NO CLARITY ON THE PURCHASE FACILITY

by Steve Brown

If Fed Chair Bernanke and Treasury Secretary Paulson wanted to make things clearer for Congress yesterday, they failed. In an attempt to explain how troubled assets would be priced as they are purchased (into the "Cash for trash" rescue plan), they made things murkier.

Bernanke made the point that assets will be purchased not at "fire sale prices," but at a "fundamental" or "hold-to-maturity" valuation. On this point, Bernanke was clear, as he spelled out the benefits to banks in selling at a fundamental valuation that would protect a bank's capital. If banks are stable, he argued, liquidity would come back to the market and uncertainty would dissipate. He went on to state that once the assets mature, taxpayer losses should be minimal. Upon cross-examination, Bernanke concluded that, "We do not know exactly what the best design is," but details will be released after consultation with "experts." Now, not to be overly critical, but given that the valuation question is the lynchpin to making this facility work, we would like our Fed Chair to work things out with Paulson before heading up the hill to Congress.

We spend a fair amount of time suggesting bankers consider marking things to market as a way to better understand the underlying risk. We argue had this been done in the first place, banks would have know back in 2005 that spreads were widening for mortgages, because defaults were increasing. Instead of valuing assets at book, lenders would have seen the impact of their origination actions and moved to decrease risk. If anyone doubts this assertion, go ask Herb and Marion Sandler of World Savings fame because that is when they sold World to Wachovia - right at the top of the mortgage market.

The thought that Bernanke endorses a mechanism that supports anything but fair value pricing make us cringe. If the belief is that these assets are really going to mature at some held-to-maturity price, then it would be easier for the government to provide cheap funding to all these institutions and let each participant work out their own assets. If the goal is to inject more capital, then that is a different story. Why not just inject capital and call it a day. Mixing the goals is going to cause problems.

If banks submit a reverse auction bid at their "held to maturity" valuation, most banks will use something close to their book price. Should that be the case, banks will get a great windfall at the expense of the taxpayer, a fact that Paulson has said will not happen and we also know how Congress doesn't want to give any windfalls to mean old bankers. The truth of the matter is that right now there is an information problem to go along with a shortage of capital and liquidity. Since we continually value assets, we can tell you that no one knows what these mortgages or commercial loans are worth. While some will mature close to their fundamental value, many more won't. Otherwise, they wouldn't have been sold in the first place.

We agree the plan needs to be kept simple and get approved fast. We are less concerned about punitive or political ramifications and know these issues can be worked out when the markets stabilize. We only request more clarity on the auction mechanism or implore Congress to restructure it to better target either capital or liquidity. On that front, we kind of like the AIG-type deal. That way, the Treasury gets all the bad troubled assets, but at least it has an equity stake in the game and controlling say over how the game is played. With the current explanation of the rescue plan, it is no wonder why the markets are losing confidence. Hopefully, as the 2nd day of testimony begins today, Paulson and Bernanke will get another chance to provide additional clarity.

BANK NEWS

M&A

CBFH Inc. ($640mm, TX) will buy Crosby Bancshares, Inc. ($361.9mm, TX) for an undisclosed amount.

More Equity Coming

The FRB has revised prior policies and will now allow private equity investors to take as much as a 33% equity interest in a financial institution, of which 15% can be voting common stock, without being deemed a controlling investor. In addition, the Fed clarified a prior policy on director seats, stating that private equity investors can get 2 seats if, among other factors, there is another larger shareholder that is already a bank holding company. The moves should encourage private equity firms to buy stakes in banks.

Cost of Bailout

Including the Treasury plan, loan to AIG and all other bailout costs (Fannie & Freddie funds injection, Bear financing for JPM, etc.), U.S. taxpayers would have to foot an estimated $1.8T bailout tab. For those keeping score, that is more than Spain and Canada's individual GDP for 2007.

Lending Review

Ask your business customers how many days their receivables are outstanding. Analysis shows the average company receivable has reached 41 days, the highest average since the 2001 recession, so customers that are above that number should receive personal attention.