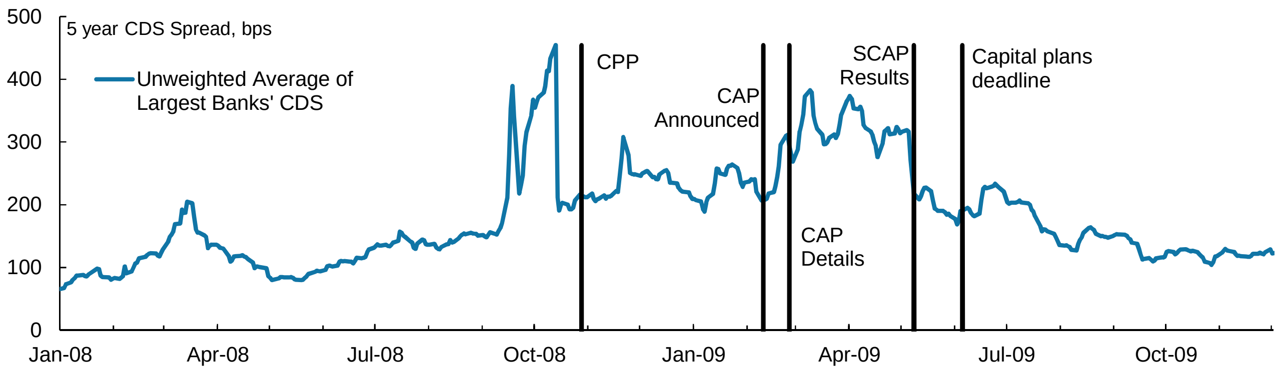
Capital Assistance Program

Background: The H1:2009 US stress test (SCAP) was designed to provide information of downside risk in banking system, and Capital Assistance Program (CAP) was the capital backstop to mitigate that risk.

- Four months earlier the Capital Purchase Program (CPP) supported about 50 financial institutions with up to $200 billion of TARP funds (initially).
- SCAP, announced at the same time as CAP, published results in May 2009. The test found 10 BHCs required additional capital.



"The purpose of the CAP is to restore confidence throughout the financial system that the nation's largest banking institutions have a sufficient capital cushion against larger than expected future losses, should they occur due to a more severe economic environment, and to support lending to creditworthy borrowers."

Design

- Institutions would issue mandatorily convertible preferred securities, normally 1-2% of RWA
- Preferred security carried 9% dividend; came with warrants
- Redemption:
  - Any time within the first two years the firm could redeem the preferred shares at par
  - Had to do so with cash proceeds from issuance of new common stock
- Conversion:
  - Within first seven years, the firm could convert the preferred shares to common equity at 90% at the average closing price before CAP's announcement
- Mandatory Conversion:
  - After seven years, the security would automatically convert to common equity
- Other various limitations on compensation, hiring, senior management reviews

Results

- SCAP found a capital shortfall of $75 billion; all banks except one fulfilled capital needs privately.
- Treasury did not receive any applications for the CAP, and program closed on November 9, 2009.
- Handful of estimates suggest the value of CAP was advantageous to the issuer initially.
- So why wasn't CAP used?
- Preferred shares could only be redeemed with cash proceeds of new common equity issuance → if price of issuing new equity is sufficiently large it simply removes option of redeeming.
- Firm might have seen CPP (with 5% dividend) as implicitly convertible, so reluctant to pay for explicit conversion option in CAP in the form of a higher dividend.