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THE CAPITAL PURCHASE PROGRAM REVISITED

Back in the ominous days of October 2008 when the financial markets appeared to be collapsing, the U.S. Treasury announced its Capital Purchase Program (CPP), a program that provided Tier 1 capital to U.S. financial institutions through senior preferred share investments. DBRS believes that the CPP was a necessary program that was successful in injecting capital into banks and helping bolster the markets' confidence in banks. While the CPP has not spurred loan growth (one can debate whether this is a function of banks not willing to lend or a lack of loan demand from creditworthy customers), it clearly played a vital role in stabilizing the banking system at the height of the financial crisis. Furthermore, U.S. taxpayers should profit from their investments in U.S. banks, especially if the proposed Financial Responsibility Fee is passed.

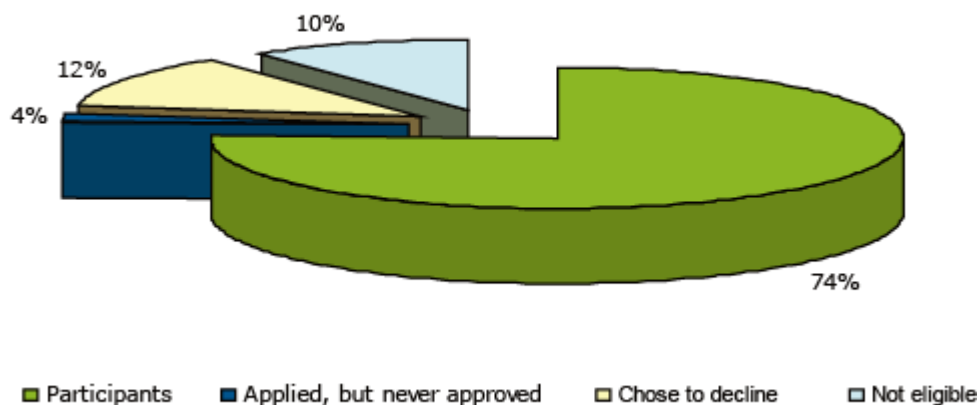
Now that the economy is on more solid footing and the capital markets are accessible again, DBRS views TARP repayment favorably. While not repaying TARP in 2010 will not necessarily result in ratings downgrades, no ratings upgrades will be considered until TARP is fully repaid. Repayment indicates that a bank has the franchise strength, earnings power and financial health to be able to generate sufficient capital to repay the U.S. Treasury. DBRS sees that potentially impeding some TARP repayments is the lack of clarity surrounding both domestic and global capital standards.

At the time of its introduction in late 2008, DBRS viewed participation in the CPP as an excellent insurance policy against potential future losses at a time when the capital markets were nearly inaccessible. Specifically, participation would enhance capital providing bondholders added protection in the case of elevated losses at banks in a very uncertain and difficult operating environment. Some banks that were hesitant to accept TARP funds were strongly encouraged to accept the capital as a validation of the concept. Other steps banks took to protect/preserve/build capital were to cut dividends, sell assets, reduce unnecessary expenses and tighten loan underwriting standards.

DBRS Rated Banks Participation in the CPP

At the height of the crisis, the rational decision was to participate in the government program. Only six banks rated by DBRS turned down the capital injections, all of which either had very strong capital positions, relatively better asset quality and/or access to private capital. Meanwhile, most banks decided to participate with DBRS rated banks receiving \$173.6 billion in preferred share investments. DBRS notes that the five banks in its coverage universe that are owned by foreign banks were not eligible to participate in the CPP.

DBRS Rated FIs Participation in the CPP



Source: SNL Financial, DBRS

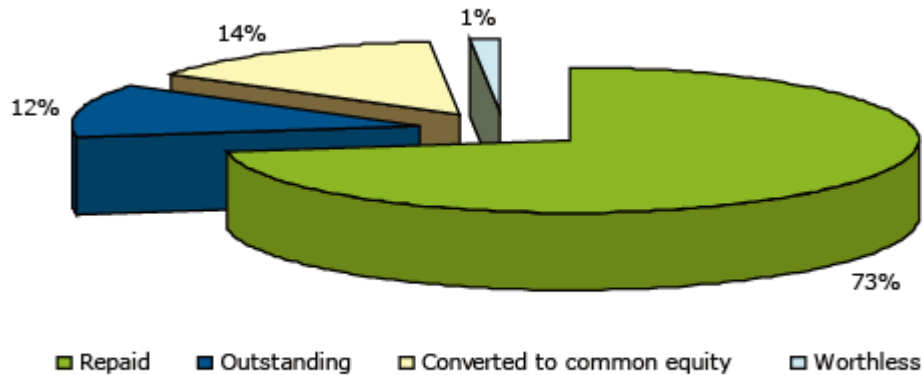
CPP Investment Status

Through February 18, 2010, the U.S. Treasury had invested a total of \$204.9 billion through the CPP, of which \$72.8 billion remains outstanding. In other words, the U.S. Treasury has recovered approximately two-thirds of TARP investments made to all banks and earned \$17 billion in income from those investments. If the Financial Crisis Responsibility Fee is passed, the bank returns and the fee will more than offset TARP losses from other companies receiving government money including AIG and the auto finance companies.

For the CPP as a whole, there have been three failures from financial institutions that received a total of \$2.6 billion in TARP funds; CIT Group Inc. (\$2.3 billion in TARP), UCBH Holdings, Inc. (\$298.7 million), and Pacific Coast National Bank (\$4.1 million). Another 74 qualified financial institutions missed at least one dividend payment in 2009, although 15 have since paid back their outstanding dividends. At least three banks have publicly stated that they will miss the February 2010 dividend payment, so this list should only grow as the year progresses given the large amount of problem loans many banks have yet to fully work through.

Of the \$173.6 billion in preferred share investments received by DBRS rated institutions under the CPP, \$125.2 billion has been repaid, \$21.1 billion remains outstanding, \$25.0 billion has been converted to common equity (Citigroup Inc.) and \$2.3 billion had no value (CIT Group Inc.) as of February 23, 2010. Additionally, three banks have stopped paying dividends altogether including TARP dividends (Citizens Republic Bancorp, Inc., The South Financial Group and Pacific Capital Bancorp) to further protect their deteriorating capital positions.

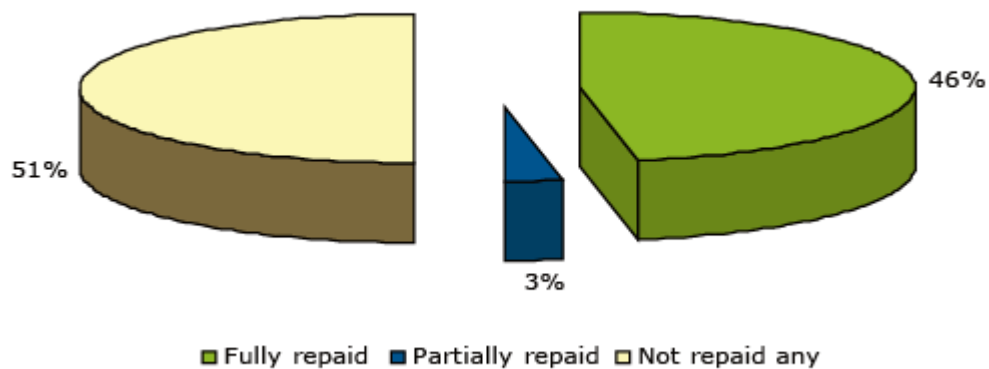
\$173.6 billion CPP Investment Status



Source: SNL Financial, DBRS

In total, 35 financial institutions currently rated by DBRS participated in the CPP. To date, 16 companies have fully repaid TARP and one bank has repaid half (City National Corporation). The remaining 18 have yet to repay any funds. All of the financial institutions have issued common equity to help repay TARP, which has improved the overall quality of their capital bases. Specifically, since the beginning of 2009, DBRS rated banks have raised over \$100 billion in common equity from the capital markets. Banks have also issued preferred and trust preferred shares to help fortify balance sheets. To improve the quality of capital and improve deteriorating common equity metrics, several banks have entered into exchange agreements that have converted preferred and trust preferred securities into common equity.

DBRS Rated Banks CPP Repayment



Source: SNL Financial, DBRS

Even most banks who have not repaid TARP have accessed the capital markets to raise common equity to bolster their balance sheets. Indeed, only five banks (Comerica Incorporated, M&T Bank Corporation, Fulton Financial Corporation, Susquehanna Bancshares, Inc. and Pacific Capital Bancorp) have not tapped the equity markets since receiving TARP. Almost all of these banks have the ability to access the markets, but have chosen not to at this point and are instead hoping for improving internal capital generation

capabilities and recovering stock prices to provide a more “shareholder friendly” exit of TARP with little or no shareholder dilution.

While being shareholder friendly makes sense financially, the CPP has been politicized and modified for the worse since its inception. TARP has been labeled a bailout of the banks at the expense of taxpayers and politicians have attached additional regulations to TARP including compensation limits, which could negatively impact the competitiveness of companies who have not repaid TARP. Many equity investors in TARP-funded banks view dilution as inevitable, especially since it appears that a certain amount of new equity issuance is a requirement to exit the program, so banks might as well eliminate the uncertainty surrounding potential capital raises. Rightfully or wrongfully, many investors view banks that have repaid TARP as stronger, more robust institutions. Furthermore, the Treasury investments were meant as a bridge to self-sufficiency, not as a permanent investment. Consequently, DBRS would look to see all banks that are able to raise common equity to help repay TARP in the near-term, especially since the capital markets appear willing to invest in these offerings.

CPP Capital Better Than the Alternative

Even though DBRS would like to see TARP repaid in the near-term, capital adequacy must be maintained. If a bank is under significant asset quality stress, DBRS would prefer that the bank keep the CPP capital cushion as an insurance policy against higher than anticipated losses. Additionally, regulatory uncertainty remains regarding future capital requirements, not to mention what banks must do in order to garner regulatory approval for TARP repayment in the first place. While regulators have been telling banks that capital requirements will be going higher with an emphasis put on common equity metrics, nothing specific has been articulated or mandated yet. In other words, banks are likely to continue to protect capital and be reluctant to lend until there is more clarity on the regulatory and economic fronts. DBRS expects a slow economic recovery where unemployment remains elevated for an extended amount of time. This should also translate into still weak earnings at most banks as 2010 progresses with improvement weighted towards 2H10 and 2011.

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