E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: October 24, 2008
SUBJECT: Are We There Yet? – The TARP Version

Last month we asked the question, "Are we there yet?" How could we have been so naïve? Decades of financial history have been compressed into the forty or so days since then. Wall Street as we knew it is no more; the besieged investor must be forgiven for replacing the question, "What's next?", with, "What's left?" The titans of investment banking are now major commercial banks (Goldman Sachs and Morgan Stanley), part of a commercial bank (Merrill Lynch), or, simply, a memory (Lehman Bros.). AIG is now the insurance arm of the federal government. In the commercial banking world, major players now send annual reports to Hank Paulson. Soon, commercial banks of all sizes and shapes from around the country will be doing the same.

In times like these, the chronicler of financial markets risks egg on his face every time he puts pen to paper as one development quickly eclipses another and uncertainty reigns. We're no different. When we sent our last E-Memo, we did not know Wall Street would be transformed, and with it, the American commercial banking industry. So, we are cautious in our predictions.

TARP Terms

First, let's get our hands around what the government proposes to do with commercial banking. Under the $700 billion Troubled Asset Relief Program (TARP), the federal government proposes to buy troubled assets (assets, such as mortgage-backed securities, that have either impaired income flows or depressed market prices or both) from banks. The idea behind this plan is to inject liquidity into the banking system by "creating" a market for these assets that more fairly prices the assets.

The other part of TARP, the Capital Purchase Program, is much more interesting to us as it will likely have a far greater, and more immediate, impact on the banks we follow. Under this part of the plan—which is also designed to inject liquidity into the banking system—the Treasury will purchase as much as $250 billion in "senior" preferred shares newly issued by banks. Though we are always skeptical of the government's "help", this plan clearly has some of the marks of lessons learned.

First, though called senior, these preferred shares will not be senior to existing preferred shares, unless the latter are junior by their own terms. This avoids the problem created by the Treasury's bailout of Fannie Mae and Freddie Mac, which wiped out existing holders of preferred shares, while still providing banks with Tier 1 capital. Our reading of the TARP Capital Purchase Program suggests the government's investment will not wipe out holders of bank preferred shares.

Second, the Treasury's capital injection is inexpensive. For the first five years, the shares will pay a 5% dividend; thereafter, 9%. Banks can buy back the shares after three years. Before three years, banks may buy back the shares with the proceeds of a common stock or perpetual preferred stock offering that provides no less than 25% of the value of the preferred share issue price. Third, the plan is minimally dilutive. Along with the preferred shares, the Treasury will take warrants worth 15% of the preferred investment. Finally, the government will not have voting rights unless the bank fails to pay dividends on the preferred shares for any six quarters.

The Law of Unintended Consequences

In the last several months we have all gotten PhDs in the law of unintended consequences. For example, when one money market fund broke the buck, the government stepped in to back up all money markets. This certainly had the effect of restoring confidence in money market funds, but it had the unintended consequence—or could have, if not for the government's quick-thinking flexibility in limiting that insurance to existing investments—of producing a run on deposits held at commercial banks.

Last spring, the government *sort of* let Bear Stearns fail, but *sort of didn't*. Whatever good the government intended in facilitating the fire sale of Bear Stearns to JP Morgan Chase, it did not intend the mixed message it sent to other Wall Street investment banks. Since then, the government's ad hoc approach to the potential collapses of major financial institutions has exacerbated an already difficult situation. Fannie Mae, Freddie Mac, and AIG are too big to fail, Lehman Bros. was not. No wonder Goldman Sachs and Morgan Stanley compliantly took their medicine and became commercial banks.

So, what will be the unintended consequences of the TARP Capital Purchase Program? Well, unintended consequences are, almost by definition, unforeseen. But we can already recognize several possible problems with the program. First, the Treasury will not invest in banks simply to postpone failure. This means that everybody will soon know, or think they know, which banks the Treasury expects to fail. News of a possible failure can quickly snowball into an actual failure when the bank's depositors withdraw their savings.

Banks whose applications are accepted by the Treasury do not have to worry about that consequence. But these banks will now be in bed with the federal government, and there is uncertainty in that. Moreover, while we are familiar with the broad outlines of the plan, the details of the preferred stock agreements are unknown. Will the Treasury append additional terms to the agreements? Will it force participating banks to buy up weaker competitors as a condition of receiving the Treasury's capital? Banks—especially those that remember when the federal government pulled "supervisory goodwill" out from under their feet in the 90s—will be gun shy about taking the government's help. This reluctance is completely understandable and, quite frankly, a healthy counterweight to uncritical enthusiasm.

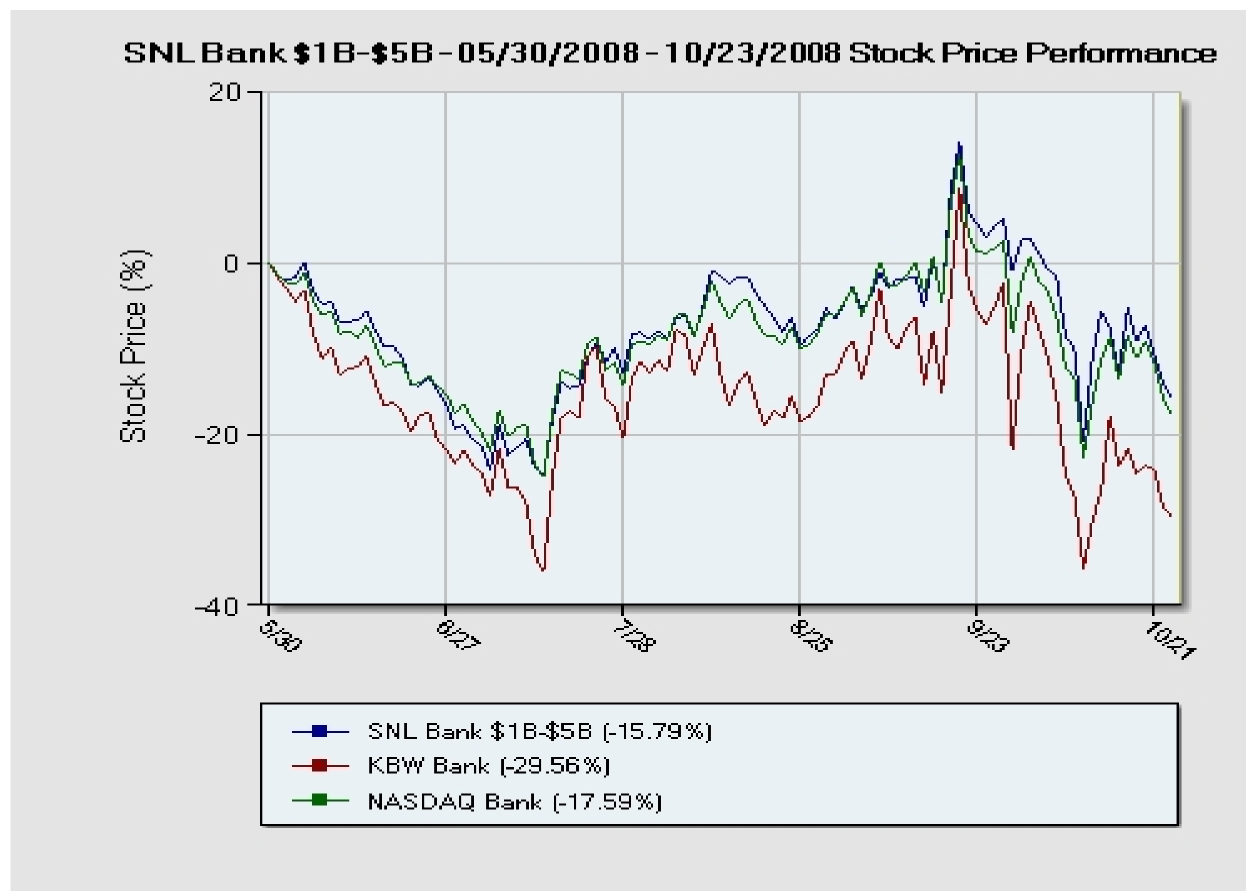
Weighing the Pros and Cons

These considerations should not deter banks. We believe that the TARP Capital Purchase Program is an attractive plan. Participating banks will have the Treasury's imprimatur and will be able to advertise that to the public. The plan is also a good way for banks to buttress their balance sheets. This will help participating banks take advantage of the inevitable economic recovery, position them well to make strategic acquisitions, and put private capital on notice that they are good investments.

We do not wish to minimize the risks of participating in a capitalization plan conceived and administered by the federal government. Moreover, we recognize that some banks may elect not to participate simply because they are already so well-capitalized that the government's involvement would be a distraction. But weighing the negatives against the positives, most banks will and should follow the strong encouragement of their regulators to apply for participation and accept the inexpensive capital to pursue growth opportunities.

Are We There Yet?

So, we've been avoiding the question. We thought we had an idea when we sent our last E-Memo. Notwithstanding the considerable financial chaos since that time, we still think we were right. On July 15, bank stocks dropped through the floor. Since that time, they have tested those lows twice; on October 10 and as we write this the bank indices have come near the July 15 lows. (See the graph below which shows bank stock performance from the end of May through yesterday's close.)



The markets have a stubborn tendency to presage conditions in the broader economy. It is no wonder that the July 15 lows have been tested; since then, economic conditions have deteriorated significantly, Wall Street has undergone colossal upheavals, and the presidential election has shown a bright spotlight on both. This a recipe for volatility and the next few days and weeks may prove us wrong that a bottom is forming. But we know that the coming quarters are sure to bring a recovery (probably as robust as the economic meltdown). Out ahead of the economic recovery will be the stocks—bank stocks—unjustly battered by the onslaught of bad news over the last several months. We will be there.

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