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Financial Turmoil ... What's Really Going On Out There?

Stimulus, TARP, TALF, Credit Crunch, Bank Nationalization ... What is really going on in the market? Why is it so hard to get bank loans? Why are banks 'not lending'? What is the impact of the government stimulus? Clearly, there is turmoil in the financial industry and much is being reported (or misreported) about what truly is happening. The following remarks are designed to be summary in nature and cover the essential points.

The Banking Dilemma

One of the most under-reported issues facing most banks today is the significant pressure they are receiving from the state and federal regulators. The regulators primary goal is to ensure that banks stay healthy and maintain industry accepted ratios. Historically, banks have been required to maintain a capital ratio equal to 10.0% (this is an overly-simplistic statement, but it will be the easiest to understand). Simply stated, your Equity (or Capital) should equal at least 10% of your assets. Consider the following formula:

$$\text{Capital} / \text{Assets} = 10\%$$

For Banks, the primary assets are LOANS. Capital is the difference between Assets and Liabilities. For banks in a growth mode, capital is increased through profitability/earnings or raising additional stock.

Many recent events have had a **negative** impact on bank's ability to maintain adequate capital ratios and have actually resulted in the bank **losing** capital:

1. Higher than expected credit losses have forced banks to increase their loan loss reserve and write-off bad debt which has severely cut into earnings (thereby reducing capital ... a bad thing)
2. Banks have had to write-down loans due to the Mark to Market accounting. This has an effect of reducing assets but also reducing earnings. Further, if any of the loans have to be downgraded or reclassified, the banks have had to maintain a larger loan loss reserve against those assets.
3. Many banks got caught off-guard when the FED lowered rates so **quickly**. To fund growth, many banks take in deposits via Certificates of Deposits. 12 months ago, CD's were selling for 4-5%. This rate,

aggregated with the interest rates Banks pay on interbank loans essentially equates to the Bank's Cost of Funds. Unfortunately, many of the bank loans are tied to Prime. Bank's try to maintain a healthy spread between what they pay for CD's and interbank borrowings and Prime ... but today they are 'upside down'. Banks are having to pay ***more*** for their funds (via CD's issued last year) but at the same time are seeing the interest rates on variable rate loans ***fall***. The result ... banks earned less money and in some cases, lost money on performing loans.

All of these factors happened so quickly, many banks could not raise capital or adjust quickly enough, resulting in over-leveraged banks. With escalating bank failures, the regulators have been putting substantial pressure on all banks to do the following:

1. Increase liquidity
2. Preserve Capital
3. Increase loan loss reserves
4. Worry less about profit...but focus on survival
5. Increase capital ratios from 10% to 12%

If you look closely at the message from the regulators, it is frightening but clear. If banks are required to increase their capital reserves and the corresponding ratios, there are only a number of options:

1. Raise new capital...this is very difficult given the current market conditions
2. Reduce assets...this is why you are seeing so many banks asking customers to leave or refinance their real estate loans

As remarkable as it may sound, many banks have to ***shrink*** their balance sheets to meet the regulatory requirements.

So How Does TARP play into this?

For most institutions, the quickest 'fix' to raising capital and getting into regulatory compliance is to apply for TARP and put those funds directly into the Bank. The intent of TARP was to get the banks to lend. However, very few banks have actually taken the TARP money and lent it out; rather they have used the funds to 'fix/shore up' their balance sheets.

This is the tragedy of the TARP plan. The government appears to be talking out both sides of its mouth. On one hand, the treasury is doling out money with the 'hope' that banks will lend. Unfortunately, Banks are most concerned about the regulators. The regulators are telling banks to ***preserve*** capital and many are being criticized for loan growth. Note: Preserve and lend are antonyms.

The end result is that small businesses and consumers continue to face difficulty finding money. Many regional and community banks are well-capitalized and able to lend. However, the capacity of these institutions is limited. Many community banks that applied for TARP, with the intent to lend, continue to wait for a response to the Fed, whose priority has been

the larger banks, who have much greater exposure to 'toxic' loans.

How has the secondary market impacted all of this?

For consumer and small business loans alike, there is a secondary market whereby loans are pooled and sold to investors. This enables banks to lend money and then sell the loans, providing additional capital to lend (similar to how a manufacturing company 'turns' inventory).

After the collapse of Lehman Brothers, the secondary market essentially froze. No loan pools were being purchased and many are still frozen to this very day. What does this mean for banks? Remember, for every loan you make, you have to allocate capital to fund the loan. The inability to sell loans in the secondary market means the lender has to retain the entire loan on its books. More loans require more capital so the ultimate result is the bank has to be more conservative about the type of loan it funds and limits loan growth.

TALF (Term Asset-Backed Securities Loan Facility) was designed to lend money to the broker dealers who were holding huge amounts of unsold pools. Their warehouse lines of credit were maxed out and in many cases, being called (paradoxically by the banks who were also trying to raise capital by shrinking their loan portfolio). TALF was supposed to be a way for these broker dealers to further leverage their portfolios until the secondary market thawed. The problem with TALF is the interest rates being charged and the discount taken on the sale of these pools was too high for the broker dealers to 'make it work'. At the time of writing, the government is considering a revised TALF plan that may address this issue.

Did the Stimulus Package do Anything for Banking?

Actually, the Stimulus plan contains a very positive change as it relates to SBA lending. It proposes increasing the guaranty on some 7a loans from 75% to 90%. The guaranty portion is sold in the secondary market so the portion on the bank's balance sheet will be *lowered* from 25% of the loan to 10%. This could be *huge* as it requires *less* capital to fund the same loan amount. Furthermore, the SBA may be waiving its servicing fee charged to banks. This should immediately drop to the bottom line, improving profitability and creating capital. While the secondary market is still soft for guaranteed loans, this change should create an immediate boost in SBA lending.

Similar changes have been made to the SBA 504 program with increased guaranties and fee waivers. All in all, the Stimulus package should have a positive impact on SBA lending.

NOTE: While the federal government has approved these changes, they have yet to be approved and ***implemented*** by the US Small Business Administration. No time frame has been identified.

Summary

Credit losses and increased scrutiny from the regulators have the banks running scared. The Banks who have received TARP aren't lending (look at their stock prices and that will tell the story). Capital preservation is of utmost importance. Rates have increased in an effort to offset higher cost of funds and create profit, which creates capital.

As with all things, we will get through this. There are plenty of lenders still lending money. It's just harder to find and more expensive. 2009 will be the year to survive. Look for a better environment in 2010.

On a personal note, Quadrant has expanded into several new markets. We continue to fund loan transactions under the following programs: SBA 7a, SBA 504, USDA, Conventional, Life Insurance Company, FHA and FNMA. We are optimistic about the future, but cautious about 2009. No bank, including Quadrant and its parent bank are immune to the regulatory requirements and the secondary market factors. Unlike many of our peer group, we are well-positioned to weather this very challenging market *and* continue to make loans to our small business clientele.

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