How the Federal Banking Regulators Are Inhibiting the Economic Recovery

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This presentation will highlight how the banking regulators are inhibiting economic recovery through unintended consequences of current policies . . .

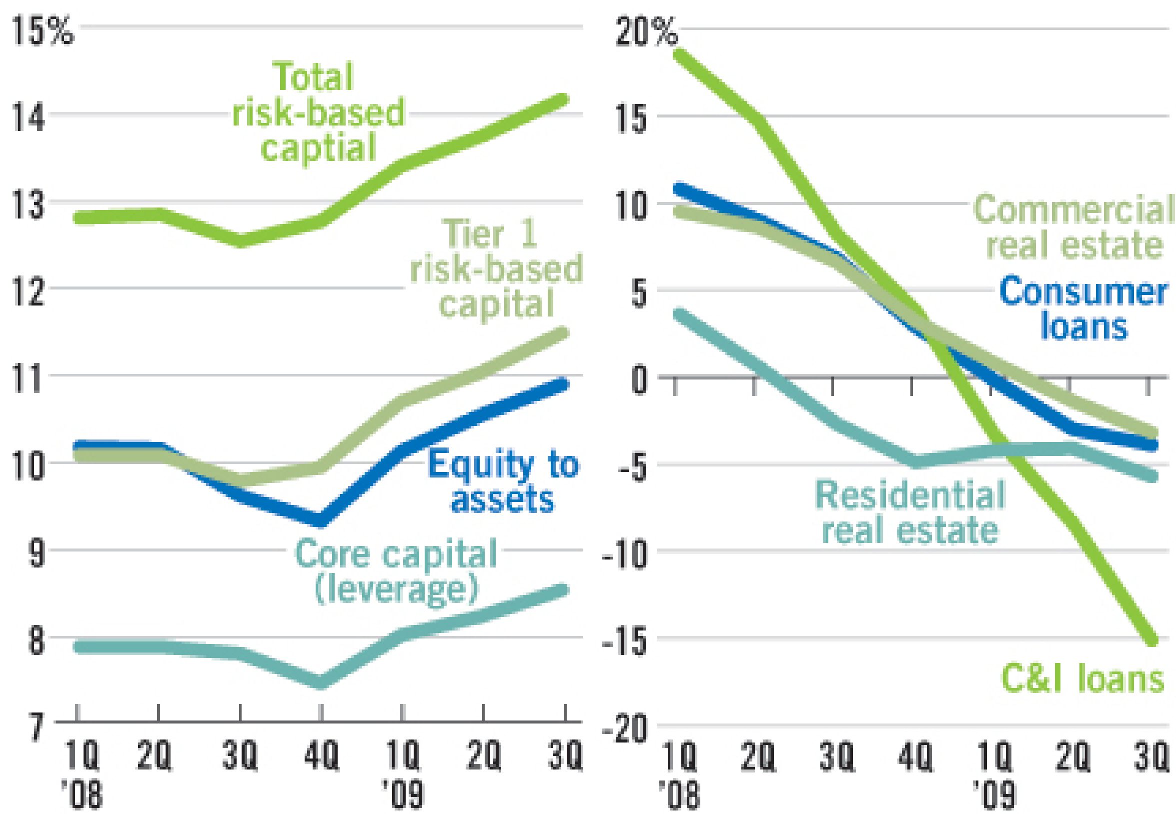
The premise is that the policies the federal regulators are currently pursuing are **directly inhibiting economic recovery**, primarily by decreasing banks' ability and willingness to lend to America.

Increasing banks' ability and willingness to lend will directly lead to economic recovery, which in turn will self correct their problem balance sheets . . .

The quickest way to economic recovery is for banks to re-ignite lending. Only an economic recovery will stop the downward spiral banks are experiencing. We must stop the decline in real estate values and provide operating capital to allow companies to grow and expand.

A regulatory push for more capital, coupled with a stagnant economy are causing a material decrease in bank lending . . .

Although banks are increasing capital, they continue to delever by decreasing outstanding loans.



The guidelines the regulatory agencies are promoting that negatively impact economic recovery include . . .

- Higher Capital Requirements
- Higher Loan Loss Allowances
- Forcing Unrealistic Non Performing Loan Reduction Timelines
- CRE Loan Concentrations
- Inhibiting Strong Secondary Markets
- Raising FDIC Premiums
- Tightening Underwriting Standards
- Mark-to-market Accounting
- Discouraging De novo Bank Formations
- Shunning Private Equity Capital

These policies directly decrease the ability and willingness of banks to lend.

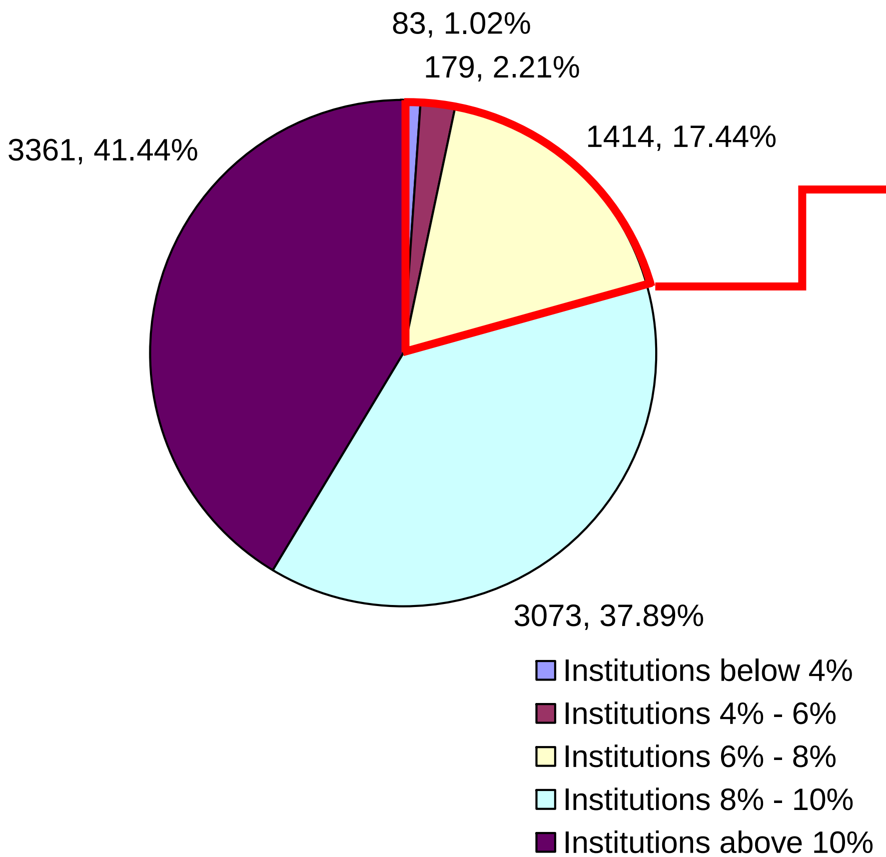
Decreasing banks' ability and willingness to lend hurts economic recovery by . . .

- Decreasing credit availability, which
- Decreases real estate values, which
- Lowers consumer and business capacity to borrow, which
- Leads to higher unemployment, which
- Fuels government spending, which
- Increases the national debt and deficit, which
- Destabilizes the economy, which
- Starts the cycle all over!

Lets look at the effect of these policies individually . . .

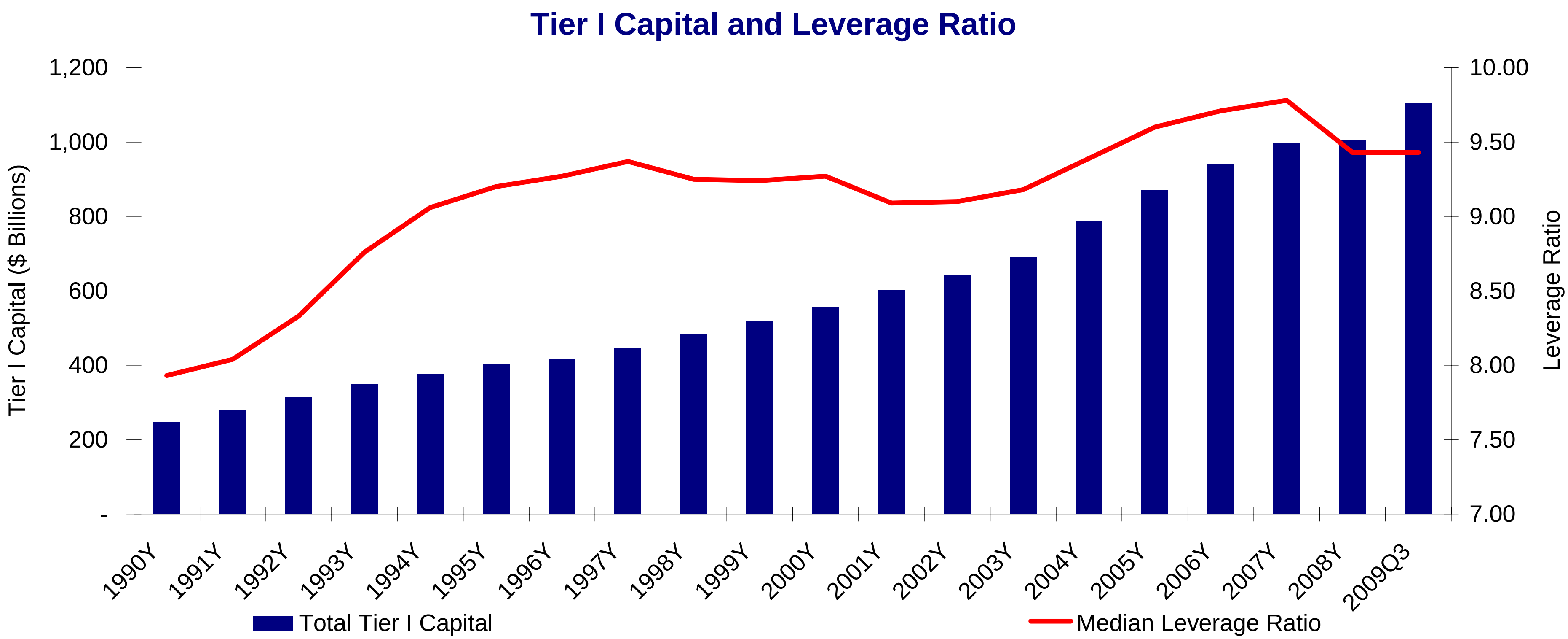
Higher Capital Requirements – The 1,676 institutions currently under 8.0% would require an additional $78.8 billion in Tier 1 Capital if required to be at 8.0% . . .

Leverage Ratio for All FDIC Banks



Impact of getting all institutions in compliance with a minimum 8% leverage ratio	
($ thousands)	**As of 9/30/2009**
Total Reporting Institutions	8,110
Number of Institutions with Leverage Ratio less than 8%	1,676
Compliance without changing Total Assets	
Minimum Tier I Capital needed to comply with 8% leverage ratio	$ 559,082,928
Additional Tier I Capital needed to comply with 8% leverage ratio	**78,829,893**
Compliance without changing Tier I Capital	
Maximum Total Assets allowed to comply with 8% leverage ratio	6,003,162,938
Reduction in Total Assets needed to comply with 8% leverage ratio	**$ 985,373,662**

Higher Capital Requirements – For every 10 basis point increase required by the regulators in Tier 1 Capital, at least (a) an additional $7.1 billion of Tier 1 capital or (b) a reduction of total assets by $75.4 billion would be required . . .



Impact of Increasing Leverage Ratio Requirement Once all Institutions are Above 8.0%			
($thousands)	**+10 bps**	**+50 bps**	**+100 bps**
(a) Additional Tier I needed to comply with increase	$ 7,091,800	$ 39,319,425	$ 86,909,908
(b) Reduction in Total Assets needed to comply with increase	$ 75,387,981	$ 404,618,319	$ 856,179,683

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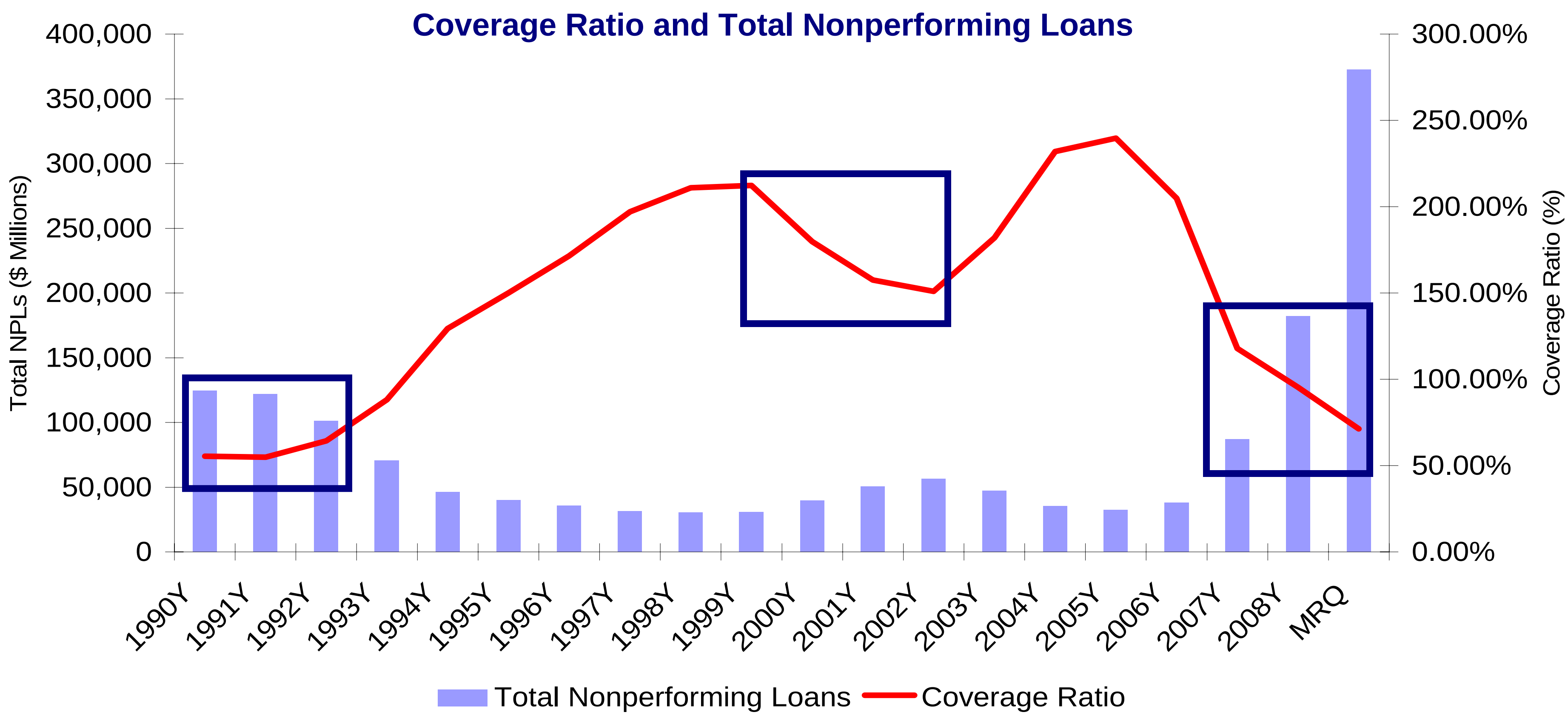
Source: SNL Financial

Higher Loan Loss Allowances – Historically, allowance for loan losses has acted as a shock absorber for banks, but recently this has not been the case . . .



In order for the coverage ratio to return to 100% while keeping NPLs constant, reserves must increase by $106.7 billion.

Source: SNL Financial

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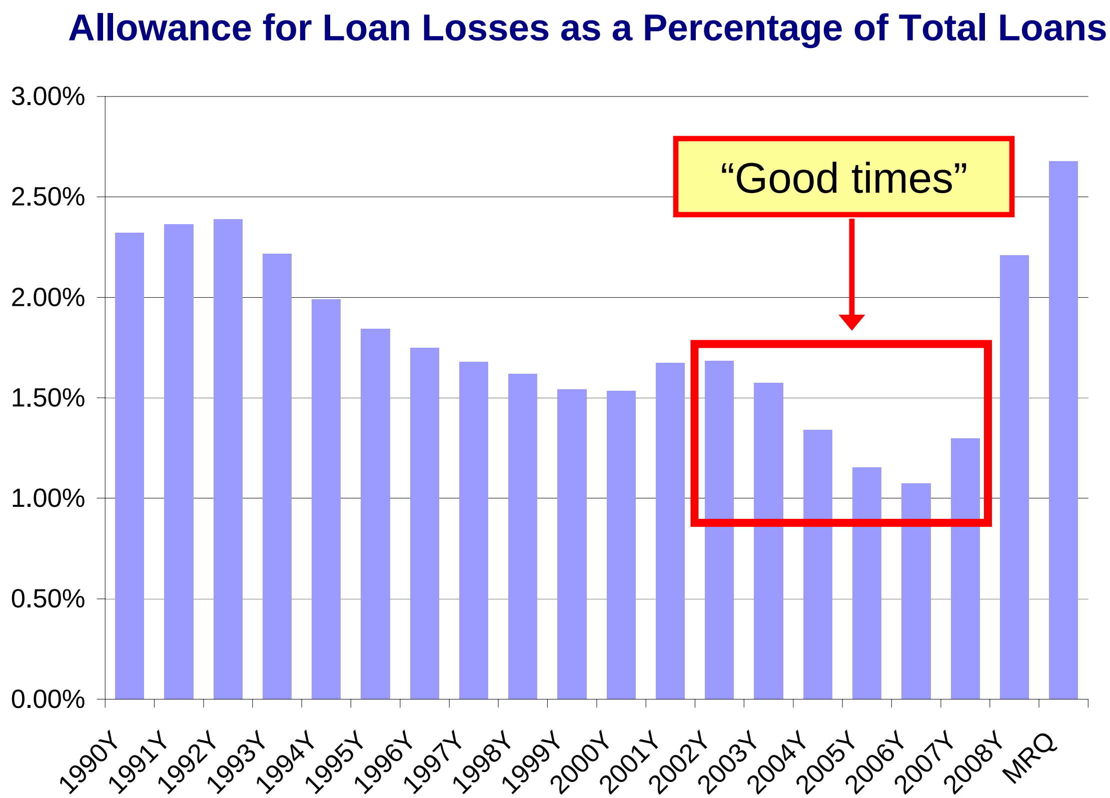
Higher Loan Loss Allowances – Allowance for loan losses decreased dramatically from 2002 to 2007, when they probably should have remained constant or increased slightly during the "good times" . . .



Impact of a 10 basis point Increase in ALLL		
		($ Millions)
Current Industy Allowance for Loan Losses	$	265,593
Current Industry ALLL / Total Loans		2.678%
New Industry ALLL / Total Loans		2.778%
New Industry Allowance for Loan Losses		275,529
Change in Industry ALLL		9,936
Change in Industry capital		(9,936)
Decrease in Industry Total Assets Necessary to Maintain an 8% Leverage Ratio	$	124,201

Note: Data is aggregate for industry

A 10 bps increase in allowance for loan losses will force banks to decrease their combined total assets by $124.2 billion in order to maintain an 8.0% tier 1 leverage ratio

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Source: SNL Financial

Forcing Unrealistic Non Performing Loan Reduction Timelines – Forcing disposition of non performing loans today immediately decreases capital due to the selling expense and investor discount . . .

Troubled Institution	
Non Performing Loan Balance	$ 2,000,000
Credit Loss	(500,000)
Net NPL Balance	1,500,000
Selling Expenses (10% of Net NPLs)	150,000
Opportunity Cost per year (6% of Net NPLs)	90,000
Distressed Sale Investor Discount (20% of Net NPLs)	300,000

Sell Nonperforming Loans Now	
NPL Balance	2,000,000
Credit Loss	(500,000)
Selling Expenses	(150,000)
Distressed Sale Investor Discount	(300,000)
Net	$ 1,050,000

Hold Nonperforming Loans for 2 years	
NPL Balance	2,000,000
Credit Loss	(500,000)
Opportunity Cost for 2 years	(180,000)
Maintanence Cost (4% of Net NPLs)	(60,000)
Net	$ 1,260,000

If a bank believes that its nonperforming loans will not suffer any more losses, then being forced to sell the loans immediately would cost the bank over $200,000.

If the bank holds the loans, the $210,000 savings in capital would allow the bank to increase lending by $2,625,000 assuming an 8.0% leverage ratio.

CRE Loan Concentrations – There are currently 1,083 institutions above the 300% risk based capital concentration threshold . . .

CRE + Construction Loan Concentration Analysis	**($000s)**
****Calculation includes NOO only***	
# of reporting institutions	7,339
# of institutions in excess of threshold	1,083
For institutions in excess of the regulatory threshold:	
CRE (NOO only), Multi, Const	299,714,596
Risk based capital	69,941,292
Aggregate ratio	428.52%
Required de-levering to meet 300% threshold:	89,890,720
- or -	
Increase in capital needed to meet 300% threshold:	29,963,573

To comply with this standard, these banks will need to decrease outstanding CRE, Multifamily and construction loans by $89.9 billion or raise an additional $30.0 billion in equity capital.

Note: OO = Owner-occupied, NOO = non owner-occupied

Source: SNL Financial

CRE Loan Concentrations - By including owner-occupied CRE into the calculation, the required de-levering or increase in capital rises dramatically . . .

CRE + Construction Loan Concentration Analysis	**($000s)**
***Calculation includes NOO and OO*	
# of reporting institutions	7,339
# of institutions in excess of threshold	2,523
For institutions in excess of the regulatory threshold:	
CRE (OO and NOO), Multi, Const	713,513,225
Risk based capital	161,899,377
Aggregate ratio	440.71%
Required de-levering to meet 300% threshold:	227,815,094
- or -	
Increase in capital needed to meet 300% threshold:	75,938,365

The addition of owner-occupied commercial real estate increases the number of institutions above the 300% threshold from 1,083 to 2,523 and will inhibit access to credit for businesses.

CRE Loan Concentrations – All CRE loans cannot be treated equally. There should be minimal limits on well underwritten loans. Severe limits should be put on poorly underwritten loans . . .

Two commercial real estate loans, with the same balance and rate, but drastically different characteristics.

A Tale of Two Commercial Real Estate Loans		
$5,000	Loan Value ($000s)	$5,000
6.5%	Interest Rate	6.5%
$98	Monthly Payment ($000s)	$98
105.0%	**Debt Service Coverage Ratio**	**150.0%**
$103	Cash Available to Cover Debt	$147
$78	*Shock to Available Cash (-$25,000)*	$122
79.4%	**New Debt Service Coverage Ratio**	**124.4%**
90.0%	**Loan to Value**	**65.0%**
$5,556	Property Value	$7,692
$4,444	*Decrease in Property Value (-20%)*	$6,154
112.5%	**Resulting Loan to Value**	**81.3%**

Recent FDIC regulation regarding classification of CRE loans is a step in the right direction.

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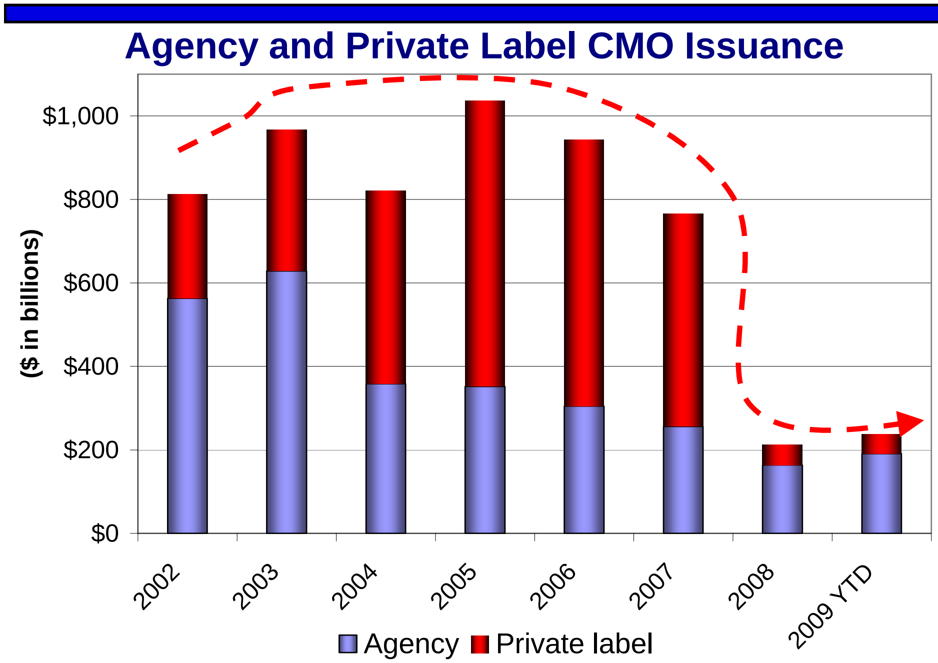
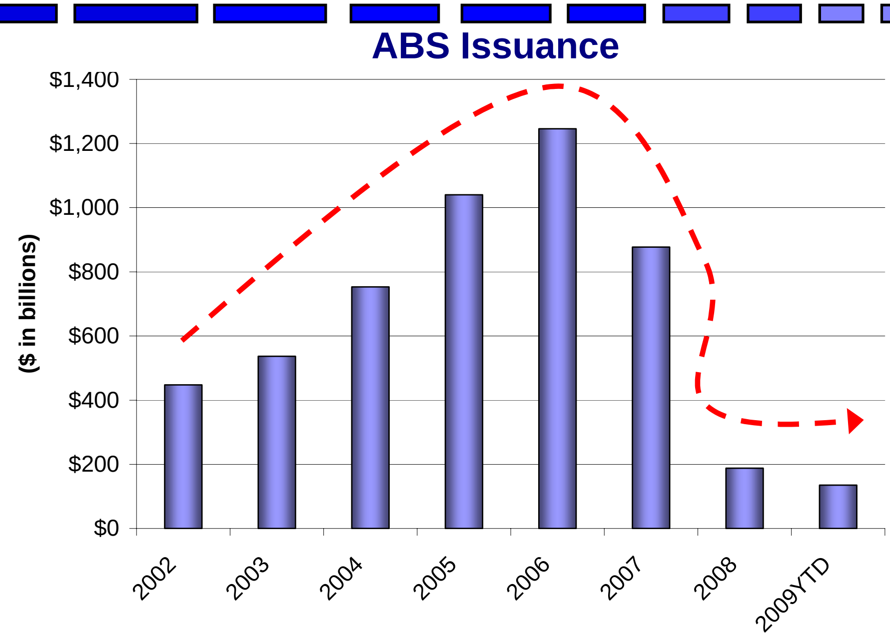
Inhibiting Strong Secondary Markets – The secondary markets – especially for private label instruments - declined significantly from the peak in 2005 as complex toxic assets have drained liquidity from the market . . .





- Many have blamed the process of securitization for the economic collapse. A combination of over-reliance on credit rating coupled with weak due diligence accelerated the decline.
  - Buyers need to "re-underwrite" the securitized loans, not just blindly follow credit rating agencies. Rating agencies did not, and arguably could not, perform the proper due diligence to accurately rate these instruments.
  - Agency ratings are not a guarantee, as many institutions have found out.

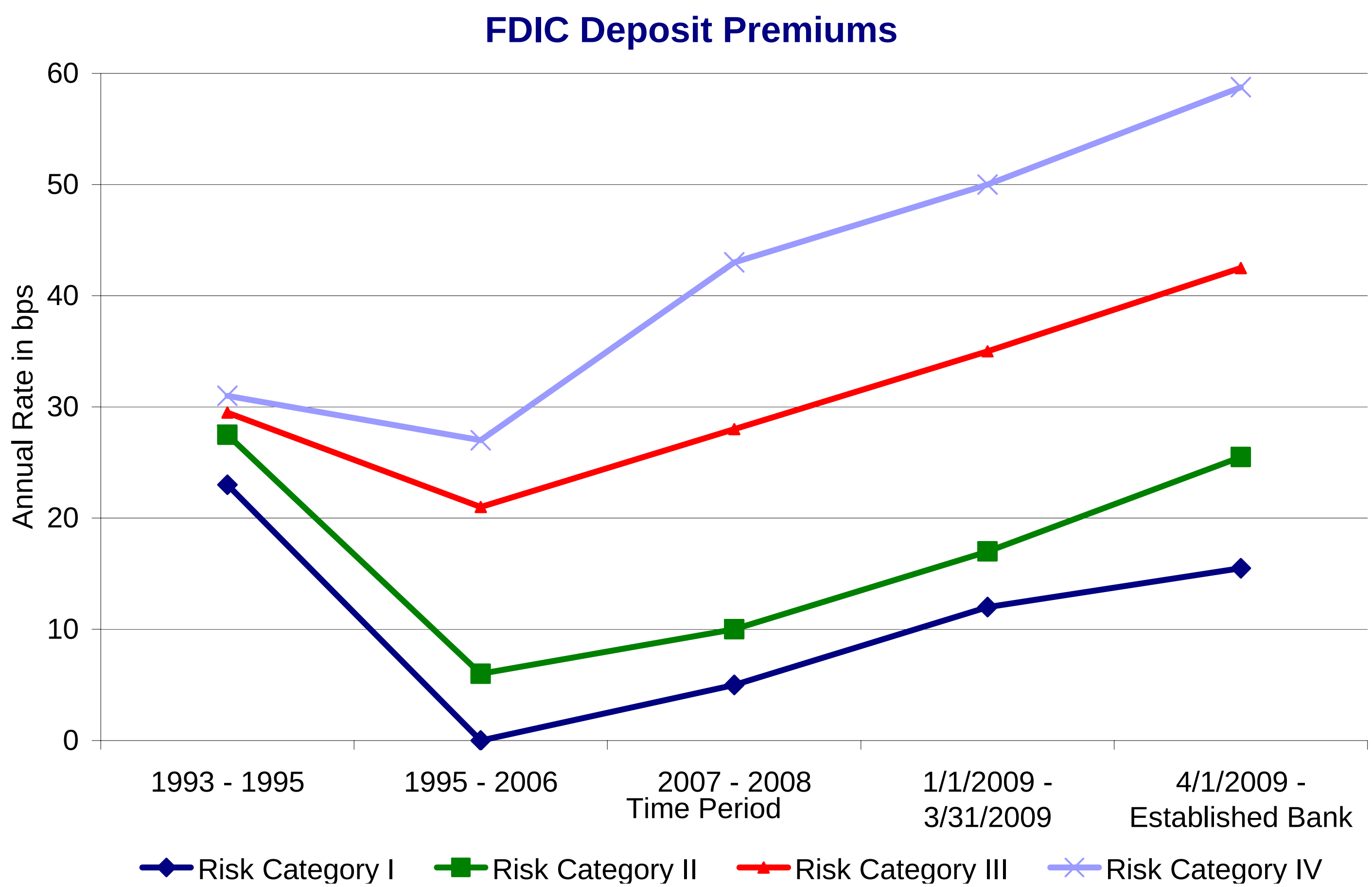
Inhibiting Strong Secondary Markets – New regulation proposes that banks keep up to 10% of the loans they sell on the balance sheet. This policy will restrict their ability to lend and will decrease income . . .

(000's)	Current rules		Proposed rules	
Loans originated by the bank:	$	25,000	$	25,000
Loans securitized and sold:		25,000		22,500
Gain on sale (1% of loans sold, 40% tax impacted):		150		135
Capital and lending impact:				
Total assets before sale:	$	500,000	$	500,000
less sale of loans:		25,000		22,500
Pro forma total assets		475,000		477,500
Existing capital:	$	47,500	$	47,500
+ gain on sale		150		135
Pro forma total capital		47,650		47,635
Pro forma capital ratio		10.03%		9.98%
Lending capacity: *(assuming 8% capital ratio minimum)*		120,625		117,938

Less income due to more loans being held on the balance sheet.

The proposed rules would result in greater pro forma total assets and lower pro forma capital ratios leading to decreased lending capacity.

Raising FDIC Premiums – FDIC premiums have increased dramatically in the past year and have become a significant part of non interest expense . . .



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Note: De Novo banks face slightly higher premiums in 2009

Source: FDIC

Raising FDIC Premiums – Elevated premiums increase the expense burden of every institution, tie up valuable capital and prevent lending growth . . .

Year	Median Premium (bps)	Total Deposits	Total Cost Cost of Insurance	Decrease in Lending Because of Insurance Costs*
($ Millions)				
1993	27	$ 3,215,999	$ 8,683	$ 65,124
1994	27	3,180,645	8,588	64,408
1995	10	3,315,248	3,315	24,864
1996	10	3,451,477	3,451	25,886
1997	10	3,599,382	3,599	26,995
1998	10	3,814,006	3,814	28,605
1999	10	3,882,053	3,882	29,115
2000	10	4,207,885	4,208	31,559
2001	10	4,559,651	4,560	34,197
2002	10	4,910,352	4,910	36,828
2003	10	5,219,178	5,219	39,144
2004	10	5,718,643	5,719	42,890
2005	10	6,220,673	6,221	46,655
2006	10	6,631,184	6,631	49,734
2007	18	6,912,800	12,443	93,323
2008	18	7,496,418	13,494	101,202
2009	25	7,553,142	18,883	141,621

*Adjusted for 40% Tax Rate

FDIC insurance will cost banks over $18.9 billion in 2009 and will reduce banks' ability to lend by $141.6 billion.

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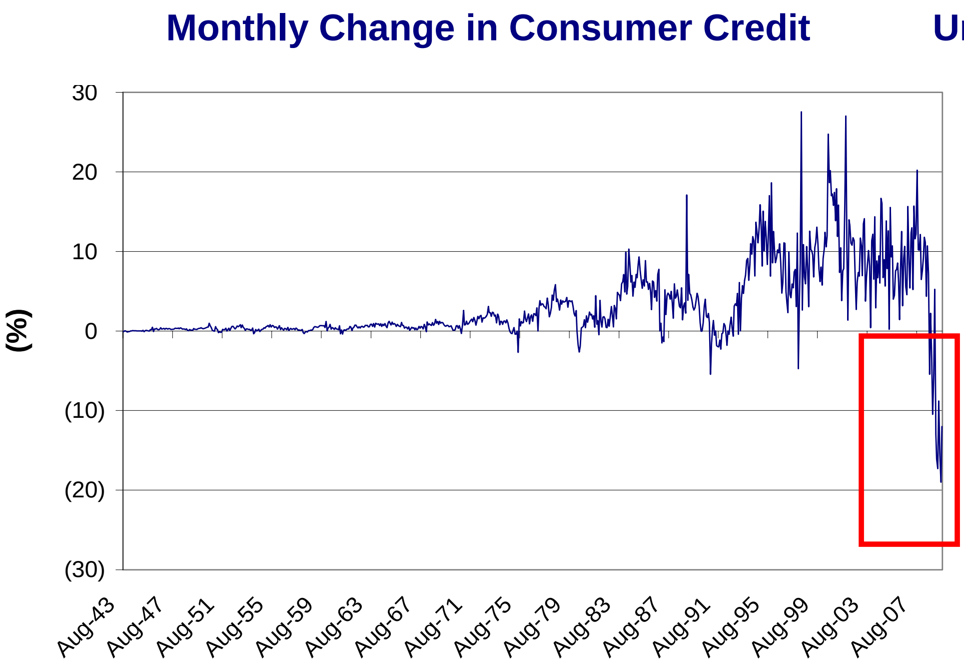
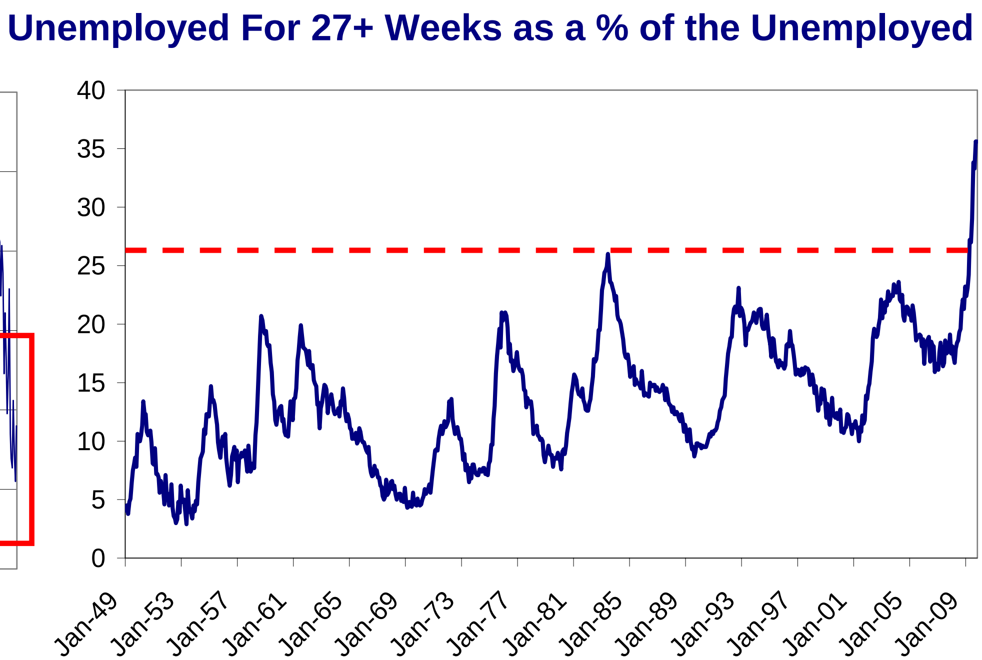
Source: FDIC

Tightening Underwriting Standards – The demand for consumer loans is down significantly as the consumer balance sheet is still de-levering. Higher unemployment and lower payrolls have increased the difficultly for the consumer to clean their balance sheet . . .





The consumer's willingness to borrow money will be directly impacted by the stability of the economy.

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Source: Bloomberg, Federal Reserve

Tightening Underwriting Standards – As consumers pull back with decreased spending habits, businesses are lowering the overall demand for loans . . .

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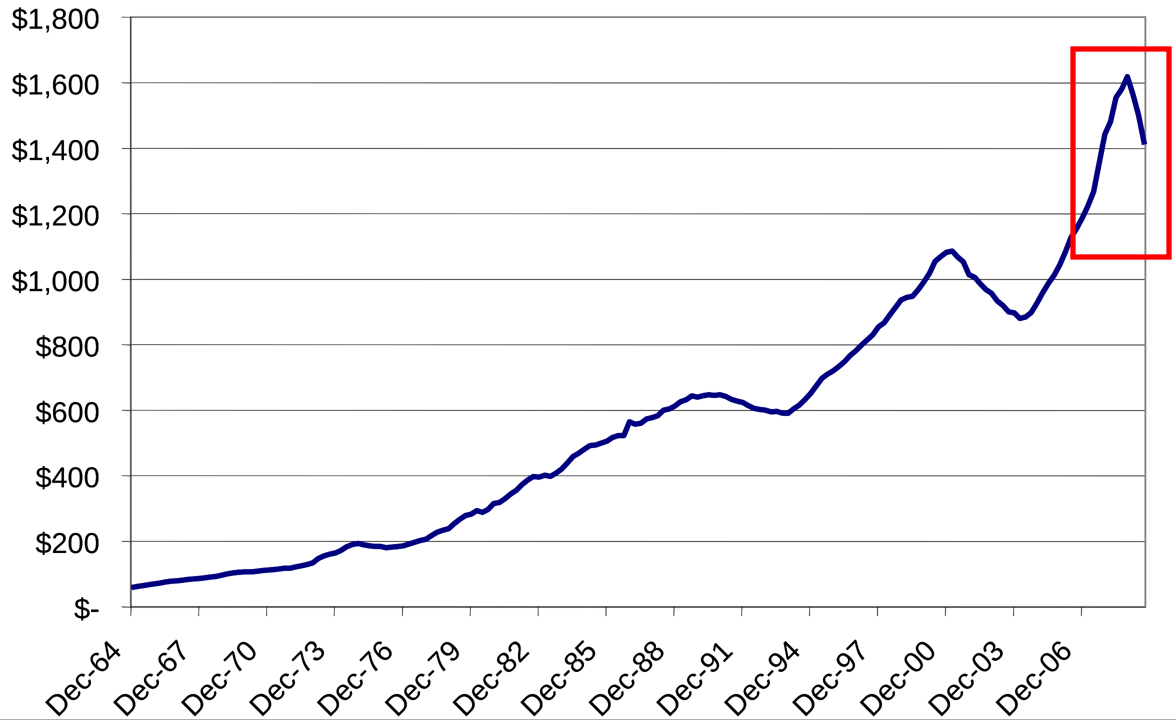
"US Stocks Remain Lower As Black Friday Sales Weigh On Retailers"

Total Commercial and Industrial Loans at U.S. Banks



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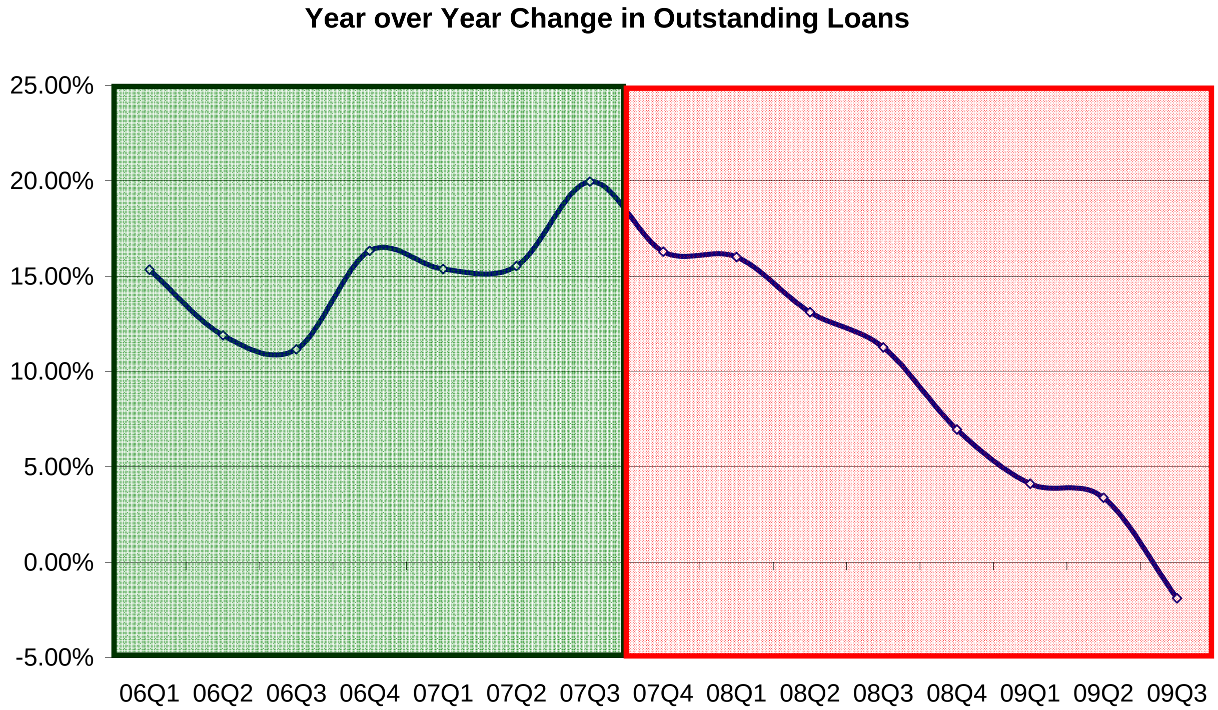
Source: Bloomberg, Federal Reserve

Tightening Underwriting Standards – As a result of the continued deterioration of consumers and businesses, loans outstanding at U.S. banks have declined significantly . . .



Loan originations by the 22 largest TARP participants has decreased from $312 billion in June 2009 to $235 billion in August 2009, a decline of 25%.

Loan growth was negative across the industry in the third quarter of 2009 after decreasing for 8 consecutive quarters.

Tightening Underwriting Standards – A rate increase will make borrowing money significantly less attractive for both consumers and business . . .

A Tale of Two Mortgages		
$1,000,000	Loan Value	$1,000,000
6.0%	Interest Rate	7.0%
$5,996	Monthly Payment	$6,653
$7,500	Cash Available to Cover Debt	$7,500
125.1%	**Debt Service Coverage Ratio**	**112.7%**
$6,500	*Shock to Available Cash (-$1000)*	$6,500
108.4%	**New Debt Service Coverage Ratio**	**97.7%**

A 100 basis point difference in interest rate, makes the mortgage on the right considerably more susceptible to a shock in available cash affecting the borrowers ability to repay the loan.

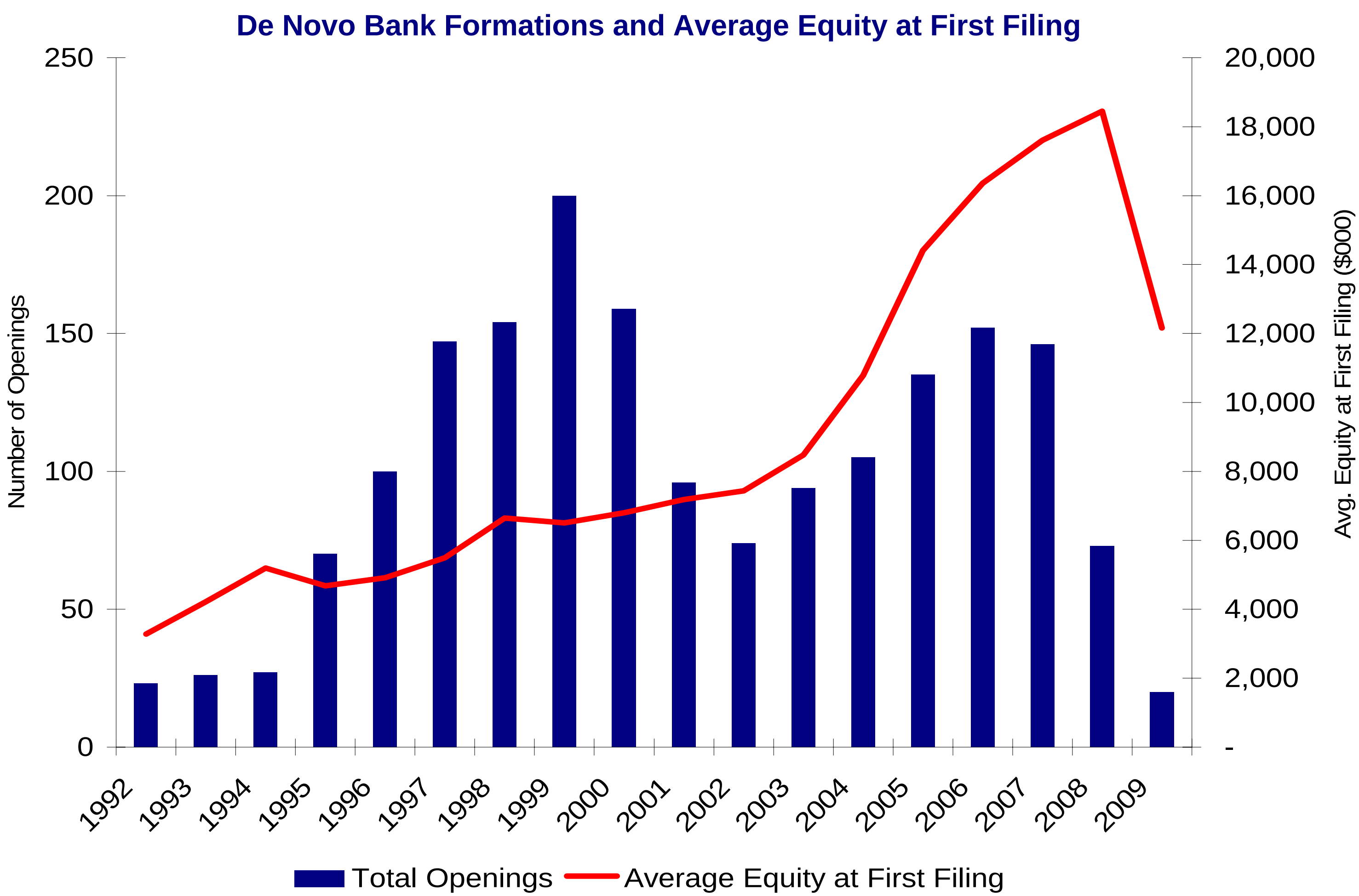
Mark-to-Market Accounting – An illustrative example of the devastating impact mark-to-market of the entire balance sheet could have on the banking industry and its capital . . .

Balance Sheet		Price (%)	Adjusted Balance
Cash	$ 24,000	100.00%	$ 24,000
Investments	100,000	99.00%	99,000
Loans, gross	350,000	97.00%	339,500
ALLL	3,500	0.00%	-
Other Assets	22,500	95.00%	21,375
Total Assets	500,000		483,875
Deposits	$ 390,000	98.50%	$ 384,150
Borrowings	50,000	105.00%	52,500
Other liabilities	20,000	100.00%	20,000
Total liabilities	460,000		456,650
Total equity	40,000		27,225
Equity to asset ratio	8.00%	→	5.63%

In this example, after the mark-to-market adjustments, the bank must decrease total assets by 30% to maintain an 8% equity to asset ratio.

Mark-to-market accounting will have disastrous effects on capital ratios and consolidation. Failures will increase as banks struggle to stay well capitalized.

Discouraging De Novo Bank Formations – De novo bank formations and the amount of new capital entering the industry have decreased significantly in the past two years. There have been only 20 de novo bank formations in 2009, a level not seen since 1992 . . .



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Source: SNL Financial

Rather than discouraging de novo formation, regulators should encourage de novo formation as this directly creates lending . . .

	De Novo Bank Formation	($000s)
a	Total Capital	20,000
b	Leverage Ratio	8.0%
c = a / b	Potential Total Assets	250,000
d	Loan / Assets Ratio	70.0%
c * d	**Potential Lending Capacity**	**175,000**

Capital infusions used to charge-off problem assets
do not increase lending capacity!

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Discouraging De Novo Bank Formations – The potential lending capacity generated by de novo banks, assuming an 8.0% leverage ratio, has dropped by over 90% in just two years . . .

Year	Total De Novo Equity	Additional Lending Because of De Novo Banks
($ thousands)		
1992	$ 75,410	$ 942,626
1993	109,691	1,371,143
1994	140,216	1,752,705
1995	327,432	4,092,900
1996	491,590	6,144,875
1997	807,647	10,095,593
1998	1,023,715	12,796,438
1999	1,301,500	16,268,750
2000	1,081,693	13,521,161
2001	689,693	8,621,160
2002	550,271	6,878,393
2003	796,330	9,954,130
2004	1,132,163	14,152,031
2005	1,945,269	24,315,863
2006	2,486,097	31,076,210
2007	2,570,622	32,132,775
2008	1,346,492	16,831,154
2009	243,208	3,040,100

De novo banks formed in 2009 combined for just $243 million in equity and have generated $3 billion in lending capacity compared to de novo banks formed in 2007 who combined for $2.5 billion in equity and generated $32 billion in lending capacity.

Shunning Private Equity Capital – Despite recent changes in regulation, private equity capital still faces numerous restrictions on investment in banks . . .

- Banks funded by private equity must maintain a ratio of Tier 1 capital to total assets of 10% for three years and maintain “well capitalized” status thereafter.
  - Institutions below this threshold are subject to “Prompt Corrective Action” rules
  - Private equity investors must also maintain their investment for at least three years.

		Common Investor	Private Equity
a	Capital	20,000	20,000
b	Required Leverage Ratio Limit	8.00%	10.00%
c = a / b	Potential Total Assets	250,000	200,000
d	Post-tax ROAA *(assumed)*	0.75%	0.75%
e = d * c	Net Income	1,875	1,500
e	Retained Earnings Addition to Capital	1,875	1,500
f = e / b	Potential Loan Growth from Capital Growth	23,438	15,000

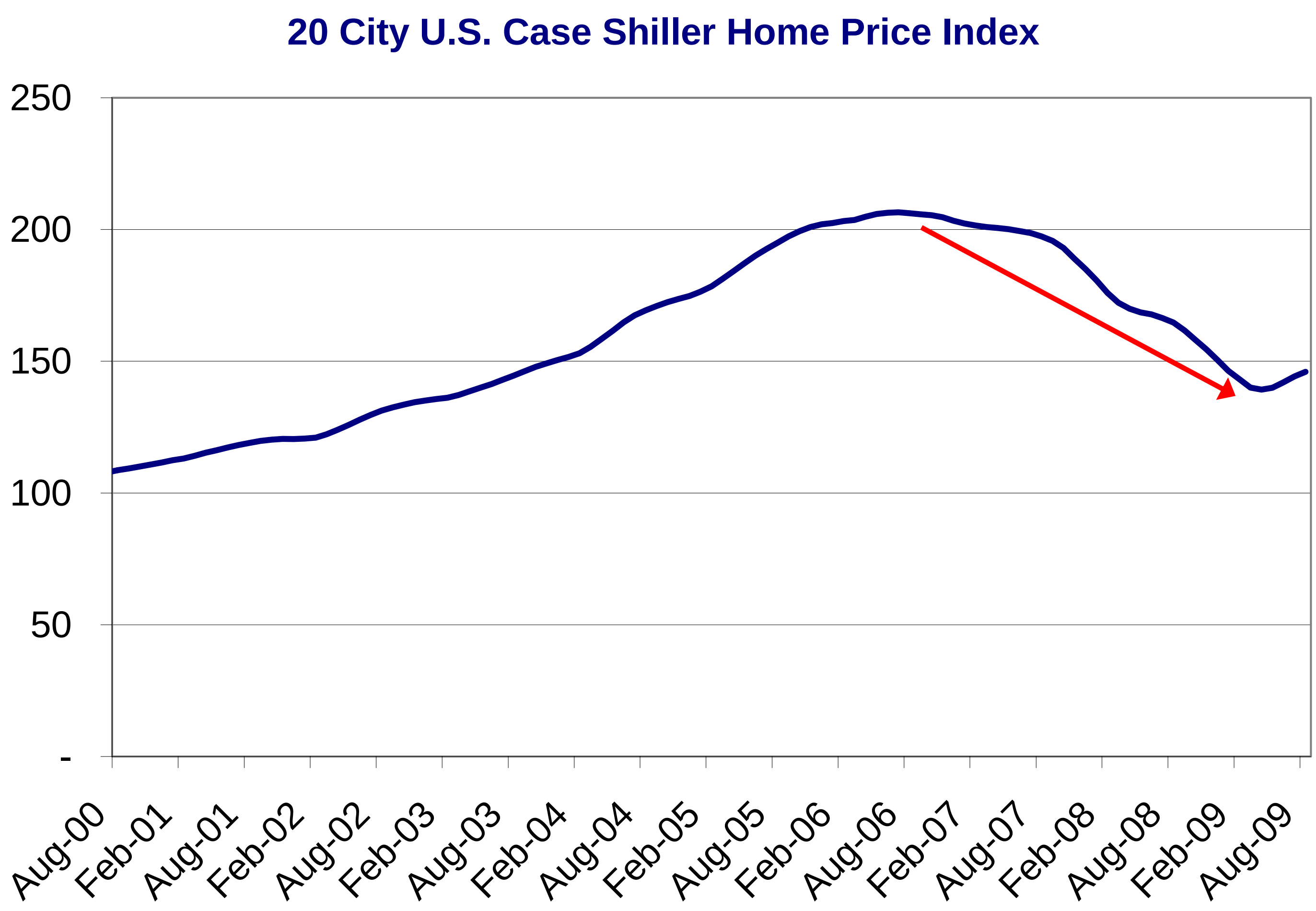
Current regulation forces private equity to operate at a significant competitive disadvantage.

Source: Reuters

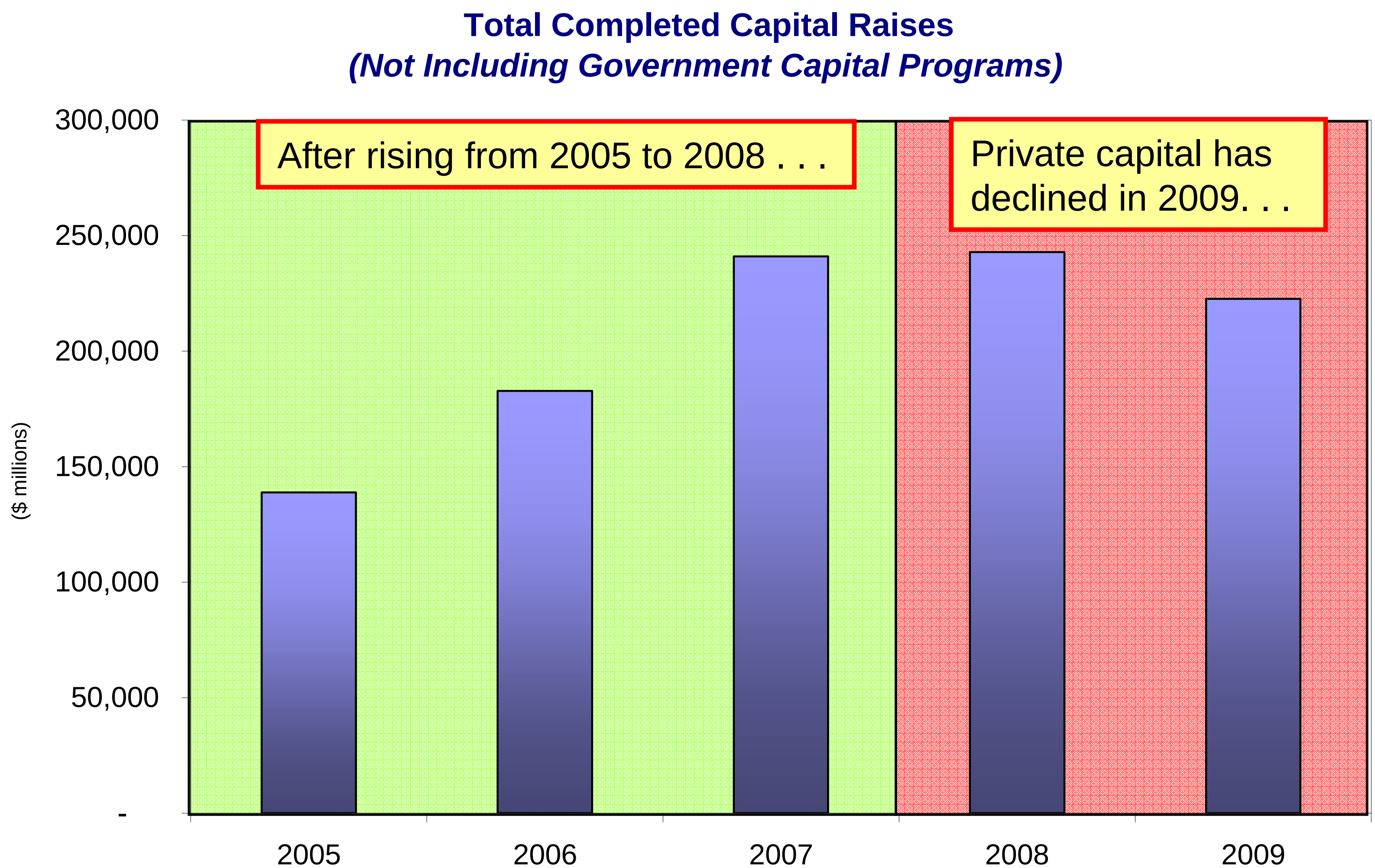
The impacts of these policies are . . .

- Feeding declining real estate values
- Inhibiting new private capital from coming into the sector
- Exacerbating the credit crunch
- Limiting access to small business operating capital which leads to more unemployment and more bankruptcies

Feeding declining real estate values . . .

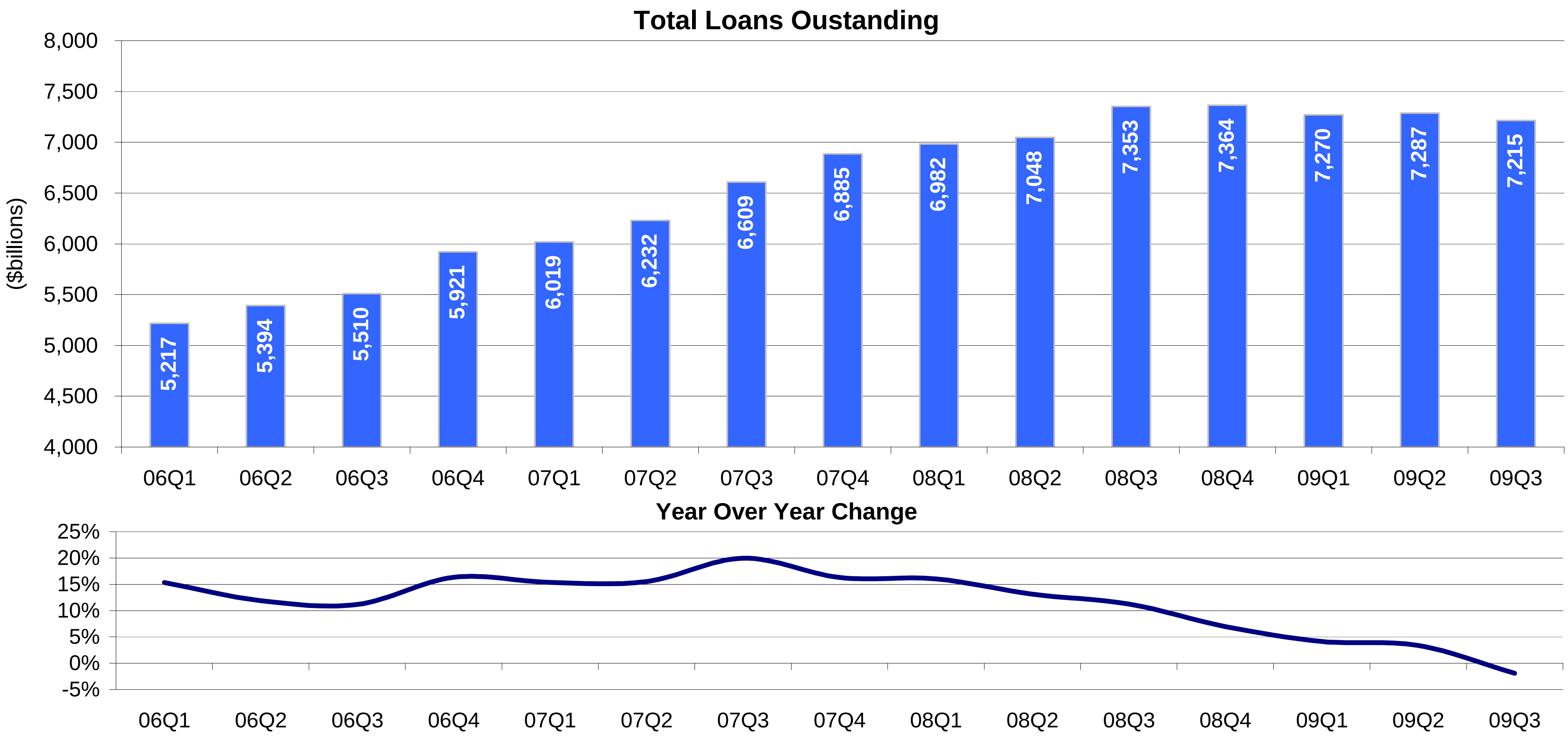


Inhibiting new private capital from coming into the sector . . .



Source: SNL Financial

Exacerbating the credit crunch . . .



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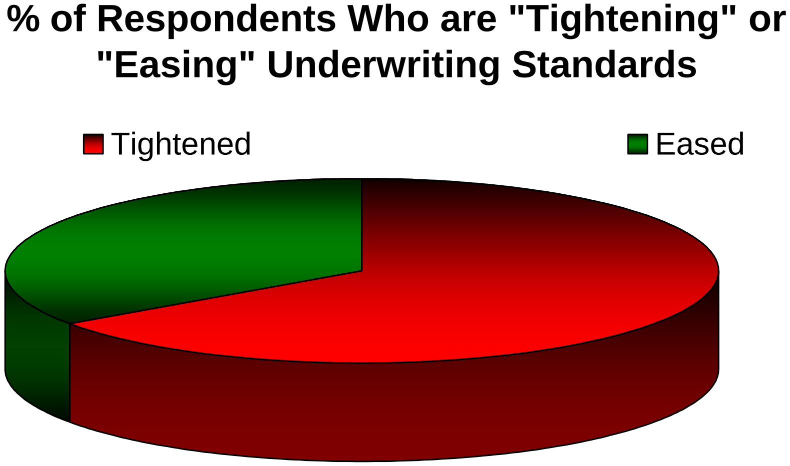
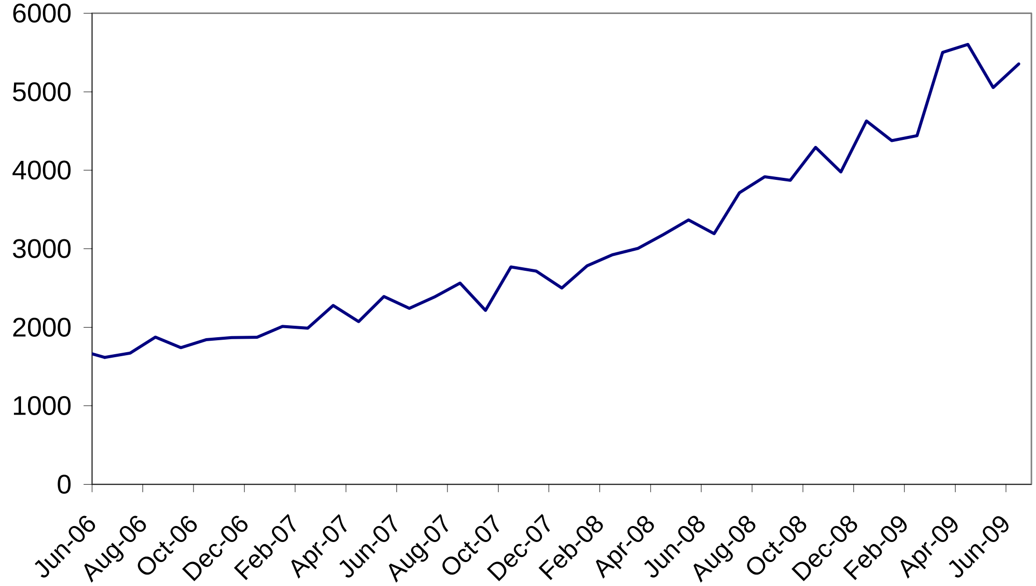
Limiting access to small business operating capital which leads to more unemployment and more bankruptcies . . .

Federal Reserve Lending Survey - Loans to Small Businesses



Business Bankruptcy Cases Commenced Per Month



Source: Bloomberg, Federal Reserve, U.S. Courts Administrative Offices

To stimulate economic recovery we need to . . .

- Maintain credit availability, which
- Maintains real estate values, which
- Increases consumer and business capacity to borrow, which
- Leads to lower unemployment, which
- Decreases government spending, which
- Decreases the national debt and deficit, which
- Stabilizes the economy, which
- Starts the cycle all over!

The following policies are inhibiting economic recover, however the solutions are clear . . .

- Higher Capital Requirements
  - **Solution:** Maintain current capital standards.
- Higher Loan Loss Allowances
  - **Solution:** Utilize current allowances while moving to a cash accounting basis.
- Forcing Unrealistic Non Performing Loan Reduction Timelines
  - **Solution:** Allow institutions to make economic or capital decisions.
- CRE Loan Concentrations
  - **Solution:** Recognize the greatest risk is poor underwriting. Loan concentration limits should be segregated by detailed category rather than lump all CRE together.
- Inhibiting Strong Secondary Markets
  - **Solution:** Maintain securitization rules. Elimination of securitization limits loan originations to capital levels.

Continued . . .

- Raising FDIC Premiums
  - **Solution:** The FDIC has been hesitant to access the line of credit from Treasury, however continued increase of FDIC premiums increases industry expenses and lowers capital.
- Tightening Underwriting Standards
  - **Solution:** Tightening underwriting standards constricts consumer and business access to credit. Credit must be made available to fuel economic recovery.
- Mark-to-market Accounting
  - **Solution:** Abolish mark-to-market. It is pro-cyclical and exacerbates the problems in economic downturns.
- Discouraging De novo Bank Formations
  - **Solution:** Encourage de novo bank formation. Banking is a competitive industry and de novo banks introduce fresh capital into a clean balance sheet.
- Shunning Private Equity Capital
  - **Solution:** Allow private equity to infuse capital into the system and play by the same rules as the rest of the industry.

Conclusion . . .

- Policies enforced by the regulatory agencies have been increasing capital ratios across the industry. To manage to regulatory guidelines, institutions are having to cut back on lending and shrink their balance sheets. Decreased availability to credit directly, negatively impacts the economic recovery.
- To spur economic growth, credit must be available to consumers and businesses. The regulators must entice lending, not inhibit lending.
- As access to credit improves for consumers and businesses, real estate values will stabilize.
- Stabilization of the real estate market – the initial cause for the recession – will provide confidence in the economic recovery.
- Confidence in the recovery will initially stem the tide of unemployment with the long term effects of decreasing unemployment and increasing consumer confidence.
- Increased consumer confidence increases consumer spending, which increases business output.
- Increased business output increases the demand for labor.
- Increased demand for labor increases payrolls and decreases unemployment.

Another thought provoking idea . . .

- Make all newly originated residential 1-4 loans tax free and possibly small business administration loans, like municipal bonds
  - Limit total volume, or
  - Limit to loans originated in next three years
  - Must have stated interest rate of less than 4.00%
  - Loans must be originated by banks and kept on banks balance sheet

- This will provide banks with incentives to increase lending in the right areas and give much needed credit to the sectors that will drive economic recovery

A special thanks to the FinPro staff who spent time on this presentation . . .

- Donald Musso
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- Michael O'Byrne

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