PRIVATE BANK TARP MODEL

by Steve Brown

We are getting tired of staring into the abyss. We are not sure how bad the economy is going to get, but the signs around Citibank and the general market are ominous. As of this week, the Treasury released the Term Sheet for private bank TARP capital and gave this group of banks until Dec. 8th to submit an application through their primary regulator. Our advice - unless you feel rock solid about your loan portfolio under stressed conditions that could be as much as 40% lower from where they are today (cash flow and valuation) - take the capital.

Realize, for the most part, that bank performance has been largely degraded due to a shock to the residential and construction portfolio. Granted, this is the largest concentration for many community banks, but it is only a portion of the balance sheet. Should commercial real estate and the rest of the consumer portfolio start bottoming out; the other half of the industry will feel pain bordering on insolvency.

This all makes additional bank capital a must-have for the holidays. Given the new term sheet, privately held banks basically follow the same guidelines and rules as public banks (including being subject to certain restrictions on executive compensation and prohibitions from increasing dividends or repurchasing shares without approval) with several exceptions. For starters, the Treasury may only buy an additional 5% of the underlying shares. That compares to 15% for publicly traded banks. The primary difference for the lower amount is that instead of the warrants being valued at the last 20 day's average price (as they were for public banks), the Treasury valued the warrants at a penny for private banks. While this may seem to make the private bank version of TARP more expensive, if private bank shares traded in liquid fashion, they most likely would result in a similar cost (if not cheaper).

Private banks may also have an additional hurdle if they are closely held (less than 500 shareholders). Some of these banks may not be able to issue preferred shares without shareholder approval, which needs to be sought immediately after filing the TARP application. In addition, boosting the number of shareholders to above 500 could bring these banks into a whole other regulatory realm that needs to be considered.

Another factor to consider is that because the Warrant Preferred under the private program will be treated as Tier-1 Capital, the net ratio of capital to risk-weighted assets could potentially exceed 3%. However, if comparing equal amounts of capital, it is intuitive that the 9% dividend per annum from the Warrant Preferred causes the total cost of capital to exceed 5% at the outset. The good news is that unlike the public program, this additional expense can be quantified with precision. That said, it is impossible to predict with confidence the potential dilutive effects (financial as well as intangible) that common stock resulting from a warrant conversion will bring. Likewise, the potential cost of repurchasing that common stock is also impossible to predict (many institutions plan on attempting to purchase this amount back into an ESOP or similar vehicle). Overall, both programs have distinct features, each requiring a completely different set of tools when costs and other issues are considered and analyzed.

In order to help community banks analyze the comparative cost of capital, we have updated our model to include the private program structure. This model is based upon publicly available information regarding the TARP Capital Purchase Program as of November 20th, 2008, and of course, is subject to change. The model allows for a variety of leverage that can be employed post-capital, details the impact to capital ratios, builds a pro-forma income statement, highlights post-capital expected ROA/ROE and breaks down the cost. This model is free and available, see Related Links section on this page.

In the next few weeks, privately held banks will undoubtedly be weighing the same questions that public companies did. While it appears that only about 30% to 40% of private banks applied for TARP capital, we are hoping the ratio is higher for privately held banks that have time to reconsider the economic environment.

Related Links:
Bank TARP Model

BANK NEWS

TARP Update

Thrift Industry: According to the OTS, 61% of public thrifts have applied for TARP capital, while 38% of private thrifts have already applied as well (despite a Dec. 8 deadline to do so).

3Q Thrift Earnings

Savings and loans posted the industry's 4th highest loss ever, after reporting 3Q losses jumped to $4B from $1.7B in the 2Q. Income tanked as thrifts increased reserves and accelerated loan writedowns.

Citigroup Plan

Citigroup shares dipped below $5 yesterday, pushing the stock to its lowest level since 1994. The strain led executives of the firm to reportedly discuss selling off pieces of the company or selling it outright (to perhaps Morgan Stanley or Goldman Sachs (who both need deposits for their new bank models to work).

Doom & Gloom

In a trend making the rounds at major banks, Bank of New York said it will cut 1,800 jobs (4% of workers) and JPMorgan said it would cut 3,000 jobs (about 10% of its investment banking staff).

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