U.S. Treasury Capital Assistance Program (CAP) for Banks and Implications of the Citigroup Preferred Exchange Offer

This week the preferred securities market saw two fairly significant events with the U.S. Treasury Department's release of details of its Capital Assistance Program (CAP) on February 25, 2009 and with Citigroup's announcement today of an exchange offer for its preferred stock.[1] For the reasons expressed below, we view both these events as encouraging to the long-term interests of preferred securities holders.

We believe the following are the key features of the CAP for preferred investors

- The primary objective of the CAP is to support the provision of credit by the financial system. Treasury specifically states that "U.S. government ownership [of banks] is not an objective of CAP."
- There are two main elements of the program: (1) a comprehensive forward-looking capital assessment by banks' regulators (the so-called "stress test"); and (2) contingent common equity capital in the form of CAP preferred stock.
- All banks with assets greater than $100 billion must undergo the stress test, which will be completed by the end of April 2009. Other qualified banks may apply to participate. In addition, any qualified bank may request CAP capital immediately, even before the stress test has been completed.
- The supervisory review will focus on the bank's capital adequacy under both "baseline" and "more adverse" economic scenarios.
- If a bank fails this stress test (i.e. it fails to have adequate capital under the more adverse scenario), then the bank must raise capital either in private markets or directly from the Treasury under the CAP. It will have six months to complete the capital raise. The goal is to assure markets that large banks (both those that pass the stress test as well as those required to raise additional capital) have sufficient high-quality capital to absorb losses even in a worse-than-expected economic environment.
- CAP preferred stock is available in an amount equal to 1-2% of risk-weighted assets (possibly more in exceptional circumstances).
- CAP preferred stock ranks *pari passu* with (or equal to) outstanding DRD-eligible and earlier Capital Purchase Program (CPP) preferred stock and rank junior to taxable preferred securities. Thus, if CAP and/or CPP preferred dividends are paid, all outstanding preferred dividends must also be paid.
- CAP preferred stock will carry a cumulative 9% dividend and be convertible into common stock at 90% of the average closing price of the bank's common for the 20 trading days ended February 9, 2009.

[1] Details of the U.S. Treasury's announcement are available at http://www.financialstability.gov. The terms of Citigroup's exchange offer are available at http://www.citigroup.com/citi/press/2009/090227a.pdf?ieNocache=237.

- CAP preferred stock conversion is mandatory after seven years and is convertible ***at the option of the bank*** any time prior to that. Thus, it starts off as preferred capital but can become common equity capital at any time at the bank's request, or mandatorily after seven years.
- Terms of the CAP specifically allow a participating bank to pay common (and thus preferred) dividends. However, Citigroup's agreement with Treasury to suspend dividends on DRD preferred upon conversion of CPP preferred into common stock indicates it is likely that conversion of CAP preferred stock to common stock would trigger suspension of both common and DRD-eligible preferred dividends. Although DRD-eligible preferred dividends have been suspended, Citigroup will continue to pay dividends on taxable preferreds. This suggests that taxable preferred dividends will continue to be paid if CAP preferreds are converted into common stock, although there is no assurance that will be the case.
- CAP preferred stock may be redeemed by the bank at par in the first two years. Thereafter, it may be redeemed at the greater of par or the as-converted price. Redemption proceeds must be from the sale of common stock or additions to retained earnings.
- Treasury will receive 10-year warrants in the amount of 20% of issued CAP preferred stock with the same conversion price as the preferred. The amount of warrants will not be reduced if the CAP preferred stock is redeemed early (unlike the CPP warrants, which are subject to reduction if the bank repays CPP preferred stock within three years of issuance).
- Banks may convert CPP preferred stock to CAP preferred stock.
- Banks issuing CAP preferred stock will have to agree to certain restrictions including limits on executive compensation and a maximum common stock dividend of $0.01 per share per quarter.
- Applications must be submitted by May 25, 2009. Banks have 6 months from the date of preliminary approval of CAP capital to close the transaction.

It's reasonable to assume that CAP preferred stock will only convert to common equity in the next seven years ***if and when it is needed***. Thus, it is likely less dilutive than if a bank were to raise common equity capital in today's market, but it supports existing preferred securities in the same way that common stock does. We view the CAP as a significant positive for preferred securities. It provides a means of converting ***all*** government-provided capital (both CAP and CPP preferred stock) into common equity, which adds a meaningful amount of protection for existing preferred securities holders.

Today's actions at Citigroup support our view that bank nationalization is currently viewed by the government as a last resort, not the next step in its plans for recapitalizing banks.[2] Following the exchange, the U.S. government will own from 29-36% of the common stock of Citigroup, depending upon participation by holders of publicly held preferreds. That is a sizable stake, but it demonstrates the government's desire to keep these institutions in private hands. Moreover, the company will continue to pay dividends on taxable preferreds, and DRD-preferred holders will have the opportunity to exchange their preferreds for common stock on terms similar to those negotiated by the Treasury. That is a substantially better deal for preferred shareholders than receivership (i.e., nationalization). None of this means that the government won't take different approaches in the future. Both the CAP and the Citigroup exchange offer are very recent developments and the U.S. Government may not respond as favorably for preferred investors if Citigroup encounters further capital deterioration or with other banks that need additional tangible capital. Some banks will fail, and when they do, all capital providers will share the pain. However, today's actions surrounding Citigroup and its announcement earlier this week of CAP indicate the government's intention in appropriate circumstances to provide capital support that falls well short of full nationalization.

Supported by sizable amounts of capital and loan loss provisions and the extension of the government insurance schemes for deposits and newly-issued debt, we believe that most banks of the types we invest in have the financial strength to weather the current crisis. Our focus is to identify the survivors and avoid the losers. We know that our record will not be perfect, but as we have explained in *Preferred Valuation after the TARP*[3], prices on preferreds currently leave a very large margin for error.

Flaherty & Crumrine Incorporated
February 27, 2009

[2] As of February 27, 2009, Flaherty & Crumrine Preferred Income Fund (PFD) had an approximately 0.3% position and Flaherty & Crumrine Preferred Income Opportunity Fund (PFO) had an approximately 0.4% position in the preferred stock issued by Citigroup. As of the same date, neither Flaherty & Crumrine/Claymore Preferred Securities Income Fund (FFC) nor Flaherty & Crumrine/Claymore Total Return Fund (FLC) had any position in Citigroup. Other information about Flaherty & Crumrine funds, including top 25 holdings and industry concentrations, is available at the funds' websites at www.preferredincome.com and www.fcclaymore.com.

[3] Available at the funds' websites and www.flaherty-crumrine.com.