

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss and James Bruss  
**DATE:** November 21, 2008  
**SUBJECT:** What's Going On Under The TARP?

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Anyone who thought the markets were waiting for the election to re-introduce some stability has been disabused. It is difficult to argue the campaign—the constant media spotlight, the demagogic finger pointing, and, frankly, the circus of bad ideas—did not affect the trajectory of the financial crisis. The uncertainty that began on the balance sheets of financial services companies (investment banks, insurance companies, and some commercial banks, not to mention Fannie Mae and Freddie Mac) morphed into political uncertainty. But unfortunately, once that ball got rolling, the election couldn't put a stop to it.

In the bailout—the Troubled Asset Relief Program, or TARP—there is plenty blame to go around for this political uncertainty. Treasury Secretary Henry Paulson, for instance, has swerved all over the road. He would argue he was avoiding unforeseen potholes and deer darting across the road. To others it has looked as though he may have had a few drinks. What began as a *necessary* plan (can anyone recall the breathless pleas from Secretary Paulson and Fed Chairman Ben Bernanke that without the program to buy troubled assets, the economy would spiral into perdition?), has since been scrapped in favor of direct capital injections. And that followed months of Treasury occasionally watching from the sidelines, occasionally dabbling when it felt appropriate, though everyone else was left to wonder how Treasury defined “appropriate.” Whether you like the TARP capital injection or not—and let's face it, a direct capital injection is a very efficient way of boosting loan capacity for banks—the ad hoc nature of Treasury's conduct over the last nine months or so has done little, if anything, to restore any kind of confidence.

The question of confidence is central, but it's rooted in certainty, or the lack thereof. There is a direct correlation between the breathtaking loss of confidence over the last two months and the increasing uncertainty about what comes next. Congress, in its 535-headed wisdom, has only added to the confusion and made banks understandably jittery about Congress and Treasury's plan to “stabilize” their industry.

Why? Didn't Congress pass legislation that allows Treasury to conduct business with commercial banks without the threat of congressional meddling? No, it seems.

Notwithstanding Secretary Paulson's ambitious proposal that his decisions be unreviewable by anyone or any institution, the Securities Purchase Agreement (the agreement between Treasury and the banks in which it plans to invest capital and which was unavailable to us when we wrote our last E-Memo) contains the seeds of congressional mischief. Section 5.3 of that agreement has now become notorious among bankers and bank investors: “No amendment of any provision of this Agreement will be effective unless made in writing . . . *provided* that the [Treasury Department] may unilaterally amend any provision of this Agreement to the extent required to comply with any changes after the Signing Date in applicable federal statutes.” (Emphasis in original.) Black's Law Dictionary succinctly defines a contract as an “agreement between two or more parties creating *obligations that are enforceable* or otherwise recognizable at law.” (Emphasis added.) Please excuse any banker who is skeptical that he or she is really signing an enforceable contract when the time comes to take Treasury's money.

In case the point is still obscure, Senator Christopher Dodd went on NPR this morning to voice his disappointment with banks that have received TARP money. In essence, Sen. Dodd accused them of not acting in good faith by using the capital injections to ramp up lending. The solution, according to Sen. Dodd, is to change the rules:

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**Steven Inskeep of NPR:** Well, should banks hear a warning that if there is not some improvement in the next few weeks, you might be, say, at the very beginning of the next Congress, writing in revisions to that law?

**Sen. Dodd:** Absolutely, Steve, and thank you for the question.

**Inskeep:** You think that you could be changing this and making it more strict?

**Sen. Dodd:** We'd have to. I mean, I'm not left with any options. They know what they need to be doing, and they're not acting responsibly, in my view. And, if they don't act responsibly, then I'm going to require them to act responsibly.

<http://www.npr.org/templates/story/story.php?storyId=97295899>)

Well. As Sen. Dodd indicated earlier in the interview, the members of Congress don't have the requisite expertise to run the U.S. banking system. Section 5.3, however, gives them the power to do so.

But this exchange raises another, crucial point. A far brighter senatorial light, the late Patrick Moynihan, was fond of warning: "Everyone is entitled to their own opinions but not their own facts." (We know Sen. Dodd is familiar with this wisdom: <http://miamiherald.typepad.com/nakedpolitics/2008/10/dem-to-nelson-y.html>.) What if Sen. Dodd's premise is wrong? What if banks are continuing to lend money?

The facts are these:

- The Federal Reserve's H-8 Report from November 14, 2008 shows:
  - Commercial and industrial (C&I) lending is up 14.7% year over year—11.0% at "large" banks, 10.4% at "small" banks;
  - Real estate lending is up 5.8% year over year, and 3.8% since June 30, 2008;
  - Home equity and consumer loans are up 14.1% year over year.
- An October 2008 paper from the Minneapolis Federal Reserve Bank (with data available through October 17, 2008) shows continued increases in nearly all major measures of lending throughout this autumn:
  - Total bank credit;
  - Loans and leases;
  - C & I;
  - Consumer loans;
  - Interbank lending.

The volume of commercial paper has seen some declines recently, especially among financial institutions. But even at that, there is more commercial paper outstanding now than a year ago.

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In short, banks are not only continuing to lend, but increasing the volume. Some have speculated that instead of an increase in banks' willingness to lend, these numbers reflect uncertainty among borrowers: they are merely testing their lines of credit. This may be true, at least in part, but there is no hard evidence. In fact, note that C & I lending at small banks is up 10.4% year over year. It is highly unlikely that borrowers at smaller banks are testing their lines. Bankers at smaller institutions have quite close relationships with their borrowers and the financial health of those small banks is far easier for borrowers to measure. There is, in fact, no reason for borrowers at small banks to test their lines. In all events, credit has increased across the board, even where "line testing" is not a factor.

The question now becomes, why would a bank apply for the privilege of signing away its rights so it can do business with a government that doesn't have its facts straight? We may have heard the answer this morning from a banker friend in Florida. He told his regulator that his bank is well-capitalized and he saw no reason to apply for the TARP capital injection. His regulator agreed but told him he should still apply. When he pushed the regulator on why he should do it, the regulator responded: "Just do it."

The message was as clear to our banker friend as it is to us: Treasury is picking winners and losers. If you don't apply, you run the risk that your customers will think you didn't qualify—i.e., that you weren't worth saving. That, of course, is a matter of perception, but we have all seen perception trump reality many times over the last several months. Take the money or leave it, but at least let the world know that Treasury thinks you are worth the investment.

So what is really going on under the TARP? Should banks apply for and accept Treasury's money, even in the face of political risk? In the absence of Section 5.3, the answer is clearly yes. TARP is cheap capital that considerably grows a bank's capacity to lend and that is a good thing. As the regulator above suggested, TARP is also a stamp of approval from the federal government. At this point, however, the question needs to be addressed case-by-case. Banks that don't accept the government's largesse risk not having dry powder to use when the economy turns. Banks that do accept it risk having the rules changed on them.

Banks should apply for the TARP capital injection (the deadline for publicly held banks has already passed; for privately held banks the deadline is December 8, 2008), but if accept it, they are well-advised to immediately devise a plan for buying back the preferred shares as soon as possible. Neither banks nor their investors can afford to be in business with Congress when it changes the rules. Any acceptance of the government's money must include an exit strategy.

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