INTERESTING BOARD MEMBERS ON CAPITAL

by Steve Brown

How would you like to be so interesting that alien abductors actually allow you to probe them? So interesting that even your enemies use you as an emergency contact? Hopefully, you are blessed with the world's most interesting board members to render advice on the TARP Capital Purchase Program ("CPP"), but if not, that is OK. Since strategic planning and management oversight are two of the most important activities that a board member can partake, the CPP is fertile area to have an interesting conversation.

For starters, interesting board members will hopefully temper the current trend we see of banks looking to apply to the Treasury, but not plan on taking the capital. Yes, we agree that getting the capital and turning it down could be a marketing opportunity, but in the scheme of things, that move will likely be forgotten in 15 minutes. Considering that it takes a minimum of 5 hours of analysis for each bank submitted, our Nation's resources (particularly your primary regulator and the Treasury's) are too valuable to waste at a time like this for the sake of vanity.

With regard to communication, your bank should be prepared with a message to employees, shareholders, customers and the public, no matter what you decide. Either you are anointed with the capital because of your strength (and the bank is ready to do its part to stimulate the local economy), or the bank is already strong and doesn't need the additional capital to do its part to stimulate the local economy. Should the information become public (and it most likely will) that you applied, but did not get approved, a communication should be at the ready with a plausible reason to explain how the outcome does not mean weakness (you weren't eligible, there were more needy candidates, yada yada,). Interesting banks communicate their intentions as thunder precedes lightening.

The more important advice that the board can render is over what to do with the excess capital. If a bank already has exacerbated credit problems, the choice is easy. If however, a bank wants to take the capital for an abundance of caution, management should be prepared walk the board through a credit stress analysis of the portfolio (using our CSA product for example) to make a case for the capital. Without knowing the sensitivity of the balance sheet to future credit shocks, how do you know a bank needs capital?

If the capital is to be used for bank and non-bank acquisitions (there are some great buys available), then a general outline of what that potential target looks like (size, location, financial position) is prudent in order to keep management focused on the long run strategic objectives of the bank. Letting management look around for a home for capital without guidance carries its own set of risks.

In closing, there is another trend that interesting board members should watch out for. Taking the capital and leveraging it up in securities comes with a set of risks that may not be appropriate for this market. Not only does leverage tie the capital up away from its intended use, but it creates a much higher level of interest rate risk. As we discussed yesterday, volatility is near an all-time high. Some of the leverage programs that we have seen include volatility back below their mean. While this makes the credit shock analysis of the program look good, given the lessons we have learned over the past year, this might be a mistake. At a time when the mortgage landscape has the potential to be radically altered, prepayment assumptions on investments may end up being strongly muted or wildly exacerbated. Since volatility is the death to most leverage programs, executing this strategy may destroy the very capital that banks hold dear.

While it is nice to have dolphins come on out when you swim and police pull you over just so they can learn about you, it is even better to have interesting conversations about capital. As any Hemingway-esqe board member will tell you - Stay Thirsty (for knowledge).

BANK NEWS

Fed Funds

After the employment report, many economists (Goldman Sachs for instance) lowered their Fed Funds projections calling for another 50bp to 75bp in cuts. It is possible that we may live in a zero interest rate world and banks will have to find a way not to drop their Prime rate in order to protect margins. The takeaway - stop using the WSJ Prime or other indexed rate in loan documentation. GO TO A MARKET RATE (LIBOR) OR YOUR OWN ADMINSTERED RATE to give added flexibility.

Economic Growth

GDP is now projected to contract through mid-2009 at an annualized rate as low as a negative 4.5%.