as a bridge to receiving increased private capital. New investments would not be made by the Treasury directly but through a separate entity called the "Financial Stability Trust."

The Treasury released more details regarding the Stress Test and the FSP's capital assistance plan ("CAP") on February 25. The Stress Test is required of the 19 largest U.S. bank holding companies holding more than $100 billion in risk-weighted assets. Eligibility for capital under the CAP will be consistent with the criteria and process established for identifying viable qualifying financial institutions in the Troubled Assets Relief Program's ("TARP") Capital Purchase Program ("CPP").

Also on February 25, the four federal bank regulators issued a release on the Stress Test confirming that the major U.S. banking organization have "capital in excess of the amounts required to be considered well-capitalized."

The FDIC reported on February 26, 2009, that 97.6 percent of all FDIC-insured institutions, holding 98.7 percent of all industry assets, met or exceeded the highest regulatory standards.

APPLICATION OF THE STRESS TEST

The bank regulators will conduct the Stress Test on an interagency basis and will require all participating financial institutions (firms with $100 billion or more of assets) to:

- Analyze potential firmwide losses, including potential losses in their loan and securities portfolios as well as with respect to their off-balance-sheet commitments and continued liabilities/exposures.
- Estimate potential trading-related losses where they have $100 billion or more of trading assets.
- Use a “baseline” and a “more adverse” economic scenario specified by the Treasury.
- Forecast internal resources available toward losses, including net revenue before provision for possible loan losses, as well as the adequacy of the allowance for loan losses.
- Have discussions between the regulators and senior management regarding the institution’s loss and revenue forecasts.

The bank regulators will assess specific potential losses and estimated resources, and they will determine whether each institution has a “sufficient capital buffer necessary to ensure that the institution has the amount and quality of capital necessary to perform their vital role in the economy.”

The assessment is intended to cover all aspects of a financial institution’s business, including:

- The inherent risks of exposure in business activities.
- The quality of balance sheet assets and off-balance-sheet commitments.
- Earnings projections.
- Expectations regarding economic conditions.
- The composition, level, and quality of capital.
- The potential for unanticipated losses and declines in asset values.
- The ability to raise additional common stock and other forms of capital in the market.
- Other risks that are not fully captured in regulatory capital calculations.

ECONOMIC SCENARIOS

The Stress Test will be based upon the two economic scenarios shown below for 2009 and 2010:

Stress Test Economic Scenarios

	Baseline		**More Adverse**	
	2009	**2010**	**2009**	**2010**
Annual Average Real GDP Growth	-2.0%	2.1%	-3.3%	0.5%
Annual Average Civilian Unemployment Rate	8.4	8.8	8.9	10.3
House Prices	-14.0	-4.0	-22.0	-7.0

BANK HOLDING COMPANY OBLIGATIONS

The Treasury indicated that bank holding companies must have capital in excess of minimum capital requirements commensurate with their firm’s specific risk profiles and must account for all material risks. On February 24, the Federal Reserve released Supervisory Letter SR 09-4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” which reminded bank holding companies of the requirement to be sources of financial and managerial strength to their subsidiary banks, especially with regard to dividend payments, capital planning, and redemptions and repurchases of capital instruments. The Federal Reserve also noted that risk-based ratios do not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banking organizations may be exposed, such as interest rate, liquidity, market, and operational risks.

The Treasury White Paper, “The Capital Assistance Program and its role in the Financial Stability Plan” (February 25, 2009), states that the Stress Test:

> "…does not represent a new capital standard and it is not expected to be maintained on an ongoing basis. Instead, it is available to help banking institutions absorb larger than expected future losses, should they occur, and to support lending to creditworthy borrowers during the economic downturn."

Nonetheless, the Stress Test will have many of the same effects as a capital standard, and its open-ended term indicates it may be utilized for the foreseeable future. It remains to be seen whether bank examiners will adopt some or all of the Stress Test in their examination and enforcement action processes.

TIMING AND CONSEQUENCES

The Stress Tests are proposed to be completed as soon as possible, but no later than April 30. The Stress Test will be part of the supervisory process and used for bank examinations. If the bank regulator believes that an institution requires additional capital, the institution apparently is required to enter into a commitment to issue the CAP mandatory convertible preferred stock and related warrants to the U.S. Treasury pursuant to the CAP (assuming it qualifies). The institution will then have six months to raise capital in the private and public markets to meet this requirement and can cancel the commitment to issue CAP mandatory convertible preferred stock without penalty. The CAP mandatory convertible preferred stock will have a 9 percent cumulative dividend and 20 percent warrant coverage, based on 90 percent of the 20-day trading average prior to February 9, 2009. These terms are considerably more expensive and dilutive to common shareholders than the TARP CPP preferred stock and warrants. (Additional information regarding the CAP is being provided in a separate *Commentary* entitled "The Financial Stability Plan's Capital Assistance Program and an Update of the TARP Capital Purchase Program," March 2009).

Financial institutions not among the largest 19 may voluntarily undergo the Stress Test to participate in the CAP, which will be available to Qualifying Financial Institutions ("QFIs"). QFIs are defined identically for purposes of the CAP and the CPP. It does not appear that QFIs, other than possibly the largest 19 institutions, will receive CAP if these did not receive approval under the CPP, or whose CPP approval was accompanied by conditions that have not been or cannot be satisfied. The Interagency FAQs on CAP issued by the federal bank regulators on February 25 states:

> "Eligibility [for obtaining capital from CAP] will be consistent with the criteria and the deliberative process established for identifying…QFIs in the existing Capital Purchase Program."

As in the CPP, only institutions that were approved as a bank or thrift holding company by January 15, 2009, will be QFIs eligible for CAP.

CONCLUSIONS

We suggest that institutions that are required to take, or are considering voluntarily taking, the Stress Test prepare carefully. The institutions are required to prepare substantial information for the Stress Test and to discuss it with their primary regulator. This information and analyses may have unexpected consequences outside of the Stress Test and CAP. For example, these analyses may affect various accounting judgments and estimates, such as the level of the allowance for loan losses, goodwill, and intangible impairments, other than temporary impairments on assets, and certain mark-to-market estimates. It is unknown how the bank regulators may apply the Stress Test or require its use in examining or supervising financial institutions, especially in evaluating credit quality and risks.

The Treasury indicates that eligibility for the CAP will use the same criteria and process used for the CPP, and therefore the Stress Test is likely to be viewed as a test of whether an institution is viable or not. It also means that institutions that are denied CPP capital or are allowed to access the CPP only upon satisfaction of various conditions, such as raising matching private capital, are unlikely to receive CAP capital. Also, any Stress Test information will become sought-after diligence in any private capital raising or merger efforts.

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