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At the Margin

The Treasury's Capital Purchase Program: *Boon or Boondoggle?*

The Doctor Is In!

Why can't we explain the Treasury's Capital Purchase Program (also known as Troubled Assets Relief Program or TARP) to the general public? Politicians don't seem to understand it. The financial press doesn't seem to understand it. But the worst indictment is that the executives of banks themselves, along with their public spokespeople, don't seem to understand it well enough to explain the plan to the general public.

Well here's my take on it. Simple, direct, and hopefully helpful to you as you talk to your directors and your community.

U.S. financial institutions as well as most of their counterparts throughout the world are regulated through a "fractional-reserve" system. That is, the financial institutions hold a fraction of their assets (loans and securities), say 6 percent to 10 percent, in the form of capital and loan reserves (money set aside for losses). This is the basis of financial leverage, i.e., \$1 of capital supporting \$10 of loans.

As earnings accrue and/or capital is injected into the bank (through additional stock offerings or subordinated debt), financial institutions can lend out this multiple, for example, \$10 of loans for every \$1 of capital, to support economic growth.



This multiplicative power of capital leverage is exactly the reason we created the fractional reserve system. All, of course, based on the depositors' confidence that regulators are making sure that the capital and reserves are sufficient to support outstanding loans and securities.

However, when assets fail to perform as expected (loans are not paid back according to schedule or securities market value falls below its book value), regulators classify (specify as requiring additional reserves) these "non-performing" assets and require more capital to support them, say 20 percent to 50 percent capital coverage. This dramatically reduces the leverage of the capital from 10-to-1 to 5-to-1 or even 2-to-1, and finally, if the asset is written off, 1-to-1.

So, instead of my \$1 of capital being used to support \$10 in new loans, it is being used to

reserve against \$1 to \$5 in existing non-performing assets.

Our financial system is currently forced to classify billions of dollars of existing assets and also to worry about billions of dollars of loans that may be classified “non-performing” due to the worst recession in 75 years. It is this unknown volume of recession-generated classified assets that threatens the deleveraging (shrinking the balance sheet) of the banking system. These financial institutions must take their existing capital that would have supported projected lending volume to support classified assets. The purpose of the Treasury capital (Capital Purchase Program or CPP money) is to support their projected lending, preventing the catastrophic deleveraging of the banking system that would ensue without this “bridge-capital injection.”



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You see, there really is an order in the use of capital. Even though capital is theoretically fungible, that is, no precise assignment of earmarked capital dollars to a specific purpose, it is not true in this circumstance. The capital that is first-up for disposition, if you will, is the institution’s own indigenous capital. If the institution is not suffering significant increases in classified assets, and is not likely to foresee a significant

increase in classified assets over the next several years, then it has the ability to use its own capital to support a continuation of growth given the normal leverage of capital to loans.

If however, the institution’s own capital has to be allocated to support existing and projected classified assets, that capital cannot be used to leverage lending. Planned lending cannot be supported.

Enter the decision to use Treasury capital. This capital injection is used to maintain projected

lending, thereby preventing the deleveraging of the institution and the economy. Remember, this debt capital is not a gift from the taxpayer.

It is a **loan** from the taxpayer that must be repaid. This debt capital is expensive, since interest on the debt is not tax deductible. The capital must be used to support enough new lending over the five years it will be used to pay for the after-tax cost of 7.75% per year. Thereafter, the after-tax cost jumps to 13.8% until the money is repaid to the Treasury. Expensive capital indeed! Management of stock institutions must plan for the repayment of the capital through more cost effective private equity when confidence returns to the equity markets. The structure of the Treasury capital injection for Sub S Corporations (100 shareholders or less) and mutually owned institutions (owned by their depositors) is another order of complexity that requires significant analysis to plan for the repayment of the capital.

Deleveraging of a financial institution reduces interest margin (income generated through loans and securities less expenses from deposits and borrowings supporting them) and should be avoided if at all possible. If the injection of Treasury capital permits the growth of earning

assets and thereby interest margin, it will have to be leveraged at least 3-to-1 to pay for the interest expense associated with this capital. Even greater leverage would be required if increased earnings are to be the means for the repayment of the Treasury capital.

Of course, it may turn out that the Treasury capital is not needed to replace the institution's own capital that would have been used for reserves against classified assets. In such cases, the capital is merely serving as an insurance policy. Nevertheless, the interest expense for this capital has to be accounted for, hopefully through increased lending.

Even the much maligned use of CPP money for bank acquisitions can be explained using

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analogous arguments regarding leverage. Bank B is “El-Dumpo,” therefore not leveraging capital and probably not even replacing loans that are running off. If Bank A can use capital to acquire Bank B, deleveraging in Bank B’s market can be prevented.

Troubled asset acquisition, new regulation and other parts of a multi-faceted bank system restructuring will be necessary to restore health to our credit system. However, the Treasury’s Capital Purchase Program is an irreplaceable component of this process. It represents a critically needed stop-gap to prevent the catastrophic deleveraging of the banking system.

Of course, a few commentators have shown a very astute realization of the dichotomy between the economic solution and the resolution of economic equity. Ultimately when the citizens lose faith in the ability of any economic system to resolve

resource distribution with some consideration of equity, we invite substantial political interference with the economic institutions themselves. This institutional change, in this case significant legislative and regulatory change, may be imposed with negative impacts for economic efficiency. So be it! At the very least, one should allow the market to deal out its inherent penalty of the loss of all shareholder capitalization while the legal system pursues civil remedy from corporate officers.

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Parliment Consulting Services focuses on Strategic Financial Planning to help community financial institutions gain and maintain sustainable superior earnings growth.

