

On the Government's Stimulus Package: Banking

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MORE INFO AT: <http://pages.pomona.edu/~lbc04747/>

Outline

1. Current State of Affairs
2. Government Plans
3. Thoughts and Opinions

1. Current State of Affairs

- TARP = Troubled Asset Relief Program. Purpose is to allow the Treasury to purchase up to \$700B of troubled assets from banks. In exchange, the banks must give the government equity warrants or some form of ownership in the bank so as to participate on the upside.
- Trouble Assets include (a) residential or mortgage related assets and (b) any asset that the Treasury Secretary and Chairman of Fed believe to be a threat to financial stability.
- First round of injection into banks' preferred shares has lost 31% of its value of the original TARP \$247B.

1. Current State of Affairs

- Where has the money gone so far?

As of February 9, 2009, \$388 billion had been allotted, and \$296 billion spent,

- \$250 billion to purchase bank equity shares through the Capital Purchase Program (\$195 billion spent);
- \$40 billion to purchase preferred shares of American International Group
- \$20 billion to back any losses that the Federal Reserve Bank of New York might incur under the Term Asset-Backed Securities Loan Facility (none spent);
- \$40 billion in stock purchases of Citigroup and Bank of America (\$20 billion each) through the Targeted Investment Program (\$40 billion spent)
- \$12.5 billion in loan guarantees for Citigroup (\$5 billion) and Bank of America (\$7.5 billion) through the Asset Guarantee Program (none spent);
- \$25 billion in loans to automakers and their financing arms through the Automotive Industry Financing Program (\$21 billion spent)

1. Current State of Affairs

- Where has the money gone so far?

Company	Preferred Stock purchased (millions USD)	Assets guaranteed (millions USD)	Additional details
Citigroup	\$52,000	\$306,000	Two allocations: \$25,000 on October 28, 2008. \$20 on December 16, 2008. And another \$7 on Jan. 16, 2009.
Bank of America	\$45,000	\$118,000	Two allocations: \$25,000 on October 28, 2008 and \$20,000 in Jan 2009
AIG (American International Group)	\$40,000		
JPMorgan Chase	\$25,000		
Wells Fargo	\$25,000		
General Motors	\$13,400		
Goldman Sachs	\$10,000		
Morgan Stanley	\$10,000		
PNC Financial Services Group	\$7,579		
U.S. Bancorp	\$6,600		
GMAC Financial Services	\$5,000		
Chrysler	\$4,000		
Capital One Financial	\$3,555		
American Express	\$3,389		
Bank of New York Mellon Corp	\$2,000 to \$3,000		
State Street Corp	\$2,000 to \$3,000		
Royal Bank of Canada	\$1,000 to \$1,500		

2. Government Plan

- Budget of 2010 has a place holder of \$250B for additional needs from bank losses.

2. Government Plan

A Many-Pronged Plan

While details of the bailout plan are still sketchy, the goal is to encourage lending through a variety of efforts.

Stabilize Banks

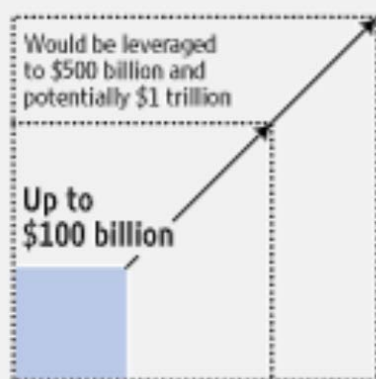


\$100 billion to \$200 billion

Fresh round of capital injections

What it does: Provides a financial cushion for banks and encourages them to lend.

How it works: Large banks will have to undergo 'stress tests' to measure their capacity to absorb future losses. Investments can be converted into common equity if needed. Banks face restrictions on dividends, stock repurchases, acquisitions and executive compensation.



Up to \$100 billion

Would be leveraged to \$500 billion and potentially \$1 trillion

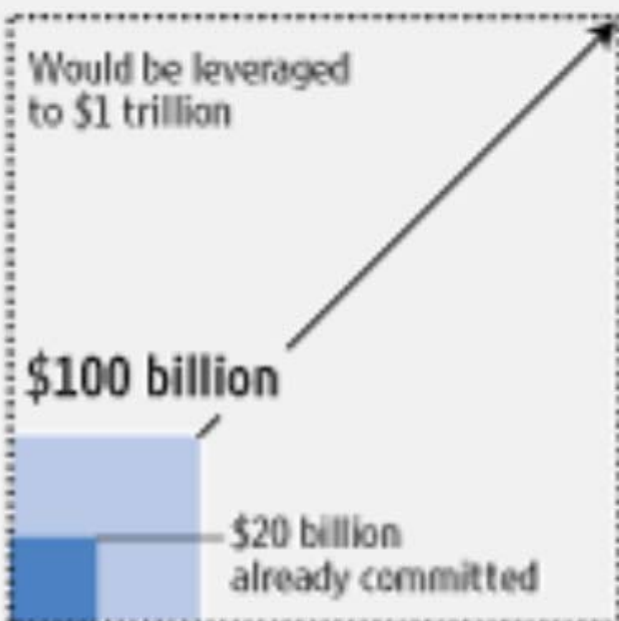
Buying toxic assets

What it does: Creates a public-private investment fund to buy bad loans that are causing bank losses and are eroding confidence in the financial system.

How it works: Fund is designed to attract private capital for large-scale asset purchases and to allow the private sector to determine the price of current troubled and previously illiquid assets.

2. Government Plan

Unfreeze Consumer Lending



Offer financing for loans

What it does: Expands a Federal Reserve program, which isn't yet running, designed to jump-start markets that provide funding for debt such as student loans and car loans.

How it works: Investors purchase newly packaged securitized loans with AAA ratings using attractive financing from the Fed.

2. Government Plan

Help Homeowners

**\$50
billion**

Modify home loans

What it does: Attempts to halt the spiral of foreclosures and falling home prices, one of the root causes of the crisis.

How it works: Full details of this plan have not been announced. Options include: Committing funds for programs to reduce monthly payments and setting guidelines for loan modification.

Source: Treasury Department

2. Government Plan

- The Financial Stability Plan, Treasury Department

Financial Stability Trust

- Increase transparency and disclosure
- Forward Looking Stress Tests

Stress Tests include:

a) 3.3% contraction in gross domestic product in 2009, which would be the worst performance since 1946.

b) home-price declines of another 22% in 2009 and 7% in 2010.

Note: Private economists on average forecast a 2% contraction in economic output this year and a 2% rebound next year, with the jobless rate remaining below 10%.

Banks must have sufficient capital for such a scenario.

- All banks with \$100B or more in assets must comply
- Capital Assistance Program (aka CAP)

2. Government Plan

- The Financial Stability Plan, Treasury Department

Financial Stability Trust

Some Details of CAP

1. US Govt will buy convertible preferred shares
2. Mandatory conversion to common after 7 years.
3. Conversion price is 90% of average closing price for 20 trading day period ending Feb. 9, 2009
4. Paid cumulative dividends of 9% per annum.
5. Reasonable efforts to sell all ownership after conversion date.

More details at www.treasury.gov

2. Government Plan

- The Financial Stability Plan, Treasury Department

Public-Private Trust

- A fund with 500B – 1T in capital to purchase bad assets
- Private capital involved
- Pricing of assets

-Plan is not specific, but some ideas might be:

(a) Value based upon discounted cash flows (requires guesses on economy)

(b) Value based upon auctions (may not get many bidders)

(c) Combination of (a) and (b)

2. Government Plan

- **The Financial Stability Plan, Treasury Department**

Consumer and Business Lending Initiative

- Up to \$1T to help purchase loans (traditionally done by banks to facilitate loans to consumers of autos, small business, but channels are frozen)
- Focus on AAA quality loans to protect taxpayers
- Builds of TALF (term asset-backed loan facility) but includes commercial MBS and residential MBS

2. Government Plan

- **The Financial Stability Plan, Treasury Department**

Transparency, Accountability, and Monitoring

- More transparency in process of aiding banks with taxpayer money
 - Banks must show how funds will lead to increased lending
 - Must have details about intended use of govt. funds
 - Must have details about new loans completed on a month-to-month basis
 - Need to have estimate of what lending would have been absent govt. support
 - All of these reports will be posted at financialstability.gov

2. Government Plan

- The Financial Stability Plan, Treasury Department

Transparency, Accountability, and Monitoring

- Commit to govt. plans for foreclosure mitigation
- Restrict dividends (\$0.01), stock repurchases, and acquisitions
- Limit Executive Compensation (\$500K)
- Prohibit Lobbying Interference with spending plans
- All transaction deals will be posted on web within 10 bus days

2. Government Plan

- The Financial Stability Plan, Treasury Department

Housing Support and Foreclosure Prevention

- Decrease mortgage rates (by Fed and Treasury buying up GSE mortgages)
- \$50B committed to prevent avoidable foreclosures
- Bring guidelines to foreclosure process
- Bank recipients must help with foreclosure mitigation

2. Government Plan

- The Financial Stability Plan, Treasury Department

Housing Support and Foreclosure Prevention

Family B: Access to Refinancing

- **In 2006:** Family B took a 30-year fixed rate mortgage of \$350,000 on a house worth \$475,000 at the time. (The family put just over 26% down.) They received a Fannie Mae conforming loan with an interest rate of 6.50%.
- **Today:** Family B has about \$337,460 remaining on their mortgage but their home value has fallen to \$400,000.
 - Their “loan-to-value” ratio is now 84%, **making them ineligible for a Fannie Mae refinancing.**
- **Under the Refinancing Plan:** Family B can refinance to a rate of 5.16%. **This would reduce their annual payments by nearly \$4,000.**

	Existing Mortgage	Refinancing
Balance	\$337,460	\$344,210
Remaining Years	27	30
Interest Rate	6.50%	5.16%
Monthly Payment	\$2,212	\$1,882
Savings	<i>\$331 per month, \$3,968 per year</i>	

2. Government Plan

- **The Financial Stability Plan, Treasury Department**

Small Business Lending Initiative

- Increased capital constraints on banks, inability to sell of loans has tightened lending to small business
- Purchase AAA-rated SBA loans to unfreeze this secondary market
- Increase guarantees for SBA loans to 90%
- Reduce fees on loans processing

3. Thoughts and Opinions

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- Nationalization? What is it? Good or bad?
- The Treasury Plan, why the markets might not like it?

3. Thoughts and Opinions

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Nationalization? What is it? Good or bad?

- Occurs when government takes over a private firm (note: 100% ownership is not necessary – even 50% can be enough for controlling ownership).
- Occurs already, like when the FDIC seizes insolvent banks. On January 30, 2009 they seized Ocala National Bank of Florida and sold it off to CenterState Bank.
- With the TARP funds, the US has taken significant preferred stock in various major banks, but this is non-voting stock.

3. Thoughts and Opinions

Nationalization? What is it? Good or bad?

- Why Good? Once taken over, govt. could rid the bad assets and sell off the good pieces eventually. It might help jump-start lending, etc.
- Why bad? Bad for shareholders who lose investments (includes you through pension funds, mutual funds, and other items) Also could lead to the “who’s next” philosophy causing much more uncertainty and panic throughout system.

Also, large burden for a govt. that really doesn't have much experience running large-scale banks.

3. Thoughts and Opinions

Nationalization? What is it? Good or bad?

U.S. Banks May Be Nationalized

The government could take bigger ownership stakes in struggling banks by converting its preferred shares to common stock. That would effectively nationalize some of them, hurting other investors.

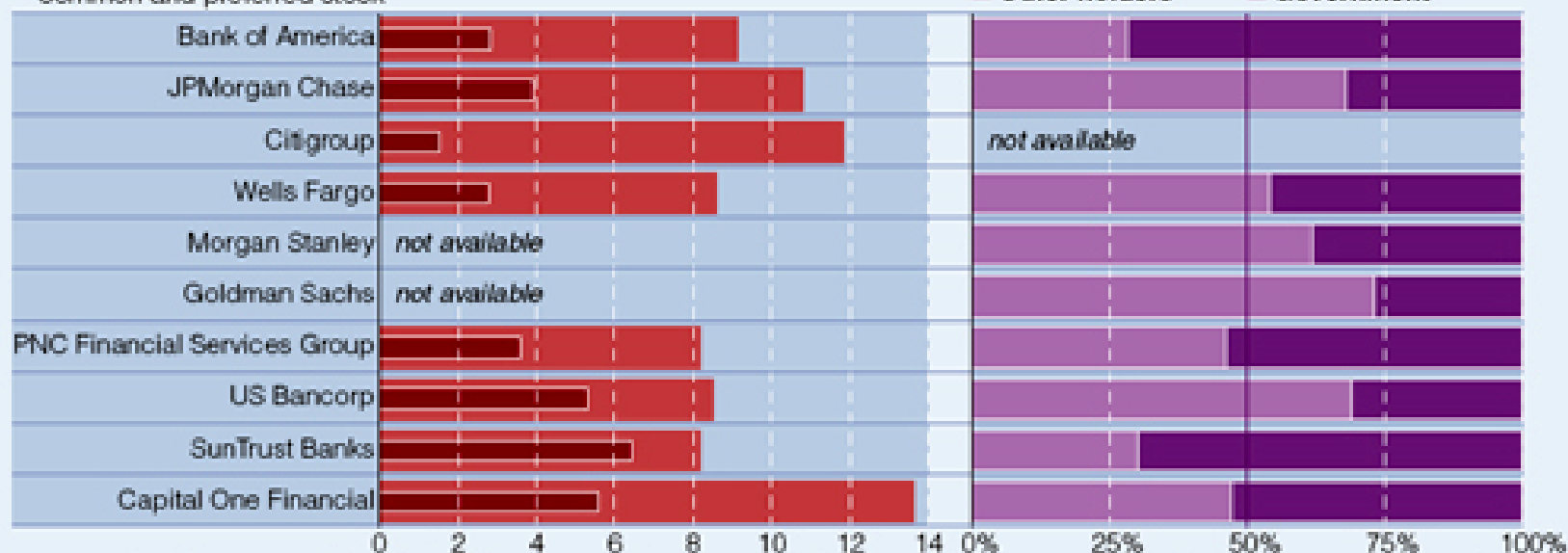
Banks could use converted shares to bolster tangible common equity.

■ **Tangible common equity**, or TCE, strips out intangible assets, goodwill and preferred stock, including shares issued to the U.S. Treasury

■ **Tier 1 capital**, a key measure of banks' financial strength that includes common and preferred stock

Conversion of preferred equity to common equity would provide a cash infusion, but it'd make the government the major shareholder in some cases.

■ **Other holders*** ■ **Government***



Sources: Keefe, Bruyette & Woods; Bloomberg

Note: Banks ranked by total assets

*As of Feb. 20

Bloomberg

3. Thoughts and Opinions

Nationalization? What is it? Good or bad?

Definition: Tier 1 Capital - is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of equity capital and , but may also include irredeemable non-cumulative preferred stock and retained earnings.

Definition: Conversion of Preferred Equity to Common Equity – the process by which a preferred share is exchanged for common shares. If the preferred shares can be converted at a preferable rate to common, usually this will dilute the common equity in favor of the converting preferred owners, making them own relatively more of the company.

3. Thoughts and Opinions

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Nationalization? What is it? Good or bad?

Note 1: Why does Tier 1 vs. TCE matter? Doesn't really for solvency, but common equity holders are more vulnerable when TCE is low, since common is the first to lose in troubled times at the expense of preferred and debt holders. Thus, to stabilize the equity might require more common equity investments, rather than other types. This is the core of the argument.

Bank of America, Kenneth D. Lewis, the chief executive, assured the bank's employees on Monday that Bank of America has enough capital, including common stock. "I have said repeatedly

Note 2: The stress tests will involve a minimum to which Tier 1 Capital as a ratio of total risk adjusted assets (e.g. 6%)

3. Thoughts and Opinions

The Treasury Plan, why markets might not like it.

1. The details are not in the plan, just broad ideas. So uncertainty still remains in market place.
2. Investors aren't certain what will happen to the equity of banks. Including fears of nationalization.
3. Markets aren't sure that Obama's administration really knows what to do. Worried that things might get worse.
4. Wall St. doesn't like capping pay. Can distort incentives and lead to flight of quality people.

