

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss
DATE: March 17, 2008
SUBJECT: Banking Basics Redux, Part I: It Depends On What The Meaning Of The Word "Bank" Is

Revisiting our E-Memos from the past five years is an interesting exercise. Some assertions have been off-base. But we've been spot on when we focus on the fundamentals of banking. Having spent the better part of five decades in banking and financial services, we ought to get it right.

Massive credit and liquidity dislocations have damaged the financial condition of big banks (emphasis on "big"). In turn, the financial weakness of big banks—as well as investment banks and mortgage bankers—has further exacerbated the credit and liquidity problems. The stock prices of all banks, big and small, have suffered as a result of over-leveraged investment in sub-prime mortgage backed securities. But it's worth noting that the underlying financial condition of most banks has not deteriorated to the extent portrayed in the media.

The media often confuse the definition of "bank" with "mortgage bank" or "investment bank." The most important distinction is regulation. Our banks are *always* regulated by at least one federal agency, whether it's the Federal Reserve System, which regulates banks and bank holding companies; the FDIC, which regulates banks and insures their deposits; the Office of the Comptroller of the Currency, which regulates national banks; and the Office of Thrift Supervision, which oversees thrifts. Institutions that are not nationally or federally chartered are subject to state regulation in addition to federal regulation. Investment banks like Bear Stearns and mortgage banks like New Century are not regulated or supervised by any of these agencies. This is a key distinction between mortgage banks and investment banks, and the banks we invest in.

Investment "banks" and mortgage "banks" want us to place the same trust in them we place in our depository institutions. Wall Street, along with big banks, investment banks, and mortgage banks (Citigroup, JPMorgan Chase, Bear Stearns, Merrill Lynch, and New Century, et al.), blur the distinction, and the media—lazy and all-too-human—perpetuate the fuzziness by calling them all banks. In fact, only Citigroup and JPMorgan are truly banks; the others are not.

Here's what bank regulation and examination brings to the table for us investors:

- **Uniformity and clarity in financial statements.** While this is true, the bigger the bank the less clarity and transparency. At times even regulators are in the dark when examining bigger banks such as Citigroup, Bank of America, Wachovia, and the like—allowing these institutions to take risks well beyond the ability of the bank's capital to support such risks. That's a major reason we focus on small cap investments, where size does not frustrate transparency.
- **Limits on capital risk.** What do 12 to 1 and 32 to 1 equity capital ratios have in common? Not a whole heck of a lot, right?
 - *Small commercial banks*, our kind of banks, must maintain a minimum level of capital to avoid additional regulatory oversight. The level of equity must be in the range of **6% to 8% of assets**. Our banks—

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indeed, most small banks—maintain at least that kind of equity capital ratio; many at a far higher percentage.

- *Investment banks* are allowed 50 to 1. Really! **Two percent equity capital.** This difference is lost on the media. It's a huge difference, nonetheless, and we as investors can't afford to miss the distinction. Small banks generally don't become ensnared in SIVs consisting of pools of tranches of pools of sub-prime mortgages (yes, such things actually exist). When these pools, which are off-balance sheet and leveraged almost infinitely, are subjected to margin calls you begin to understand why Bear Stearns needed to be bailed out.
- **Bank and holding company financial information must be provided to bank regulators quarterly.** Bank financials far more detailed than those in a GAAP audit are available on the FDIC website when filed by the bank and are easy to find. Bank examiners will review the financials within days of their submission and contact bank management to address any questions or concerns.
- **Loans to directors must be disclosed** in quarterly financial statements provided to regulators.
- **Executive borrowing relationships with other banks must be disclosed** to the board of directors and to bank examiners. Do you know of another industry where this is required?
- **A high level of transparency** is enforced by regulatory supervision. Bankers don't always take kindly to the wire-brushing examination process, but such efforts protect both depositors *and investors*.

What's most bothersome is that banks, their industry associations, and their regulators have been virtually silent on the confusion the media have created. Banks pay tens of thousands of dollars to industry associations for their lobbying and education efforts, and millions in examination fees and FDIC insurance premiums. Enlightened self-interest, if nothing else, should compel industry associations and bank regulators to bring clarity to growing concern about banks.

Almost three months ago, the director of the FDIC went on CNBC to make the point that insured banks were actually in good shape. That remains true. But one voice crying in the wilderness does not a public relations campaign make. Aside from that single instance, I have not seen any industry association representative or any regulator step up to the microphone to dispel the confusion.

As you saw from the subject line of this E-Memo, I intend to revisit the basics of banking again over the next several months. It is easy to forget what one has learned about banks when the media are so helplessly confused about the basic question, What is a bank?

I hope that by revisiting the subject we can regain our understanding about what has made this country the economic bastion of the free world. Since we began investing in bank stocks we have

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held firm to the belief that the foundation of a free economy is its diverse and competitive banking system. This country has approximately 8,000 chartered and regulated banks. That's far more diverse than any nation in the world. And it is competitive beyond belief. Our job as investors is to make sure we are knowledgeable and proactive, promoting efficiency and strong, smart performance in the banks we own. This practice will foster a healthy banking system and a strong, free economy.

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