

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
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SUBJECT: Lab Rats

I'll play it first and tell you what it is later. – Miles Davis

At a recent bank conference we attended, one of the panel moderators suggested that bankers today live in an experimental environment. That prompted one banker on the panel to agree and remark that he felt like a lab rat.

Of course, most of the experiments are being performed by regulators. Ask nearly any banker who's been through an exam in the last year and he or she will tell you a similar story about the regulators, whose marching orders seem to be inconsistency and contradiction. What to all the world looks like improvisation, may well be methodical in its madness. But if so, the method has eluded everybody.

There is nothing new with bankers complaining about their regulators. But whereas in the past bankers could gripe as this regulatory peccadillo or that one, they were largely free to do business with the assurance that the rules would not change from day to day and, indeed, that the rules were the ones written down in the United States Code and the Code of Federal Regulations. Not so anymore. The "rules" do change from day to day and bankers are inevitably caught up in the whipsaw.

Take capital ratios, which have been driven upward by regulatory fiat. Just when asset quality problems have seriously drained capital, and new capital remains hesitant because of economic and political uncertainty, regulators are forcing many banks to increase their capital ratios. Oftentimes these newly minted capital ratios are far in excess of established capital ratios and have forced banks that are unable to raise capital to shrink their balance sheets. Complying with the new capital requirements curtails the availability of funds to lend.

But Washington keeps harping on banks to lend more, which necessarily lowers capital ratios when bank earnings are under stress. The regulators say one thing (or rather, the regulators say many things, but they are most anxious to increase bank capital) and Washington says the opposite. Confusion reigns for those caught in the mix, leaving them wondering who is in charge and what the rules are. This discordant song that results is enough to give any banker a migraine and feel like a lab rat.

The regulators have also taken a "ready, shoot, aim" approach to grading the banks they oversee. Banks' CAMELS ratings are a composite score of several different relevant performance and risk categories (C=capital; A=asset quality; M=management; E=earnings; L=liquidity; and S=sensitivity to market risk) and range from 1 to 5, with 1 being the best. Increasingly, regulators are putting grades on management (M) *before* their examinations. Prior to the exam, they know a particular bank suffers from asset quality problems, needs capital, and can't make a healthy profit. Therefore, the bank's management must be deficient, right? But this has occurred even with new bank management teams hired by troubled banks to clean up a mess. I.e., the regulators are grading management a) before they examine them and b) even if the management team had no part in the bank's troubles, except to remediate the problems.

What's more is others are reporting that their regulators are bunching together banks of quite different relative quality under one grade. Three banks might all get the same grade of 4, but one is a "straight 4", another is a 4 with some fairly large problems, and still another is rated 4 but is teetering on the edge of the abyss. To those bankers who've been given a 4 rating, the perplexity is palpable.

Another unhelpful regulatory development relates to new deposit rate rules. Banks under regulatory orders must now frequently hew to caps on depository rates. The intent, of course, is to force banks to reduce their cost of funds. At the same time, however, regulators have forbidden most of the same banks from accessing the market for brokered deposits which, while less desirable in terms of liquidity, are often less expensive and can be a good tool for banks to lower their cost of funds and improve their margins. Just as frustrating is that these new deposit caps, which are based arbitrarily on a national average, unduly prejudice banks operating in markets with high deposit rates. Banks, again, are caught in the middle of regulatory schizophrenia, restricted in doing what they do best: taking deposits, lending money to businesses in their communities, and creating value for their shareholders.

So, why are banks caught in this confused experiment like lab rats? For one, they're easy targets. The banking industry has been the media and public's whipping boy for well over a year. Politicians have blamed banks for everything from making obscene profits to losing money, from igniting the worst financial crisis in memory to being bailed out against their will. The sleight of hand, here, is that Washington and the media conflate commercial banks with investment banks (even the regulators do; just ask Goldman Sachs, the very definition of an investment bank, which now takes deposits).

The media can be partially forgiven. The 1999 repeal of Glass-Steagall encourages this view, as money center banks have become financial supermarkets. But Goldman Sachs is not now and will never be "State Community Bank". Whether out of laziness and condescension to their audience, the media don't care to clarify that distinction. Nor do politicians who, from laziness or political point-scoring, ignore the myriad differences between highly leveraged large investment banks with widely varied investment strategies and community banks that take deposits and lend to small businesses. Instead, they pillory both under the name of Banks.

The investment banks, along with Fannie Mae, Freddie Mac, big money center banks, and largely unregulated mortgage brokers built a house of cards. Community banks, with few exceptions, steered clear of the subprime mortgage business only to see a real estate bubble fueled by leverage (created in many cases by the investment banks) wreak havoc on their balance sheets when the bubbled popped.

It takes considerable talent, experience, and patience to navigate the cruel maze of community banking today. The lab rats who manage to find the exit will certainly reap the benefits of their hard work. But it is no credit to anyone—regulator, politician, or journalist—throwing up roadblocks seemingly designed to confound logic and experience.

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PARTNERS

CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029

262-369-1095 (Jon Bruss and James Bruss)

www.fortresspartners.com

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