

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: February 27, 2009
SUBJECT: Next Time We'll . . .

Paul Volcker, former Federal Reserve Board chairman and current member of President Obama's economic team, was recently invited to speak in Toronto about the US economic crisis. His prepared remarks were to the point. Eschewing the obfuscation we have seen from recent Fed chairmen, he said: ". . . We are having a great financial problem around the world. And finance does not work without some sense of trust and confidence and people meaning what they say. You take their oral word and their written word as a sign that their intentions will be carried out."

There it is: trust and confidence. The commercial banking industry blew it. The industry's regulators blew it. Its accountants blew it. We put in decades of hard work and long hours. We tossed and turned at night worrying about this credit or that farmer or hardware store or tool and die maker. We anchored our banks on hard work and built them on trust and confidence so that when our customers and clients walked through the door they could completely rely on our word. But we blew it.

The Regulators

Over the last several years, the banking industry has been witness to extremes. For most of that period, banks have been fat with profitability. But over the last year or two, profits have been frittered away with enormous loan loss provisions, other-than-temporarily-impaired (OTTI) charges, and a collapsing net interest margin. Beneath that simplified narrative is the failure of regulators to understand trends that affect the entire industry. Many banks—even typically solid community banks—succumbed to some of these trends: excessive concentrations in real estate development and construction; overly generous loan-to-value ratios; a lack of focus on core deposits and a resulting dependence on brokered CDs. Especially disconcerting was the concentration on *residential* real estate construction and development loans. Yet, regulators, who were supposed to possess the best industry-wide knowledge and had the legal authority to do something about it, sat idly by.

Ultimately, the regulators bent to the trend. From Alan Greenspan to the lowliest FDIC examiner, everyone adhered to the principle that a house can only appreciate in value. This encouraged skewed loan-to-value ratios, which required wholesale funding (like brokered CDs), which, in turn, ate away liquidity. This was bad enough, but factor in the possibility of defaults by homeowners and developers, and the potential for disaster was magnified.

Regulators exist for a reason: to prevent bad ideas from becoming bad banks. Bankers are rightly suspicious of regulators—as one banker pithily remarked, the role of regulators is to walk through the battlefield after the war and shoot the dead—but the regulations under which bankers toil are frequently (and sometimes well) designed to promote sound credit practices. Failure to observe the basics of asset allocation remains a temptation for bankers looking for a quick buck; it should be anathema to regulators. For too long, it wasn't.

The result of this lack of oversight would have been bad enough had the regulators merely reverted to traditional credit supervision. Instead, the regulators over-corrected. For example, when the indirect auto loan market began to show stress (largely as a result of veering off tried and true credit metrics), regulators overreacted. Bankers made loans to borderline sub-prime credits; those credits showed stress; and the regulators forced the banks to increase their FICO score limit well beyond sub-prime. If that wasn't enough, the regulators treated lending institutions differently. They looked the other way while GMAC (after becoming a bank holding company in record time—only hours after applying for that status) lent money to sub-prime borrowers but forcing Main Street State Bank to shutter its profitable indirect auto business. What sense did that make?

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When our regulators are wrong and we know it, it is time to push back. We know the adage that when the examiners are in the bank they are “the controlling shareholder”. But we can push back and we must when our regulators overstep their bounds. There are remedies and even though it may be necessary to engage legal counsel. This isn't a call for indiscriminately bad relations with one's regulators; it's a call for perspective. When the regulators are wrong in fundamental ways, bankers need to pull out the stops to ensure their businesses are not negatively impacted.

The Politicians

When it comes to the political response to this crisis, we are tempted to say: don't get us started. There's not enough blood pressure medication left in the bottle. Unfortunately, bad ideas trickle down, and there is no better example than the gasbag that is Congress. It is quite breathtaking the lack of basic understanding that permeates the halls of Capitol Hill. No sooner did Hank Paulson change his plan from buying bad assets to recapitalizing banks than Congress began hammering banks for their failure to convert the capital injections directly into loans. Yet, early in November—at the same time Congressional tirades were gaining steam—the Federal Reserve in Minneapolis issued a paper dispelling the idea that banks weren't lending. In fact, as the Minneapolis Fed noted, bank lending had even increased since the fall of Lehman Bros. According to the most recent H-8 report of the Federal Reserve Board banks are actually making more loans than they did last year at this time. And that has been the case with each and every H-8 report issued since September 2008.

It took numerous bank experts to circulate the basic banking principle that you don't lend capital, you lend deposits. Capital creates capacity for lending, but banks still need actual deposits if they are to lend. Even this lesson has fallen on deaf ears. Bert Ely's simple and concise explanatory editorial on the matter was relegated to a dark corner of the Wall Street Journal's op-ed page. Front page news on the Wall Street Journal over the past weeks, however, exhibits a complete ignorance of that explanation. Political grandstanding and the accompanying media coverage have won the day. Banks are bad because they don't lend capital.

But the emperor has no clothes. It turns out some of those grandstanders exposed the fatuousness of their own criticisms when they successfully inserted themselves into the regulatory process. OneUnited, a Massachusetts community bank, was the recipient of some high-level patronage when Representatives Barney Frank and Maxine Waters persuaded regulators to give OneUnited TARP money. The trouble with that? OneUnited was a bad bank with great executive perks—according to the Wall Street Journal, the bank owned a Porsche for the pleasure of its management. Barney Frank could possibly be forgiven for going to bat for a home state bank; Rep. Maxine Waters' (congresswoman from California) only excuse is that her husband sat on the board of OneUnited until last spring.

To top it off, politicians are wholly unrepentant about their role in causing the financial crisis. The Community Reinvestment Act (CRA) promoted a great idea: a homeownership society. But it artificially injected additional government participation into a market that should have produced such a society on its own. In the process it created an ethic of lending that ignored basic principles of credit. Added to this were Fannie Mae and Freddie Mac, privately-owned but publicly-guaranteed institutions that provided a market for banks to sell increasingly high risk mortgages. In every instance when someone blew the whistle on their poor credit practices, Representatives and Senators lined up to show their support for Fannie and Freddie.

And we should trust them, why?

What will we do next time? Fire our lobbyists? That would be a good place to start. We question the effectiveness of tilting at the windmill of credit unions even as many are converting to thrift charters. Rather than being caught up in policy minutia, the lobbyists need to recognize that their role—defending the banking industry—requires more than fighting tax advantages for credit unions. They must recognize that banks provide the operating fuel for economic growth in our free market and they must be

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unabashed about this. Yes, this requires the lobbyists to take a stand as free market capitalists. But more controversial positions have been successfully defended in the past.

The lobbyists must also recognize—and here, the failure is quite massive—that without *small* banks, small companies cannot grow into big companies. Banks, especially small banks, provide the lubricant of the engines of growth in our free market capitalist society. The failure to recognize this and to actually lobby for small banks, not just banking behemoths, does no one any good. Finally, we need fearless, committed community bankers—like the readers of this month's *E-Memo*—who are willing to lobby their Representatives and Senators one-on-one. If need be, they must go to Washington and camp at their legislator's office door until they get the audience they deserve.

The Public Accountants and SEC

A public accountant has much to offer as an advisor and counselor. But frequently, the public accounting industry is crippled by a concern for professional security. Because of scandals in the early part of this decade, accountants are understandably concerned not to run afoul of the SEC. Accountants too often refuse to push back against FASB and the SEC on bad practices because accepting those practices insulates them from liability. For example, many realized that forcing unreasonably low loan loss reserve levels was irresponsible and that mark-to-market accounting would not work in illiquid markets, but they were bound by FASB.

Loan Loss Reserves

Over the years banks have found loan loss reserves a valuable resource for providing cushion against shocks to the earnings statement. We don't know any bankers who know or will admit they know that a loan made today will go bad tomorrow or the next day or the next year. Experience tells them some will. Therefore, bankers used their experience and judgment to set aside a percentage of each new loan in the form of a reserve. As bankers sensed the economic circumstances surrounding its portfolio declining, they would increase the reserve. The SEC saw that as manipulating earnings and, in collaboration with the accounting profession, sought to change the practice by creating ever more complex and ever changing formulae. A mechanical practice replaced judgment and drove down reserves. Banks that wisely built capital instead of reserves (essentially providing the cushion once provided by reserves) were fortunate. Most have seen a veritable explosion in loan loss provisions in the past several quarters with little abatement of provisions in sight. Those with adequate reserves or adequate capital will survive.

Will bankers push back next time? They had very well better, if for no other reason than the losses now facing banks will make it much easier. Will an accountant really want to take part in a public dispute with its bank client, arguing that the bank's level of reserves should be lower than the bank wants? We think not.

Mark-to-Market Accounting

Last but not least, mark-to-market accounting (MTM). We don't have to wait until next time because next time is now. It isn't too late to contact your Representative, Senator, and the head of your regional bank regulatory office to speak out about mark-to-market accounting. Instead of improving the situation in the last two decades, FASB introduced FAS 157, which essentially turned illiquid assets into toxic assets. We will not pretend there are no bad assets out there; there are. But many are "toxic" not because they are bad assets, but because they are illiquid. The logic goes thusly: if there is no market there is no price; if there is no price then the price is . . . ? Zero. In turn, these "toxic" assets destroy bank capital—thanks to FAS 157.

Let's look at MTM another way. Say you wish to sell your house. You set a price and advertise it for sale. All your neighbors with similar houses decide to do the same. Assume there are no buyers in the market. What is the value of your house? Under MTM the value is zero. Does that make sense? If you answered no, you now understand MTM. So we have a stubborn FASB and SEC and an ignorant

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Congress unwilling to push FASB and the SEC. Changing MTM can be accomplished by regulatory fiat. Why it hasn't been changed is a mystery.

The Bankers

Bankers have been lulled by years of flush earnings into playing dead when controversy rears its head. This must end and it must end now. Bankers have a responsibility to their banks, to their employees, to their shareholders, and to the communities they serve to stand up and be counted. Call or write your Representative and Senator now and ask them how they would like their own home to be subject to MTM. If MTM still makes sense to your legislators, remind them that every two years, in November, there is a way to mark *them* to market—to turn them into political zeroes.

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