

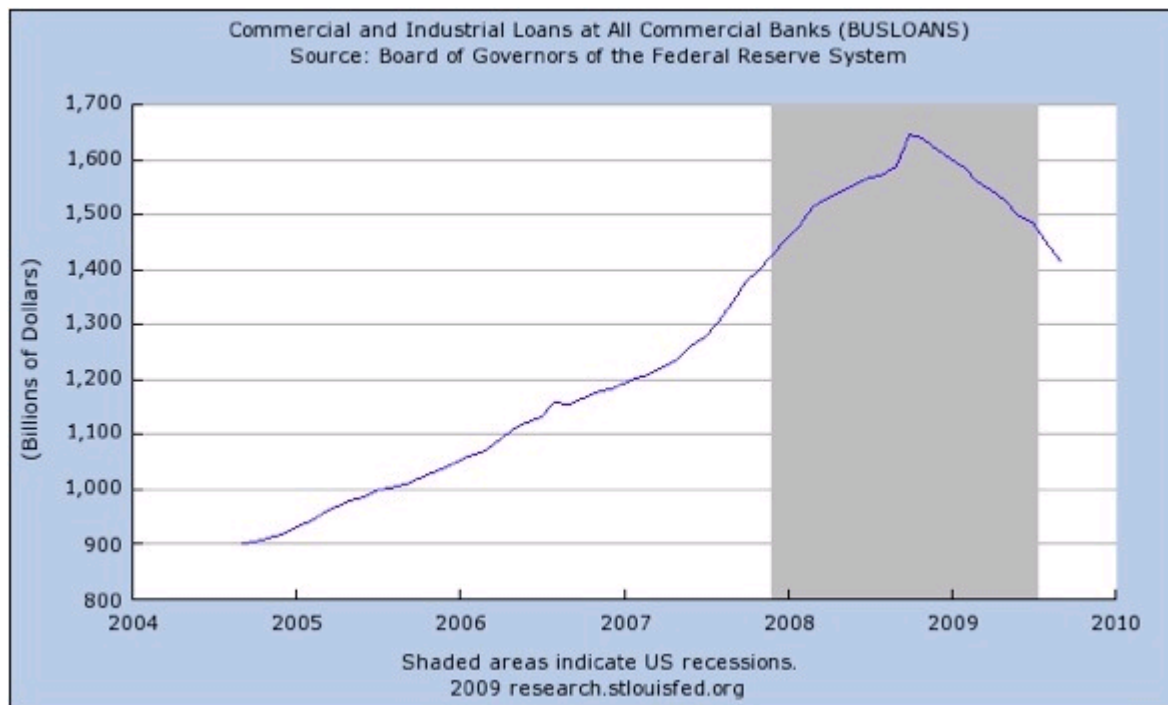
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: October 27, 2009
SUBJECT: Banks Are the Bad Guys . . . Again

When Congress gets its back up these days, you can be assured it's much ado about nothing. The latest stir is about those nasty banks that refuse to act in good faith by making credit available to Americans. (Actually, this is a sequel to Congress's horror that banks weren't shoveling TARP money out the door last October as soon as they received it.) As the logic goes, the American taxpayer bailed out the entire banking industry and now Congress—ever-protective of the federal fisc—wants to ensure taxpayers get their loans approved. But the big, bad banks (and bad, small banks) are not cooperating.

The problem is that evidence of the industry's supposed credit intransigence is incomplete, at best; the risk is that Congress might actually try to do something about it. The evidence relies on anecdotes of stingy lenders and statistics showing the decline in outstanding credit. The first source, your next door neighbor's story about not getting a loan, is suspect because it doesn't tell us why that is the case. What's your neighbor's credit history? Where does he or she bank? What's the purpose of the loan request?

The second source of evidence—presumably more reliable because it has been cast into numbers—is equally obscure. The evidence is this: loans outstanding (measured in dollars) are contracting. The graph below illustrates this trend in business lending. Since the end of the third quarter in 2008, business loans outstanding at U.S. commercial banks have declined without pause. Loans outstanding now match the amount in late 2007, just as the recession was kicking off.



The same is true of consumer credit. This troubles many because it suggests banks are withholding the fuel for economic recovery. Given the extravagant assistance from taxpayers in the form TARP funding, it stands to reason we should all be up in arms about banks' stinginess. We bailed you out; now *you* bail *us* out.

Unfortunately for the alarmists, the situation is more complex. It is helpful to steal an analogy from Gene Epstein, writing in the October 19, 2009 issue of *Barron's*. Epstein compares outstanding credit to a bathtub. For a bathtub's volume to increase, the faucet pouring water into the tub must do so at a higher volume than the drain is removing water. Thus, new credit extensions must outpace the drain on credit for the total credit outstanding to increase. This is obviously not happening. But that does not necessarily mean new credit extensions are in decline—i.e., that banks are withholding taxpayer money from taxpayers. (It's another subject altogether, but the fallacy perpetuated in the media and in Washington that banks lend capital, as opposed to deposits, needs to die quickly. For our take, see page 2 of <http://www.fortresspartners.com/pdf/0209Ememo.pdf>.)

The drain on outstanding credit comes from several places: loan pay-offs; amortization; charge-offs; REO (essentially, foreclosed real estate). In a furiously deleveraging economy, it is no surprise that loan pay-offs might increase. After the panic of last autumn, businesses and consumers alike began to pay off their loans to reduce leverage. At the same time, those same businesses and consumers continued regular loan payments on loans they were unable to pay off immediately. With the worsening economic conditions, banks were forced to charge off bad credits and foreclose on real estate. Each of these trends has continued even through the pick-up in economic activity.

The faucet has also been affected by the panic. Consumers have become debt averse—or, at least, more so than they were just a couple years ago. They have also spent less, which has led to a decline in sales and a leveling in retail prices. As a result, credit extensions have not grown for purchases consumers do make these days. Moreover, businesses have responded to the recession by liquidating inventories and paying off loans. Finally, stung by the over-leveraging of the last decade or two (note the expansion of commercial credit from \$900 billion in the middle of 2004 to \$1.7 trillion in late 2008), neither consumers nor businesses have been eager to take on new debt.

Behind the numbers on the decline in outstanding credit is a complicated set of motives and factors that tell the story of a nasty recession. But to infer that banks are practicing parsimony is reductionist at best. Banks have certainly revisited their underwriting practices, with good reason. Those that were unwise enough to make risky loans, or lacked a crystal ball that told them a major recession was just around the corner, are now working to restore credit sanity. They must do so if they are to survive over the next few years, but they also know they must extend credit to make money. The banks we're invested in are actively pursuing new loan and deposit customers. That is what banks do and they continue to do it. To paraphrase an old proverb, you can lead a customer to the bank, but you can't make him borrow.

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