

FinPro's Solutions to Fix the Economic Doldrums

Overview . . .

- The primary objectives of the plan are:
 - To stabilize the economy at minimal, or no, cost to the taxpayer,
 - To focus on the root problem, not the symptoms,
 - To be executable immediately, not over a prolonged period of time.
- The FinPro plan fixes the problem in priority stages.
 - Part of the plan can be implemented immediately,
 - After weighing the effects, follow on measures can be taken if needed.
- Remember, to fuel the economy, banks need to lend. Lending is the lubricant of economic growth in the U.S.
- Leverage and capital are the issues, liquidity is the symptom.
 - For every decline in bank equity of \$1, bank assets contracts by \$12.50 (assuming an 8% capital ratio). So every correction talked about should be thought of in that vein.

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1. Eliminate mark-to-market accounting . . .

- Eliminate, or suspend, all mark-to-market accounting.
 - This does not eliminate “real” other than temporary impairment charges,
 - Allow for immediate transfers to Held To Maturity, at cost,
 - Will dampen wild market fluctuations,
 - Will allow for proper, stable valuations of instruments,
 - Will shore up capital by slowing the artificial investment value declines.
- Eliminate stock option accounting and other dubious forms of accounting transactions that are based on projections and assumptions
- This will mitigate one of the root causes of the problem, namely having values plummet due to an inability to value an instrument or obtain other than a distressed sale.
- This will not cost the taxpayers any money and will stabilize values.
- This can be implemented immediately. The SEC or Congress just needs to make it happen.
- We can increase leverage in the system today by intelligently preserving bank equity capital. **Deleveraging is not a solution – it leads to economic contraction.**

This is a simplified balance sheet of a financial institution before assets are marked-to-market . . .

	Original
Assets	\$ 1,000,000
Liabilities	\$ 920,000
Equity	\$ 80,000
Equity to Assets Ratio	8.00%

Due to mark-to-market accounting, the Bank is forced to write-down the value of its security portfolio, which leads to a decrease in its equity . . .

	Original	Mark-to-Market Effect	Result
Assets	\$ 1,000,000	\$ (10,000)	\$ 990,000
Liabilities	\$ 920,000		\$ 920,000
Equity	\$ 80,000	\$ (10,000)	\$ 70,000
Equity to Assets Ratio	8.00%		7.07%

Due to the write-down, the Bank cannot maintain the resulting capital ratio.

Due to the mark-to-market write-down the Bank is forced to shrink its assets and liabilities (deleverage) . . .

	Original	Mark-to-Market Effect	Result	Deleveraging
Assets	\$ 1,000,000	\$ (10,000)	\$ 990,000	\$ 875,000
Liabilities	\$ 920,000		\$ 920,000	\$ 805,000
Equity	\$ 80,000	\$ (10,000)	\$ 70,000	\$ 70,000
Equity to Assets Ratio	8.00%		7.07%	8.00%

If the Bank wants to maintain an 8% capital ratio, the balance sheet must be deleveraged, which restricts lending.

One can see the damaging effect of mark-to-market accounting on an investment grade security (Key Corp. Series H Medium Term Note) that is performing, but devalued due to global issues that impact the credit markets and the result on a Bank's investment portfolio . . .

- The original coupon rate on the bond is 6.5%. As of September 29, 2008, it is “performing” and paying interest semiannually.
- Due to panic and confidence issues in the bond market, the security is currently trading at 63.55 cents on the dollar. (It was trading above par as recently as 5/23/08) The current yield on the security is 18.59%.
- Due to mark-to-market accounting rules, holders of this security have to mark the security down according to the current market price.

AFS- Key Corp Series H Medium Term Note	Price	Yield	Semiannual Cash Flow to Bank
Original Face Value	\$ 100,000.00	6.50%	\$ 3,250.00
Market Price (9/29/2008)	\$ 63,544.00	18.59%	\$ 3,250.00
Mark-to-Market Gain(Loss)	\$ (36,456.00)		
Increase/Decrease	-36.46%	12.09%	0%

To illustrate the questionability of this mark-to-market effect . . .

- Why would we decrease the value of an instrument where the cash flows have remained the same and the instrument is paying current market yield?
- The real negative effect of mark-to-market accounting in the example is:
 - A write-down of \$36,456 in equity,
 - Which would result in an asset deleveraging of \$437,472,
 - An artificial yield enhancement of 12.09%, or almost a 300% increase,
 - All predicated on future event that may or may not happen.
- This is akin to having a building valued at \$1 million marked down to \$500,000 on the premise that the building could burn down in the future and the building owner would just be left with the land, with a value of \$500,000.

In addition to write-downs on Bank's investment portfolios, working Americans are harmed due to mark-to-market accounting . . .

Largest investors in the Key Corp Series H Medium-Term Note Issue

Holder Name	Portfolio Name	Source	Amt Held	% Out	Latest Chg	File Dt
1) PIMCO ADVISORS LP	PIMCO TOTAL RETUR	MF-USA	100,000	13.33	100,000	6/30/08
2) CAPITAL RESEARCH AND	AMERICAN FUNDS AM	MF-USA	50,000	6.67	50,000	6/30/08
3) MUTUAL OF AMERICA LIF	MUTUAL OF AMERICA	Sch-D	13,000	1.73	13,000	6/30/08
4) VANGUARD GROUP INCO	VANGUARD SHORT-TE	MF-USA	12,000	1.60	12,000	6/30/08
5) JACKSON NATIONAL LIFE	JACKSON NATIONAL L	Sch-D	11,249	1.50	11,249	6/30/08
6) BANC ONE INVESTMENT	JP MORGAN HIGH YI	MF-USA	8,500	1.13	0	8/31/08
7) CONNECTICUT GENERAL L	CONNECTICUT GENER	Sch-D	8,000	1.07	8,000	6/30/08
8) VANGUARD GROUP INCO	VANGUARD TOTAL BO	MF-USA	6,750	0.90	6,750	6/30/08
9) FARMERS NEW WORLD LI	FARMERS NEW WORLD	Sch-D	6,745	0.90	6,745	6/30/08
10) EVEREST REINSURANCE C	EVEREST REINSURAN	Sch-D	5,190	0.69	5,190	6/30/08
11) DEUTSCHE ASSET MANAG	Dws SHORT DURATIO	MF-USA	5,190	0.69	0	7/31/08
12) PRIMERICA LIFE INSURA	PRIMERICA LIFE INS	Sch-D	5,000	0.67	5,000	6/30/08
13) CINCINNATI LIFE INSURA	CINCINNATI LIFE INS	Sch-D	5,000	0.67	5,000	6/30/08
14) NATIONWIDE LIFE AND A	NATIONWIDE LIFE AN	Sch-D	5,000	0.67	5,000	6/30/08
15) TENNESSEE FARMERS LIF	TENNESSEE FARMERS	Sch-D	5,000	0.67	5,000	6/30/08
16) CINCINNATI INSURANCE	CINCINNATI INSURAN	Sch-D	4,750	0.63	4,750	6/30/08
17) OM FINANCIAL LIFE INS	FIDELITY & GUARANT	Sch-D	3,750	0.50	3,750	6/30/08

- These mutual funds and insurance companies invested in this security, including Pimco and American Funds, have to take write-downs on the security.
- These write-downs effect investors 401K and investment portfolios.
- As investors exit these bond funds due to perceived losses from mark-to-market account, further price declines ensue and financial services companies and funds take further hits.
- This vicious cycle due to eroding investor confidence is caused by mark-to-market accounting and perceived losses.

Accounting for stock options can directly impact profitability for no logical reason . . .

- Stock option accounting methods currently require companies to expense stock options the moment they are issued.
 - For accounting, this provides an increased level of transparency to shareholders, but is a fictitious expense that impacts the bottom line.
- Stock options that expire due to a the stock price never achieving the strike price of the option are worthless and never exercised.
 - The result is an expense that was taken for the stock options that never cost the company a dime.
- There is a gap between what is being accounting for stock options and what happens in reality. Bridging the accounting rules and methods to incorporate actual practice of stock options can improve the bottom line of institutions.

2. Update FDIC Insurance . . .

- Similar to past recognition that different account can have different insurance limits, i.e. \$250 thousand on IRA accounts and \$100 thousand on all other accounts:
 - All noninterest bearing deposits and IRA accounts, regardless of balance are insured to the full amount. This will stabilize core business deposits and eliminate any fears of loss of payroll funds or other large fluctuating deposits, etc.
 - All other interest bearing, non-brokered deposits should be insured to \$250 thousand per account,
 - All brokered deposits should be kept at the current \$100 thousand level.
- The FDIC will continued to be funded solely through bank paid insurance premiums.
- Tier the base deposit insurance premiums going forward:
 - Core deposits at 10 basis points,
 - Reciprocal CDARs at 12 basis points,
 - All other brokered deposits are insured but cost 20 basis points,
 - Borrowings remain uninsured.
- This will force banks to pay for insurance based on real risk.
- This will stabilize the liquidity and prevent bank runs from occurring. Also, it will not cost the taxpayers any money.

3. Eliminate conflict of interests with broker/dealers . . .

- The time has come to erase the conflict of interest posed by allowing broker/dealers to both sell securities and provide advice to institutions to which they sell those same securities. Firms can either be advisory or sell securities but should not be allowed to do both.
- Much of today's problems are the direct result of this conflict. Chinese walls do not work and should not be permitted
- Forcing investment banks to have Bank Holding Company Charters is only half the battle. This will finish the job.

For example . . .

- Certain brokerage firms provide asset-liability management service or research for “free”, a service which includes an analysis of a clients investment portfolio.
 - If the same firm sells investment securities and bonds, the ability to **objectively analyze the investment portfolio** and make the correct recommendations is compromised.
 - Brokers typically try to sell their inventory, regardless of price and client suitability.
 - The client/buyer may also be able to obtain a better price elsewhere, but lack of competitive bids **limits transparency and options** for clients.
- To avoid an absolute conflict of interest, firms must be limited to either selling securities or providing advice, but in no event should they be allowed to do both.
 - Lehman Brothers not only provided fixed income research to clients but also manufactured and sold some of the most toxic products on the market.

4. Regulate Private Equity, Hedge Funds and Mortgage Companies . . .

- Any institution that deals with financial transactions must be regulated. They must pay an assessment fee to the regulators and be subject to the overriding rules promulgated as systemic by the Fed.
- Residential mortgage lenders should operate under the same set of suitability standards and fiduciary duty regardless of the charter they operate under.
- **In essence, any organization involved in financial transactions is regulated under the same rules.**
- This levels the playing field.

An example of the calamity caused in the credit markets due to unregulated funds and companies is the two Bear Stearns internal hedge funds, which collapsed in August 2007

- The two funds were based in the Cayman Island, but managed by Bear Stearns in New York City. There was no U.S. regulator for the two hedge funds.
- Current U.S. regulations and their registration in the Cayman Island's allowed them to avoid appropriate supervision by U.S. authorities.
- In turn, warnings to investors came too late, as the fund was on the brink of collapsing and caused a shock to the overall credit markets.
- A vicious cycle ensued as many other investment funds and financial companies have delevered, taken massive losses and failed
- In general, the lack of transparency about the status of many unregulated funds and financial service companies has led to a loss of confidence and liquidity in the credit markets.
- The appropriate regulation will allow authorities to catch the problem in a fund or financial company early, be able to find a solution to the problem and avoid a “shock” to the credit markets and in turn, help liquidity and valuations of securities.

5. Change regulatory perspective . . .

- Consider elimination of CRE threshold test. Rather, regulators should focus on enforcing solid underwriting and compliance. Concentrations in certain asset categories should be permissible so long as:
 - The institution has appropriate expertise
 - Robust lending and risk management policies and procedures are in place
 - Adequate oversight and reporting
- Fix the problem, not the symptom.
- While the regulators have been focusing on Commercial Real Estate, subprime and alt-A loans have gone south, construction lending has gone south and investments have gone awry.

Continued . . .

- BASEL II should be revisited.
 - Recent events have proven that models, in and of themselves, do not work.
 - As such, a pure minimum capital leverage ratio must be maintained for all institutions.
 - This will eliminate the unfair and competitive advantage being proffered to large banks at the expense of small, community banks.

Continued . . .

- To avoid “double jeopardy”, regulators should avoid demanding increases in both capital level and loan loss allowance level for the same perceived risk.
- So long as an institution meets the definition of “well-capitalized,” utilize allowance for loan losses as a shock absorber, the way it was intended.
 - If a “well-capitalized” bank takes a hit today and has to immediately fund the allowance, why have any reserves at all? The reserve was supposed to be funded in good times, used in troubled times and then replenished over time.

6. Permanently reinstate the “uptick” rule . . .

- Short sellers were previously free to continually “short” a stock on its way down without needing coverage.
- This created its own momentum which drove stock prices to depressed levels thereby ruining investor confidence and creating a self-fulfilling prophecy of the stock and institution becoming worthless.
- In some cases, this is resulted in liquidity “runs” on banks.

7. Fix the Real Estate Market . . .

- Fundamentally, banks can either modify troubled loans or write them down and dispose them.
- It is both an economic decision and an image decision.
- For a bank to modify loans, there must be some upside potential.
- Fixing liquidity should be done in a priority manner as follows:
 - Fix consumer confidence – MTM changes and FDIC insurance
 - Fix oversight – Regulate private equity and hedge funds, eliminate conflicts within investment banking houses
 - Then, after seeing how well the first two steps have done, if necessary put a stopgap real estate measure in place.
- **The current bailout bill has it completely backwards.**

For example . . .

- If a bank has a problem loan with a book value of \$100,000 and it forecloses it will write down the loan to \$70,000.
 - The Bank will write off \$30,000 resulting in less equity and therefore the inability to leverage \$375,000 in growth (\$1 capital : \$12.50 loans.)
 - In addition, the cash flow goes from \$599.55 a month (assuming 6.00% rate) for the \$100,000 loan to \$419.69 a month (assuming 6.00% rate) for the \$70,000 loan.
- Rather, if a loan modification is possible, the government should step in and buy the loan for \$100,000 and lower the rate to 3.00% on the loan providing the same \$419.69 cash flow. The government however, can fund itself at 3.00% while a bank can not. As such, there would be minimal or no loss to the government.
 - The bank has no write down so it loses no leverage stopping the market contraction.

Continued . . .

- The market stabilizes as there is no new \$70,000 market value. Rather, the value is preserved at \$100,000.
- The government can take title to the property, similar to auto titles, that will be signed over to the borrower when the note is paid off.
- The government could take a “kicker” and get some appreciation value equal to the difference between the 6.00% market rate and the 3.00% rate provided.
- The government could buy anywhere between \$70,000 and \$100,000 and the banks would realize some loss, but still not as bad as no government intervention.
- Another way to accomplish the same mission is for the government to inject preferred stock into institutions.

8. Modernize the regulatory framework . . .

- The Federal Reserve becomes the key systemic regulator, Holding Company regulator and International regulator. They might also supervise the top 20 banks in the country or minimally any bank deemed “too big to fail”. The Fed issues all Policy that is systemic in nature like BSA, CRA etc.
- The OCC and OTS merge and the combined entity regulates all national banks.
- The States maintain authority over State Banks. If a State can not handle its responsibilities, there will only be national banks in that state. Regional compacts will be permissible.
- The FDIC provides insurance and handles all failures and dispositions.
- The NCUA comes under the Fed and regulates all credit unions.
 - Any community credit union gets taxed while all others keep non tax position.
- This levels the playing field.

9. Revisit SOX and GLB . . .

- SOX is not necessary for financial institutions as FDICIA covered it for banking institutions. Eliminating it will cut costs and unnecessary work. It certainly did not stop the recent failures.
- GLB is not needed as all institutions must be bank holding companies or will not be allowed to participate in financial markets arena.

10. All digital transactions must go through the Federal Reserve . . .

- As the economy moves from cash and paper to a digitized form, the Federal Reserve is slowly losing its ability to exercise its monetary policy oversight.
- Additionally, it will enhance the governments ability to monitor money laundering and antiterrorist activities.



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