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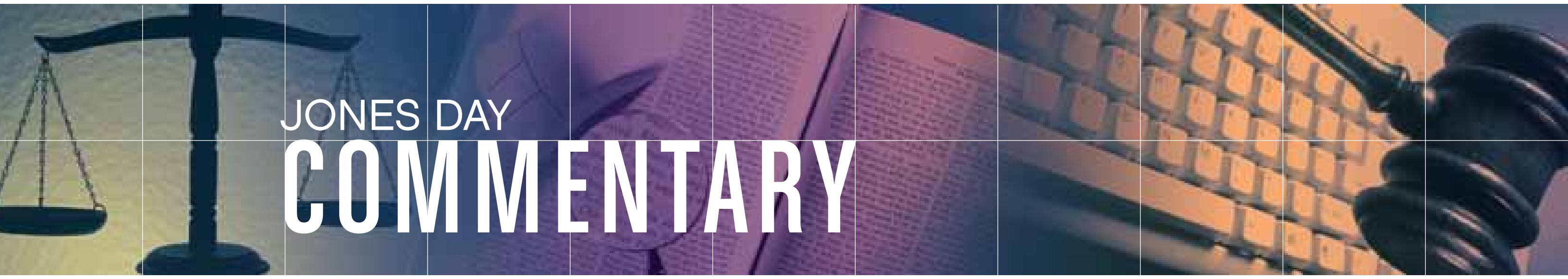

TARP AND SBLF REPAYMENTS BY BANK HOLDING COMPANIES

The Treasury invested $204.9 billion in 707 banking organizations pursuant to the Troubled Asset Relief Program ("TARP") Capital Purchase Program ("CPP"). Most larger banks have repaid TARP. More recently, 137 recipients with less than $10 billion of assets repaid TARP CPP through issuances to the Treasury's Small Business Lending Fund ("SBLF"), accounting for 48.8 percent of the 281 total bank issuers under the SBLF. As of the beginning of November 2011, 387 issuers still have $17.3 billion of TARP CPP outstanding, including 174 banks that have skipped one or more TARP CPP dividends.[1]

The Board of Governors of the Federal Reserve System and its delegees at the Federal Reserve Banks (collectively, the "Federal Reserve") review TARP repayment requests on a case-by-case basis, which means the decisions vary. However, basic principles exist, and helpful data about decisions on TARP repayments were included in SIGTARP, *Exiting TARP: Repayments by the Largest Financial Institutions* (Sept. 29, 2011) (the "*SIGTARP Report*"). While the largest, most complex banks have had and will continue to have the most formal and comprehensive capital planning and scrutiny, many of the principles are applicable to all institutions.

Various of the largest banks negotiated TARP exits with the Federal Reserve using, in part, new common stock issuances, retained earnings, asset sales, and stock issuances to employees. According to the *SIGTARP Report*, the FDIC apparently was concerned about repaying TARP using anything other than new common stock issued for cash. The Federal Reserve's response to the *SIGTARP Report* subsequently has clarified that asset sales can be used to increase capital as part of a TARP repayment, although the Federal Reserve limits the amounts of such qualifying asset

1 Source: Keefe, Bruyette & Woods, KBW TARP Tracker 84th Ed. (Nov. 4, 2011), and the U.S. Treasury.

sales. Many bank holding companies ("BHCs") have used debt to fund part of their TARP CPP repayment.

The Federal Reserve and the Treasury are supportive of TARP repayments by BHCs that will maintain sufficient capital afterward in light of their capital plans and risks. The Treasury sent a letter at the beginning of December to issuers of outstanding TARP CPP encouraging them to repay and announcing that it has hired an investment banker to help explore recovery of the Treasury's TARP CPP investments. Bank regulators have sought TARP repayment plans as part of their examination and supervisory processes.

Most institutions seek to exit TARP due to its executive compensation limits, regulatory concerns on strategic expansion and capital distributions by TARP recipients, the general stigma associated with TARP, and the expectations by the bank regulators and the Treasury that TARP should be repaid sooner rather than later. The annual TARP dividend increases from 5 percent to 9 percent on the fifth anniversary of issuance. Similarly, SBLF preferred stock has a 5 percent annual base dividend for four-and-a-half years, which then increases to 9 percent annually. BHCs with TARP CPP or SBLF funds should plan for their redemption as part of their broader capital planning, including possible redemptions of trust preferred securities, dividends, and common stock buybacks.

Preferred stock redemptions by BHCs, including TARP CPP and SBLF preferred stock redemptions, are subject to Federal Reserve Regulation Y ("Reg. Y") and the related capital guidelines included as appendices to Reg. Y, as well as Federal Reserve policies on capital and capital distributions such as stock redemptions. Redemptions of TARP CPP and SBLF preferred stock issued by thrift holding companies also will be subject to Federal Reserve approval, and similar principles should apply.

Regulatory reviews of TARP redemption requests continue to evolve with the Federal Reserve's capital guidelines, stress testing, and capital planning processes. These include the Supervisory Capital Assessment Program ("SCAP") stress testing based upon standardized inputs across the 19 largest banks, including 17 TARP CPP recipients, the Comprehensive Capital Analysis and Review for 2011 ("CCAR 2011") and 2012 ("CCAR 2012"), as well as the effects of the Basel III capital rules, increased regulatory scrutiny of liquidity, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). These principles and specific questions that have been used by the Federal Reserve in evaluating redemption requests are discussed below.

BASIC FEDERAL RESERVE CAPITAL PRINCIPLES

Source of Strength and Capital. Federal Reserve Reg. Y, § 225.4(a) has long required BHCs to serve as a source of financial and managerial strength to their subsidiary banks and to operate in a safe and sound manner. This "source of strength doctrine" has been reinforced by the Dodd-Frank Act's addition of Section 38A to the Federal Deposit Insurance Act effective July 21, 2011, which requires implementing rules by July 21, 2012. Reg. Y, including its BHC capital guidelines, contains other basic principles that affect the redemption of any capital instrument, including preferred stock issued as part of the TARP CPP or SBLF:

- Banking organizations generally are expected to operate well above minimum capital requirements.
- Organizations with significant expansion proposals are expected to maintain strong capital ratios substantially above the minimum capital ratios.
- Organizations should hold capital consistent with the level and nature of their risks, taking into account: credit, market, operational, and interest rate risks; overall interest rate exposure; liquidity risks; funding risks; asset concentrations; quality and level of earnings; quality of loans and investments; and effectiveness of loan, investment, and risk reporting and controls.
- "…Voting common equity is the most desirable capital element from a supervisory standpoint, and generally should be the dominant element within Tier 1 capital."
- BHC preferred stock redemptions, including redemptions of TARP CPP or SBLF preferred stock, require prior Federal Reserve approval.
- The Federal Reserve's Risk-Based Capital Adequacy Guidelines for BHCs in Reg. Y, Appendix A, indicate less

concern where the capital instrument is being redeemed with proceeds of a capital instrument of equal or higher quality.

SR 09-4. Federal Reserve Supervision and Regulation Letter SR 09-4 (February 24, 2009), as revised and supplemented ("SR 09-4"), is one of the most important Federal Reserve policies regarding capital actions and capital distributions, including redemptions and repurchases of capital instruments by all BHCs. It is especially applicable to BHCs experiencing financial difficulties and/or that received public funds, such as TARP CPP. It is possible that SBLF funds will be considered "public funds" for these purposes.

SR 09-4 lists the factors a BHC's board of directors should consider when repurchasing stock, including:

- Overall asset quality, potential needs to increase reserves and write down assets, and concentrations of credit.
- Potential for unanticipated losses and declines in asset values.
- Implicit and explicit liquidity and credit commitments, including off-balance-sheet and contingent liabilities.
- Quality and level of current and prospective earnings, including earnings capacity under a number of plausible economic scenarios.
- Current and prospective cash flows and liquidity.
- The BHC's ability to serve as an ongoing source of financial and managerial strength to FDIC-insured depository institution subsidiaries, including the extent of double leverage[2] and the condition of subsidiary depository institutions.
- Other risks that affect the BHC's financial condition that are not fully captured in regulatory capital calculations.
- Level, composition, and quality of capital.
- Ability to raise additional equity capital in prevailing market and economic conditions.

BHCs should not expect favorable Federal Reserve action on requests to redeem capital instruments, including TARP CPP or SBLF preferred stock, where such action "would be inconsistent with the BHC's prospective capital needs and continued safe and sound operation."

This letter also states that BHCs considering redeeming TARP CPP should consult first with the Federal Reserve before notifying the Treasury of the intended redemption. The Federal Reserve also indicated that it would consult with the state and federal regulators of the BHC's bank subsidiaries, and that such banks' prospective financial condition and capital planning processes would be considered under stress market conditions.

Applications for redemptions may be denied in whole or in part due to safety and soundness concerns, requirements for elevated capital levels, unresolved risk management issues, and other supervisory concerns.

2009 FEDERAL RESERVE GUIDANCE ON TARP REPAYMENTS FOR THE LARGEST BANKS

On June 3, 2009, the Federal Reserve issued guidance (the "June 2009 Guidance") stating that each request for TARP CPP redemption by the 19 largest BHCs that participated in the SCAP would be evaluated based on (i) each BHC's internal capital assessment planning and management processes and (ii) board-approved capital targets for the consolidated entity. Applicants needed to show that:

- The BHC could redeem TARP CPP and remain in a position to continue to fulfill its role as an intermediary that facilitates lending to creditworthy households and businesses.
- The BHC would be able to maintain capital levels following the redemption consistent with supervisory expectations, industry norms, and historical levels for the firm, including the firm's own internal capital targets.
- The BHC has demonstrated access to common equity through public issuance in equity capital markets and demonstrated the ability to raise a significant amount of unsecured senior debt with a maturity of five or more years without reliance on the FDIC's Temporary Liquidity Guaranty Program ("TLGP").

2 "Double leverage refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity. In this regard, supervisory staff should also consider the impact of any potential overreliance a BHC may have on dividends received from subsidiaries as a source of payment for its liabilities."

- The BHC and its bank subsidiaries will be able to meet obligations to counterparties, as well as ongoing funding requirements, while reducing reliance on Treasury capital and the TLGP.
- The BHC will be able to continue to serve as a source of strength to its subsidiary bank(s) after the redemption.

Further, the Federal Reserve suggested internal capital planning processes must consider: "…all risks a BHC may face, including not only credit and market risk, but operational, reputational and funding/liquidity risks as well."

The Federal Reserve's *Clarifying Guidance—Criteria for Redemption of U.S. Treasury Capital for BHCs that Participated in the SCAP* (November 3, 2009) (the "November 2009 Guidance") provided that the largest BHCs' internal capital assessment processes should be consistent with their complexities and risk profiles, and should include:

- A well-defined statement outlining the overall risk tolerance of the organization.
- Robust risk management practices to support estimates of capital needs.
- Recognition of ways in which all types of risks—including operational, reputational, and liquidity risks—can affect capital adequacy.
- Appropriate treatment of potential risk concentrations.
- Stress testing to complement more traditional risk measurement methods.
- Proper governance over the capital assessment process, including ongoing involvement of senior management and regular interaction with the board of directors.
- Clear definitions of capital components used to support estimated capital needs, including the demonstrated capacity of those components to absorb loss.
- Recognition that capital cushions above estimated capital needs are prudent, given the inherent uncertainty in estimating future capital needs and assessing capital adequacy.

These principles continue, with refinements, to be reflected in the CCAR processes and SR 09-4.

CCAR 2011

On November 17, 2010, the Federal Reserve issued a revised addendum to SR 09-4, which included the following guidelines for evaluating proposals by the largest BHCs for increasing dividend payments and repurchasing or redeeming stock in 2011:

- A firm's ability to absorb losses over the next two years, including adverse macroeconomic scenarios specified by the Federal Reserve and adverse scenarios appropriate for that BHC's business and portfolios.
- How the firm will meet Basel III capital requirements and the anticipated effects of the Dodd-Frank Act.
- Plans to repay U.S. government investments. "BHCs are expected to complete the repayment or replacement of any U.S. Government investments in the form of either preferred shares or common equity prior to increasing capital payouts through higher dividends or stock buybacks." (Indeed, the TARP CPP agreements would limit any increases in dividends even absent such action by the Federal Reserve).
- Senior management and the board of directors of each BHC subject to the CCAR 2011 were required to approve the comprehensive capital plan prior to its submission.
- As provided in the September 2010 Group of Governors and Heads of Supervision agreements under Basel III, BHCs that meet the minimum capital ratio requirements during the transition period but remain below 7 percent Tier 1 common equity (minimum capital plus a conservation buffer) would be expected to maintain prudent earnings retention policies to meet the conservation buffer as soon as reasonably possible.

CCAR 2011 applied to the 19 largest banks that had gone through the SCAP in 2010.

The Federal Reserve's CCAR Review was made "in the context of a significant change in supervisors' expectations for firms' substantive capital policies and capital planning processes." Among other things, the Federal Reserve stated:

- Firms are expected to demonstrate their ability to remain viable financial intermediaries as they make the planned capital distributions, even under stressed conditions.

- Firms are expected to continue to increase their capital base.
- In 2011, firms generally were expected to limit dividends to 30 percent or less of anticipated earnings.
- Planned share repurchases would be reviewed if there are material adverse deviations from the revenue and loss assumptions in a firm's capital plan such that capital is not increasing as anticipated.
- In the event of a sharp deterioration in economic conditions that could have negative implications for safety and soundness, the Federal Reserve may require modifications of previously submitted capital plans.

Banks that were subject to the CCAR 2011 testing had to "demonstrate with great assurance" that, taking into account their anticipated capital action and distributions, they can achieve the capital ratios required by the Basel III framework (including the effects of stock redemptions), as Basel III becomes effective in the United States. The Federal Reserve also indicated it will take into account the nature of the proposed capital action, including whether a proposed redemption of a capital instrument is funded by the issuance of instruments of equal or better quality in terms of loss absorption capacity.

CCAR 2012

CCAR 2012 was released on November 22, 2011, together with the Federal Reserve's amendment to Reg. Y originally proposed in *Capital Plans*, 76 F.R. 35351 (June 17, 2011). This release and related materials apply to all BHCs with $50 billion or more in assets, including 12 institutions not previously evaluated under the SCAP and CCAR 2011. The scope of analysis and detail "will vary based on the company's size, complexity, risk profile and scope of operations." CCAR 2012 builds upon CCAR 2011, including stress tests with more variables, and continues to emphasize risk management, internal controls, and capital planning with greater oversight by BHCs' boards of directors. BHCs' capital policies are an important part of their capital planning. Although no dividend payout ratio is specificed in CCAR 2012, prior Federal Reserve approval of any increase, subject to a *de minimus* exception, for distributions (dividends and stock buybacks) from an approved capital plan will be required, if:

- The BHC does not have a ratio of Tier 1 common stock to risk weighted assets of at least 5 percent;
- The Federal Reserve has notified the BHC that the capital distribution would result in a material adverse change to the BHC's capital or liquidity, or that the BHC's earnings were materially underperforming projections;
- The dollar amount of the distribution would exceed that in an approved capital plan; or
- The Federal Reserve is currently reviewing, or has requested resubmission of, the BHC's capital plan.

BHCs must also plan to meet applicable systematically important financial institution ("SIFI") surcharges on a timely basis, demonstrate "steady progress" in timely meeting fully phased-in Basel III requirements, including SIFI surcharges, and avoid "back-loaded increases in capital ratios in an uncertain future environment."

Earnings and earnings retention will be important to meeting these requirements, as will the phase-out of trust preferred and other securities as Tier 1 capital under the Dodd-Frank Act for larger BHCs. Capital planning will likely need to consider and provide for redeeming not only TARP CPP preferred stock, but also trust preferred and other securities that no longer count as capital, especially where their retirement is accretive to earnings available to common shares.

OTHER SPECIFIC FACTORS CONSIDERED BY THE FEDERAL RESERVE

In addition to the existing and *pro forma* capital ratios, the Federal Reserve's TARP CPP Redemption Request Decision Memo, which is reproduced in the *SIGTARP Report*, includes the following considerations:

- Classified assets/net Tier 1 capital plus allowance for loan loss reserves ("ALLR"). If 100 percent or more, further discussion is required.
- Nonperforming loans plus OREO/net Tier 1 capital plus ALLR. If 49 percent or more, further discussion is required.
- Construction and development loans/total risk-based capital. If 300 percent or more, further discussion is required.
- Commercial real estate loans ("CRE")/total risk-based capital.

- Non-owner-occupied CRE/total risk-based capital.
- Net non-core funding dependence.
- The adequacy of the management's capital planning condition vis-à-vis the applicant's financial condition and risk profile and the ability to maintain appropriate capital consistent with its risk profile over the next two years under stressed economic conditions.
- Is the redemption consistent with SR 09-4?
- Is the BHC or its subsidiary subject to any formal or informal enforcement actions?
- What is the source of repayment of TARP CPP?
- If TARP CPP is being retired with the proceeds of dividends from subsidiary banks, do the dividends require prior regulatory approval? Are dividends from the bank less than or equal to the amount of TARP CPP funds invested in the bank?
- If a subsidiary bank must liquidate a class of stock owned by the parent to redeem TARP CPP, does the liquidation require prior regulatory approval?
- The primary federal and state regulators of the bank subsidiaries should be consulted, whether or not a dividend is required to be paid by such bank subsidiaries for the BHC to redeem TARP.
- Was any debt issued under the TLGP by the BHC or its subsidiaries?
- If so, has the issuer of the TLGP-guaranteed debt demonstrated its ability to issue debt without reliance on the TLGP?
- Would redemption of the TARP CPP require an application under Reg. Y, § 225.4(b)?

This reporting form is required of all BHCs with consolidated assets of $500 million or more. We believe it likely that similar questions would be asked of smaller institutions, although under Reg. Y, Appendix C, *Small Bank Policy Statement*, capital is considered only at the bank level, not on a consolidated basis, for organizations with less than $500 million of assets.

CONCLUSIONS

All TARP CPP redemption requests are evaluated on a case-by-case basis, taking into account the BHC's risks, including those identified in recent supervisory examinations of the organization. We believe that redemptions of SBLF securities will be treated similarly. The Federal Reserve may require a form of stress test and may require that additional capital be raised by the BHC. The Federal Reserve continues to stress the need for strong capital in the current environment, and even where a TARP CPP preferred stock redemption is approved, it may be for less than all outstanding TARP CPP shares. Various of the regional BHCs that redeemed TARP did it with a combination of senior debt, which avoided dilution to their common equity holders. Smaller institutions may find issuance of common or preferred stock more desirable, especially if they cannot access the debt markets or do not find them attractive.

The more common equity that is used to replace TARP CPP preferred, the easier it should be to gain Federal Reserve approval, since the amount of capital lost to the TARP CPP redemption will be less, and the quality of capital will be increased. However, equity raises may not be required in all cases, and debt as well as asset sales, retained earnings, and other measures may be used to fund repayments, *provided* the BHC remains strongly capitalized after the redemption. For example, on November 22, 2011, First Midwest Bancorp, Inc. ("First Midwest") announced that it had sold $115 million of five-year senior notes, and that it had Federal Reserve approval to redeem all $193 million of TARP using the proceeds from the sale of the notes plus other available funds. In addition to equity issued in earlier debt conversions, First Midwest had raised approximately $197 million from the public offering of common stock in January 2010. Following the redemption of TARP CPP preferred stock, First Midwest will remain strongly capitalized with a Tier 1 leverage capital ratio of 9.20 percent, Tier 1 capital to risk-based assets of 11.65 percent, and total risk-based capital of 13.72 percent.

Existing or pending regulatory enforcement actions or material supervisory concerns, as well as the BHC's capital plans, risk profile, and risk management, have to be taken into account. Supervisory concerns and enforcement actions may necessitate higher levels of new common equity and/or perpetual noncumulative preferred stock, and limit the amount of TARP CPP redemptions.

BHCs seeking to redeem TARP or SBLF securities in the future should consider and document the elements discussed above, and consider the potentially wide variety of alternatives that may be available in light of their desired capital structure and other planned capital actions. While the CCAR and earlier capital pronouncements applicable to the largest institutions illustrate the Federal Reserve's thinking, smaller and less complex BHCs will not be subject to the same rigorous analyses as CCAR institutions. Smaller BHCs do need to present well-documented, forward-looking plans appropriate to their size and risks that demonstrate their ongoing capital adequacy in light of their risks and contemplated capital actions, including TARP CPP or SBLF redemptions.

Any redemption should be discussed with the BHC's Federal Reserve Bank to obtain further insight into the Federal Reserve's view of the specific BHC, and to better prepare an appropriately responsive, well-documented request to the Federal Reserve. Alternative plans should be developed that are consistent with the Federal Reserve's capital principles and discussions, and to speed potential negotiations with the Federal Reserve. BHCs should allow sufficient time for the Federal Reserve to consider TARP CPP redemption requests. The creditability of any BHC proposal, including its supporting documentation, is critical to obtaining a timely, favorable decision from the Federal Reserve. The Treasury is clearly seeking to wind down TARP, and the market volatility and the relatively short term remaining for favorable TARP CPP and SBLF preferred dividends makes it imperative to plan now for their redemption.

It is possible that the Treasury will seek to sell its TARP CPP investments to private investors. Private investors will want to consider the regulatory process and prospects for dividends and a redemption of TARP CPP as part of their investment diligence. Such investors will price any purchases of TARP CPP securities at a discount based, in part, on the risks and returns available from timely dividends and speedy redemptions by issuers of these securities.

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