

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & James Bruss
DATE: January 31, 2009
SUBJECT: A Note of Optimism

As we reviewed different approaches to this month's E-Memo, we found ourselves, like the market, in a very black mood. It has been difficult, if not impossible, these past months to view the world with any optimism. Even the hope many placed in the election of a new president is being dimmed by the droning bad news about his cabinet appointments, his legislative initiatives, and the lack of a solution for the financial crisis—note, we said *financial*, not *banking*, crisis.

At its core, the predicament we have been dealing with for more than a year is *financial* in nature. We are not dealing in semantics; there are real differences between the financial and banking systems. We'll try to explain.

Banking provides credit to business to support growth. But over the last few decades, credit markets have greatly expanded with the help of secondary markets—what might be termed a “shadow” banking system—that provided additional funding for growth. One of the primary tools of this expansion is securitization, the creation of a new security that derives its value from an underlying pool of (generally financial) assets.

Wall Street created securitization nearly 30 years ago. In itself securitization was not a bad thing, even now in early 2009. In the late '70s and early '80s, securitization became a way for Wall Street to create products it could then sell to investors. Auto loans, credit card receivables, department store receivables, secured and unsecured consumer loans, and residential mortgages were pooled, securitized, and sold. Investors, both institutional and individual, bought pieces of these pools because they provided yield characteristics that were superior to corporate bonds, though comparably rated. This process greatly added capacity to the financial system as the economy grew. But it should be pointed out that all of those department store charges, credit card receivables, car loans and mortgages grew exponentially and well beyond what the banking system could handle. This shadow banking system eventually grew larger than the banking system itself, providing enormous amounts of fuel for growth. The banking system did participate in funding for the securitized assets, most frequently holding the securitized mortgages created by Freddie Mac, Fannie Mae, and Ginnie Mae on their books as investments. Nevertheless, the largest share of securitized assets was held by non-bank entities: large multi-national corporations that used securitized assets as (often high-yielding) treasury management tools; investment companies; and other individuals.

According to Robert Albertson, chief investment strategist at Sandler O'Neill, the non-bank financial market is enormous. In a January 6th, 2009 note entitled “The Lone Lenders,” he says that residential mortgage volume through the non-bank markets peaked at \$1.1 trillion in 2006 and has since dropped to zero. Bank mortgage lending volume was over \$225 billion in 2006, declined in early 2008 to approximately \$50 billion, and has now rebounded to \$150 billion. Non-bank mortgage lending is virtually dead. Similar trends characterize consumer lending. At its peak, consumer lending by non-bank entities was running at an annual rate of \$150 billion; it is now reduced to nothing. Banks on the other hand have managed quite nicely to grow their annual new consumer loans from \$40 billion in new loans at the peak of securitization of consumer loans in 2001 to \$75 billion in new loans in the past 12 months. The de-leveraging in non-bank consumer financing—not consumer lending by banks—has caused credit markets to dry up.

Looking at outstanding loans at banks vs. non-banks provides an even more stunning comparison. Mortgages outstanding at banks are running at about \$2.3 trillion; at non-banks, the outstanding balance is over \$9 trillion—almost four times as much as at banks. According to the Federal Reserve, banks fund only 20% of *residential* mortgage loans. When a \$9 trillion lender (the secondary credit markets) stops making loans, banks cannot make up the difference overnight or even in one year.

So are banks lending? The evidence we shared with you in November was a resounding YES! According to Bob Albertson, the answer is still “yes”—to the tune of \$500 billion in 2008! Half the \$500 billion has gone into consumer loans and residential mortgages. That is a pittance compared to historical volumes in non-bank markets, which peaked in 2006 for mortgage loans at \$1.1 trillion and for consumer loans back in 2001 at \$150 billion.

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The problem that needs to be fixed is not bank lending, but the financial system—Wall Street. Providing more TARP capital to the likes of Citi, JPMorgan or Bank of America does not properly address the problem. The evidence from the studies done by the Minneapolis Fed, even before TARP, showed that banks were lending. Banks did not need TARP to make loans; they were already doing it. TARP may have been a band aid for the wounds caused by pricing soured assets, but it was not the fix. Let's remember these numbers in the non-bank markets: \$9 trillion outstanding in securitized mortgages vs. \$2.3 trillion in bank-held mortgages, and \$1.7 trillion in consumer loans vs. \$850 million in bank-held consumer loans. Banks only fund 1/5 of mortgages and 1/3 of consumer credit. The rest is financed in the non-bank markets created by Wall Street. There is no way in the foreseeable future—no matter how much capital the government injects—that banks will be able to pick up the slack.

We do need to get the economy growing. The engine of growth in our economy is small business. By providing credit to small business, community banks provide the lubricant for that growth. But growth drives credit expansion, not the other way around.

This is where community banks come into the picture. Given the dysfunction in the non-bank credit markets, there is a phenomenal opportunity for all banks to lend. This is especially so for community banks. The conduits that created securitized assets are no longer in existence. Wall Street hasn't created a single securitized pool of assets in recent memory. The big banks have been traumatized by TARP—the specter of compensation oversight and governmental meddling in banking practices—and will remain so. Some small banks that took TARP may have second thoughts. But they are, by and large, far better capitalized than their much larger brethren, and this bodes well for community banks. While their stock prices have been slashed to levels previously unimaginable, the opportunities to make loans in the future are equally unimaginable.

But community banks are challenged for attractively priced deposits as they compete with banks with liquidity problems that won't hesitate to pay high rates. That's where we think attention must be paid by the financial strategists trying to figure out appropriate policies for spending the remaining \$350 billion in TARP funds. Without substantially increasing deposits, banks cannot replace all the credit capacity created by the securitization market.

Banks don't loan capital, and therefore they don't loan TARP funds. Rather, they invest those funds to support balance sheet growth—but they cannot lend additional money without first growing deposits. This won't happen overnight: deposit growth year-over-year is in the 9% range, while loan growth continues to decline and is currently in the 8% range. We expect the latter to continue declining until the process of de-leveraging is over. That may take a few more months. When it is over, we expect the good news will be that banks will be lending and significant loan growth will be found among the small banks in which we invest.

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