Today, Treasury is announcing its policy with respect to the disposition of the warrants received in connection with investments made under the Capital Purchase Program (CPP). In the case of investments in publicly-traded institutions, Treasury received warrants to purchase common shares which have not been exercised. (In the case of institutions that are not publicly-traded, Treasury received warrants to purchase preferred stock or debt and these warrants were exercised immediately upon closing the initial investment so they are no longer outstanding.)

Repurchasing Warrants under the CPP Contract

When a publicly-traded institution repays Treasury’s CPP investment, the original contract under the CPP provides the bank a right to repurchase the warrants at fair market value via an independent valuation process. The relevant sections of the transaction documentation describing this process can be found in the Warrants FAQ on www.financialstability.gov.

The warrant repurchase process works as follows:

Step 1: Within 15 days of repayment, a bank wishing to repurchase the warrants should submit a determination of fair market value to Treasury.

Step 2: Treasury will ensure that taxpayers’ interests are protected by conducting a process (described below) to determine whether or not to accept the bank’s initial determination. Under the contract, Treasury has 10 days to respond to the initial determination.

Step 3: If Treasury objects to the bank’s determination and cannot reach agreement with the bank regarding fair market value, the transaction documents outline an appraisal procedure by which the two parties will reach a final price. In this appraisal procedure, the bank and Treasury will each select an independent appraiser. These independent appraisers will conduct their own valuations and attempt to agree upon the fair market value.

Step 4: If these appraisers fail to agree, a third appraiser is hired, and subject to some limitations, a composite valuation of the three appraisals is used to establish the fair market value.

In order to protect taxpayers in this process, Treasury has developed a robust set of procedures for evaluating repurchase offers in Step 2 above. Treasury’s determination of value is based on three categories of input:

- **Market Prices**

  When available, observable market prices are used. However, Treasury has warrants that are not listed on a securities exchange or otherwise traded. These warrants do vary from typical listed warrants, mostly due to their long term (10 years). Therefore, the only observable market prices are for securities that have similar characteristics. The prices of these comparable securities can be used to assess the fair market value of the warrants held by Treasury.

  - Comparable securities for the warrants held by Treasury include: traded warrants, traded options, and common equity issued by the institution as well as similar securities of peer institutions. Generally speaking, the largest institutions in the CPP have a broad array of comparable securities with observable market prices. Mid-sized institutions have fewer comparable securities and those securities may trade somewhat infrequently. Many of the smallest CPP participants have no meaningful comparable securities with observable market prices, so Treasury will rely on other valuation methods.

  - Treasury will also obtain quotations for the warrants from 5 - 10 relevant market participants that may include investment banks regularly trading options or other securities with embedded options (e.g. convertible bonds) or asset management firms focusing on the financial sector.

- **Financial Modeling**

  Treasury will also use a set of well-known financial models to assess the fair value of the warrants. These models will include, but will not be limited to, binomial and Black-Scholes option-pricing models, and are widely used in financial markets to value options and warrants.

  - These models depend on known inputs (the expiration date, interest rates, and the current stock price) and on assumptions about the future volatility and dividends of the underlying common stock.

  - Assumptions about future volatility will be based on both the historical volatility and the option-implied volatility for a given stock and, where necessary, adjustments will be made for the expected mean-reversion of volatility over time. Treasury uses the average 60-day trailing volatility for the last ten years to determine a stock’s historical volatility. Some larger publicly-traded institutions have existing short-dated options and longer-dated options (with maturities of up to two years) that provide data on option-implied volatility, so we use these also.
Background on Warrants and the Capital Purchase Program (CPP)
Frequently Asked Questions (FAQ)

Q: What is a warrant?
A: A warrant is an option that grants the holder the right to buy another security at a specified price on a specific date or during a specified period of time. A warrant is very similar to a call option, but differs in that the firm itself is the seller of the option, rather than an outside party. Warrants for common stock give investors the right to buy new shares in the firm, which has a dilutive effect not associated with typical call options.

Q: Why does Treasury take warrants?
A: EESA mandates that Treasury take warrants in conjunction with the purchase of troubled assets from any institution for more than $100 million.

Q: Does Treasury always take warrants?
A: Yes, except in the case of a Community Development Financial Institution that receives less than $50 million from Treasury.

Q: Do the warrants look the same for all banks?
A: No.

- For publicly traded institutions, Treasury receives warrants to purchase common shares. Treasury has not exercised these warrants.
- For all other institutions (private companies, S corporations, and some mutual organizations) Treasury receives warrants to purchase additional preferred shares or subordinated debentures. Treasury immediately exercised these warrants upon receipt.

Q: How many warrants does Treasury get?
A: For publicly traded institutions, the number of common shares that underlie the warrants were calculated by taking 15% of the original investment amount, and dividing it by the exercise price. The exercise price was set at the average of the stock price during the 20 day period preceding the day that Treasury granted preliminary approval to participate in the CPP program.

**Example:** Bank A was approved for $100 million on December 1. Over the 20 days prior to December 1, the average stock price was $10. Treasury would have received a warrant to purchase 1,500,000 shares at $10 each. (15% of $100 million is 15,000,000. 15,000,000 divided by 10 is 1,500,000)

For all other institutions, Treasury received a warrant for an additional 5% of the original investment.

**Example:** Bank B is approved for $100 million on December 1. Treasury will receive a warrant to purchase an additional 5% of preferred shares or subordinated debentures. Treasury will exercise this warrant immediately after closing the transaction. Thus, Treasury will have $105 million of preferred shares.

A small bank participating in the CPP under the new terms (Small Bank program) announced on May 13, 2009 will not be required to give warrants for any incremental investment above 3% of RWA (they may get up to 5% of RWA under the CPP expansion).

Q: Is the number of warrants subject to reduction or adjustment?
A: Yes, a bank can reduce the number of warrants it issued to Treasury by 50% if it completes a qualified equity

- Assumptions about future dividends will be based on current, historical, and option-implied dividend yields. These assumptions will be limited by the parameters of the dividend protections outlined in the warrant documents.
- The value of the warrants will be calculated for a range of different assumptions about the future volatility and dividends.
- Deviations between market prices and the output from these models may occur due to model biases. Many of these biases are well-documented, and Treasury will make appropriate adjustments to correct for any potential biases.

**Outside Consultants/Financial Agents**

Treasury has retained 3 asset managers and intends to use other outside consultants to assist Treasury in enhancing its process and independently assessing value of each repurchasing bank’s warrants. Each of these outside asset managers will provide full independent valuations for each repurchase, including key assumptions affecting their value determinations to inform Treasury’s decision process.

Alternate Disposition of Warrants

If an issuer chooses not to repurchase the warrants according to its existing contractual rights, Treasury has the discretion to dispose of the warrants as it sees fit over time. In these instances, Treasury will sell the warrants through an auction process over the next few months. Treasury is currently establishing guidelines for these auctions, which it will publish on www.financialstability.gov.

The President has clearly stated that his objective is to dispose of the government’s investments in individual companies as quickly as is practicable. In reaching the judgment to dispose of the warrants in the manner described, Treasury considered a range of options including holding the warrants for a longer term or until their expiration. Under those alternate scenarios, there was no certainty that we would realize higher values, and it was not appropriate for the government to be exercising discretionary judgment on timing market sales.

Accordingly, a fully transparent auction as described above provides the best method for the Treasury to realize the market value of the warrants in the near term on behalf of taxpayers.

**Transparency**

Treasury publishes information on all CPP transactions, including investments, repayments and warrant repurchases, in the TARP Transactions Reports within 2 business days of closing. All transaction reports are available on our website at www.financialstability.gov.

Further, Treasury will begin publishing additional information on each warrant that is repurchased, including a bank’s initial and subsequent determinations of fair market value, if applicable. Following the completion of each repurchase, Treasury will also publish the independent valuation inputs used to assess the bank’s determination of fair market value. All of this information will be available www.financialstability.gov.
offering. This is a sale of common stock or certain types of preferred stock for cash in an amount at least equal to the original amount of Treasury's investment.

- **Example:** Bank A issues $150 million of common equity to market participants. Since it raised at least 100% of the original investment amount of $100 million, the warrant is cut in half. Treasury now has a warrant to purchase 750,000 shares at $10 (1,500,000 shares multiplied by .5).

The warrants are also subject to customary "anti-dilution" adjustments in the event of other changes to the Company’s capital structure, which is designed to ensure that Treasury’s interest is not "diluted" by such changes.

**Q: Can the exercise price change?**
**A:** Yes, the exercise price can be revised pursuant to the anti-dilution adjustments so that the value of what Treasury is entitled to receive is not affected by certain changes in the capital structure.

**Q: Where can I find the relevant sections of the Securities Purchase Agreement ("SPA")?**
**A:** The entire SPA for publicly traded institutions can be found at [http://www.treasury.gov/initiatives/financial-stability/investment-programs/cpp/Documents/spa.pdf](http://www.treasury.gov/initiatives/financial-stability/investment-programs/cpp/Documents/spa.pdf). The relevant sections mentioned above are copied below:

- **Section 4.9 (c)(i):** "Appraisal Procedure" means a procedure whereby two independent appraisers, one chosen by the Company and one by the Investor, shall mutually agree upon the Fair Market Value. Each party shall deliver a notice to the other appointing its appraiser within 10 days after the Appraisal Procedure is invoked. If within 30 days after appointment of the two appraisers they are unable to agree upon the Fair Market Value, a third independent appraiser shall be chosen within 10 days thereafter by the mutual consent of such first two appraisers. The decision of the third appraiser so appointed and chosen shall be given within 30 days after the selection of such third appraiser. If three appraisers shall be appointed and the determination of one appraiser is disparate from the middle determination by more than twice the amount by which the other determination is disparate from the middle determination, then the determination of such appraiser shall be excluded, the remaining two determinations shall be averaged and such average shall be binding and conclusive upon the Company and the Investor; otherwise, the average of all three determinations shall be binding upon the Company and the Investor. The costs of conducting any Appraisal Procedure shall be borne by the Company.

- **Section 4.9 (c)(ii):** "Fair Market Value" means, with respect to any security, the fair market value of such security as determined by the Board of Directors, acting in good faith in reliance on an opinion of a nationally recognized independent investment banking firm retained by the Company for this purpose and certified in a resolution to the Investor. If the Investor does not agree with the Board of Director’s determination, it may object in writing within 10 days of receipt of the Board of Director's determination. In the event of such an objection, an authorized representative of the Investor and the chief executive officer of the Company shall promptly meet to resolve the objection and to agree upon the Fair Market Value. If the chief executive officer and the authorized representative are unable to agree on the Fair Market Value during the 10-day period following the delivery of the Investor’s objection, the Appraisal Procedure may be invoked by either party to determine the Fair Market Value by delivery of a written notification thereof not later than the 30th day after delivery of the Investor’s objection.