

Equity Match Proposal

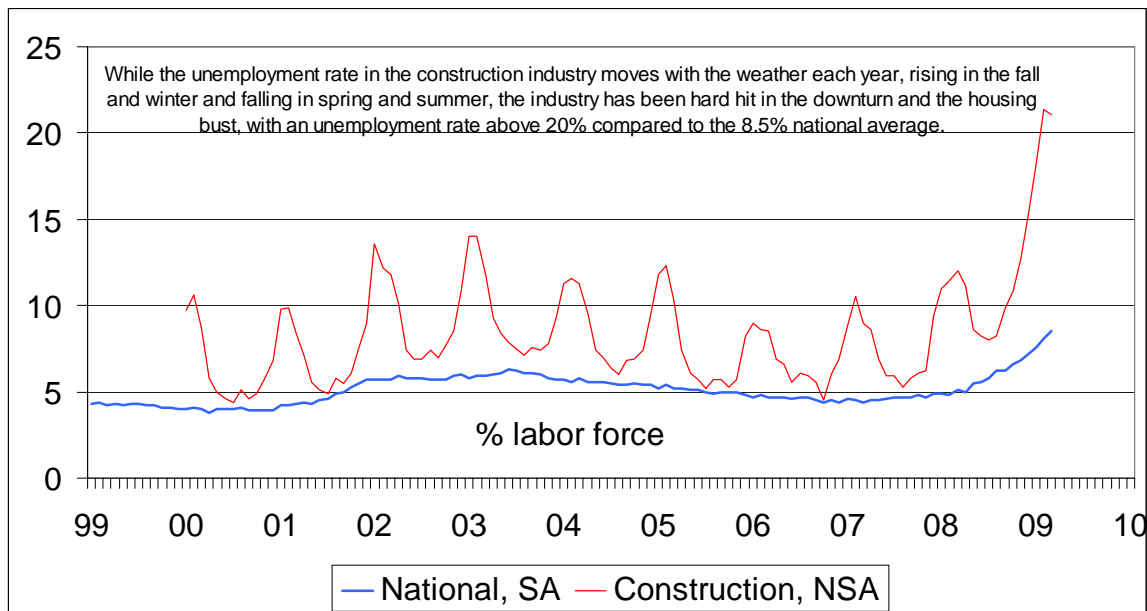
As the financial crisis and the ensuing worldwide recession continue to batter the US economy, the Obama administration has entered the fray with a multi-pronged attack that combines aggressive fiscal and monetary policy with an expansive legislative agenda that seeks to address the suffering and collateral damage of this now historically severe meltdown. As is the case in any crisis management situation, it is critical to evaluate the effectiveness of the tactics deployed to meet the crisis, and considering that a number of separate initiatives emanating from two different administrations are now in play, this task becomes essential. Towards that end, a review of the results of the initial deployment of the TARP funds is now in order, with an eye towards the effectiveness of that deployment in regard to the stated mission.

In his comments in early March, Chairman Bernanke made it clear that the Fed's stated policy surrounds getting the credit markets moving, and that the collapse of the credit markets now and historically are understood to be the proximate causes of a continued deterioration of the economy towards a depression. Clearly, the initial goal of deploying the TARP funds in order to get the banking system to begin the credit easing that the Fed feels is fundamental to a recovery has not occurred. Instead, the TARP funds that were deployed over the past quarter have been used by the largest recipients of those funds to support the cratering value of the compromised assets on their balance sheets. Critics of the subsequent efforts to use the remainder of the TARP funds in a more effective manner rightly point out that any plan that simply aims at purchasing troubled assets at a price higher than they are currently marked and trading is not a solution that fits into the stated mission of credit easing. Even the stress-testing of the largest 19 financial institutions is geared more towards understanding the potential cash needs of the banks that have been deemed Too Big To Fail, an important and essential task, but one separate from the near term loosening of bank credit.

As a scorecard of TARP to date, the program has purchased \$328 billion in preferred securities from 495 financial institutions. While the program was first established for the banking sector, it has been widely expanded to other finance companies, such as AIG, American Express, and GMAC. The fifteen largest borrowers from TARP have garnered the bulk of the funds, accounting for 85% of total lending. There are therefore over 7500 banks that have not participated in TARP, which maintain over \$3 trillion in bank assets (versus the \$10 trillion in assets controlled by TARP banks).

These banks are generally sound with capital ratios well above market and regulatory guidelines (both Tier-1 and tangible equity ratios). However, lending activity remains morose, indicating that banks still feel that their capital levels are inadequate, and are therefore hesitant to lend.

It is hard to overstate the importance of the Community Bank’s role in the broad economy. According to the FDIC, banks with less than \$5B in assets, which hold only 18% of the assets in the banking industry, are responsible for outsized percentages of particular loans, including construction and land development (43%), commercial real estate (45%), and multi-family residential (33%) and the broad category of all real estate loans (29%). These smaller banks are directly involved in the creation of wealth and commerce at the most fundamental level of our economy, and provide the working capital that will be necessary for any recovery. The disproportionate impact that these institutions have in the construction and real estate sectors is notable due to the fact that reinforcement of these vital areas will provide the most immediate stimulus for our recovery. The unemployment rate in the construction industry has dramatically decoupled from the overall unemployment rate, and while it remains cyclical, it clearly shows the effect of the ill effects of the downturn in the housing industry. The latest data shows an unemployment rate in the construction industry of 22%, versus an overall rate of 8.5%. That compares to a year ago, when the rates were 11% versus 5% respectively. The chart below illustrates the dislocation in the construction industry:



The conclusion that can be drawn is that if we can get the community banks lending to this disproportionately distressed part of the economy, we may be able to create jobs where we have experienced the largest job losses.

Towards this end, we suggest that the Government creates an equity fund that will match non-TARP capital raises by banks, capital raised through the sale of common equity with the stated purpose of raising the capital adequacy of the ultimate lending institutions. We estimate that outside of the small group of mega-banks that have received the lion’s share of the TARP funds and continue to struggle with their deteriorating capital positions, the other banks in the system could double their tangible equity position by raising only \$300 billion, largely in line with what has been doled out by TARP. Unfortunately, at the same time that the largest banks are wrestling with their balance sheets, the thousands of other lending institutions are struggling with the effects of the recession, particularly the effects of the commercial

real estate and the residential housing market. We propose that Government funds match the equity raised on a dollar for dollar basis, providing the imprimatur of a private/public partnership focused on restarting this essential machinery of commerce.

Our proposal focuses on the issuance of common equity, which provides permanent capital to bolster operations, rather than through the sale of preferred stock, which is viewed as more temporary in nature. If the Government sends a strong signal to the marketplace that a permanent long-term capital raise by these regional and community banks will restore them to the point that they can begin to lend again, much of the uncertainty that plagues the market place and the broader lending environment will be removed. An ancillary benefit of doing such a capital raise will be the general qualification of the banks themselves, a necessary and integral part of the process of raising public money through the capital markets. The discerning buy-side clients will become the ultimate arbiter of an issuing bank's creditworthiness, particularly in a transparent and open issuing market. Banks could use any method to raise capital including private placements, registered offerings, auctions, or traditionally underwritten deals, and by utilizing a matching fund that includes private market investors, the government will be ensured market pricing at a moment when attractive valuations and fair returns can be reasonably expected.

Banks could choose to raise capital for another reason altogether; they may choose to use the funds that they receive from a successful raise and match in order to replace TARP monies they have already received as well. The terms of the initial TARP now seem onerous to many of the recipients, particularly with regard to the ongoing dividend payments as well as the five-year term of the capital. Undoubtedly, many of the original recipients would be willing to replace the TARP funds with permanent long-term capital.

Chairman Bernanke and the Fed have clearly stated that credit easing is the essential element that needs to occur, both to halt the slide towards a more severe recession as well as to begin the process of recovery. While the deployment of the initial TARP program has done the good work of cauterizing the balance sheets of a few institutions deemed Too Big To Fail, the broader lending system needs to be addressed in such a way that effective and targeted capital returns them to a position of strength, a position from which they can begin the essential function of providing credit to the system.