UPDATE ON TARP - GET THE CAPITAL

by Steve Brown

Yesterday, Treasury Secretary Paulson gave a speech providing an update on the TARP. He began by providing some perspective on the history of the rollout, focused on where money had been allocated and finished strong by indicating Treasury would not use the money to buy distressed mortgage assets through auctions. Wait, wasn't it just 8 weeks ago when Paulson asked Congress for an unprecedented $700B so he could buy distressed mortgage assets? Maybe when you are living in dog years (i.e. 7 dog years for each human one), he thought more time had gone by, or maybe he is just reacting to changing conditions. Who knows, but if you were one of those bankers holding your breath for a long shot bailout for distressed land or construction loans, it isn't coming through Treasury and the TARP program.

In building his case, Paulson said the idea of purchasing troubled assets from financial institutions was good, but wouldn't be sufficient given the severity of the problem. He also focused on how long it would take to implement the program and seemed to indicate it was time the country could just not afford to lose. He then smoothly transitioned to investing capital directly into banks, pulled in the Federal Reserve as a consultative partner in the process to add credibility and dropped the zinger that the idea of purchasing illiquid mortgage-related assets was "not the most effective way to use TARP funds" and effectively put a bullet in the idea of massive auctions of troubled assets.

He then outlined three strategies Treasury felt were the best way to use TARP funds. These were focused on strengthening the capital base of the financial system; supporting the asset-backed securitization market and increasing foreclosure mitigation efforts. In a good situation for banks, however, Paulson took specific time to reemphasize that while all of these strategies were important, ensuring the financial system had sufficient capital was essential to getting credit flowing to consumers and businesses (this is where the bulk of the remaining TARP funds should be deployed). He even went so far as to state TARP funds should provide a contingency reserve for addressing unforeseen future systemic events.

Since we care most about community banks, we focus on the first "modified" use of TARP. That is providing support to the capital base of the financial system. In discussing this portion of TARP, Paulson talked about "designing further strategies for building capital" in banks. He indicated doing this would allow banks to better manage illiquid assets on the books and ensure health to the system is maintained. He also introduced another new concept, saying Treasury was evaluating programs that would leverage TARP investment by also "attracting private capital, potentially through matching investments." He then broadened that by introducing yet a 3rd concept, saying such a matching program would support "capital needs of non-bank financial institutions" that were not eligible for TARP under the current program. While he acknowledged that non-bank financial institutions were not directly regulated, he hinted at a world where they too could receive government funding.

So, where do things stand now? Clearly Treasury is interested in expanding capital injections into banks and other financial services companies. Banks interested in TARP must apply before the program deadline of November 14 and we urge all banks to strongly consider doing so. While Treasury has indicated documentation for private banks is still forthcoming, making sure your bank is considered under the program is critical. Whether you need capital or not, our suggestion is to apply using the public documents within the deadline and indicate on the forms that you are a private bank (if the question does not apply to you). Applying for the capital ensures your bank at least gets a shot at it and if approved you can then decide whether or not to take it.

While the rules are such that banks taking TARP cannot increase dividends for 3Ys or repurchase stock (and must adhere to executive compensation rules during the period Treasury holds the equity), the equity cost is relatively inexpensive. Consider that equity costs 15% or more for community banks right now, so the Treasury infusion at 5% for the first five years and 9% thereafter is inexpensive (even with the warrants).

We're not sure if Treasury's latest shift will be better than buying distressed mortgage assets, but it is nice to hear the emphasis remains on capitalizing financial institutions.

BANK NEWS

Fees

Banks across the US are increasing banking fees to cope with the troubled market. According to a 2008 study run by Bankrate Inc., insufficient funds fees for checking accounts are now averaging $28.95, average surcharges for using other banks' ATMs have moved up to $1.97 and interest account minimums now average $3,462, new records on all "accounts." Nearly 90% of a bank's fee incomes are generated from overdraft and insufficient-funds charges.

Realtors FCU

The National Association of Realtors, the largest real estate trade association, will charter an internet based credit union providing full deposit services and a number of loan options for its 1.2mm members. The credit union is scheduled to open mid-2009.