Is the Troubled Asset Relief Program a cure for the U.S. financial system and the economy?

The U.S. financial system needs to build capital in light of the events of the past several months. Investors have become extremely risk averse and that aversion across both fixed-income and equity markets has resulted in the worst liquidity and credit crisis in decades.

The Troubled Asset Relief Program (TARP) is bringing unprecedented capital assistance to the U.S. financial sector. Initial expectations for the success of this policy response was low because the primary focus was on buying troubled assets at an unknown prices. Such action would have reduced uncertainty, as difficult to value assets were removed from the balance sheets, but it would not have improved capital levels unless the program was planning on overpaying for the assets. By mid-October, the focus of the plan had changed to granting new capital to the banking system through preferred shares at a very attractive cost to the institutions.

By injecting up to US$250 billion into banks, brokers and thrifts, the capital strength of the system will be materially enhanced. Goldman Sachs research has estimated that the capital injection will temporarily lift tangible equity in the U.S. banking industry above 9% – the highest level in 65 years. In addition to injecting capital, the program will establish government guarantees on significant bank liabilities, including some deposits not currently insured through the Federal Deposit Insurance Corp. (FDIC).

Over the past year, banks have increasingly been forced to hoard liquidity and capital as their wholesale lenders have abandoned them. This hoarding has magnified feelings of distrust in the financial system. New government guarantees on bank-to-bank deposits, and inter-bank lending, should restore confidence in the system. The government guarantees for inter-bank lending started in Ireland and are spreading across the globe. Bank liquidity should normalize with the guarantees and banks will be able to get back to the business of providing credit – which will support economic growth. It won't be an immediate fix, but the measures should be sufficient to improve sentiment.

In order to assess the potential impact of these measures, we have selected a basket of U.S. banking stocks, representing 10 significant U.S. banks that have minimal foreign operations: Bank of America, JPMorgan Chase, Wells Fargo, Wachovia, SunTrusts Banks, Fifth Third Bancorp, National City, TCF Financial, Regions Financial and US Bancorp. For the group, tangible shareholders' equity is down modestly from peak levels because writeoffs have largely been offset by raising capital. The pre-provision and pre-tax earnings run rate is roughly US$100 billion, but common dividends currently being paid by the banks have been cut in half over the past year. Cumulative credit losses for these institutions may approach 6% of risk-weighted assets, or $250 billion, of which roughly $50 billion has already been expensed. This significant projected loss figure exceeds the group's current tangible equity base. In order to maintain current equity and asset levels, the banks can attempt to recognize losses at the rate of $21 billion per quarter. In the absence of capital injections, this would take approximately three years to

Earnings vs. Credit Loss Provisions: Basket of 10 U.S. Banks

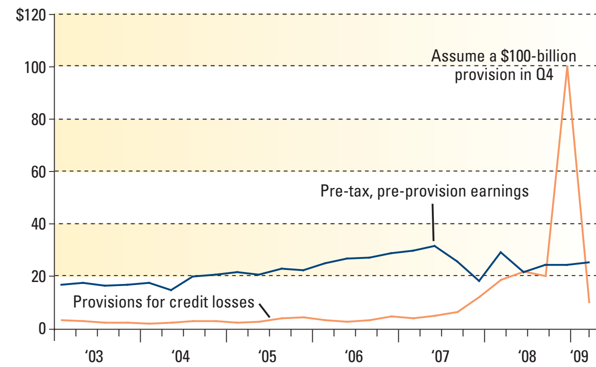

Chart 1: The earnings of a group of 10 major U.S. banks before taxes and provisioning expenses continue at the levels of recent years. However, expenses for credit loss provisions have risen sharply, wiping out pre-tax earnings. The TARP program should allow the banks to take a large provision in the fourth quarter of 2008, reducing the need for provisions for losses in future quarters and setting the stage for a return to positive earnings in 2009.

Tangible Equity as a Percent of Risk-Weighted Assets: Basket of 10 U.S. Banks

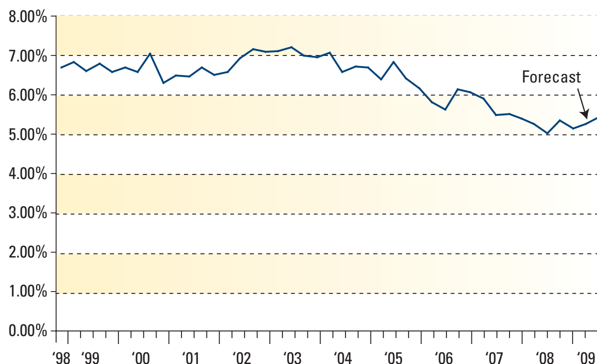

Chart 2: The combined capital base of a group of 10 major U.S. banks has continued to decline. However, a large writedown of trouble assets this year, facilitated by the TARP program, should allow the banks to begin to slowly rebuild their capital bases.

cleanse balance sheets of the combined losses. If the banking system did not grow its balance sheets for three years, the economy would remain stagnant. Authorities are now prudently reacting to the risk of that happening.

The capital injections into the banks under the TARP should significantly change the economic outlook. If these banks receive $75 billion to $80 billion for preferred shares, with new capital they can immediately write off $100 billion in assets (at a cost of $60 billion to $65 billion after tax) and expense the additional losses at the rate of perhaps $10 billion per quarter – a level that will facilitate positive earnings, equity growth and balance sheet growth (see charts 1, 2).

With government guarantees bringing stability to bank funding, and capital injections facilitating more rapid balance sheet cleansing, the U.S. banking industry should be in a position to generate positive earnings in 2009. This should facilitate balance sheet growth and a more reasonable credit environment, which will avoid a worst-case scenario for the U.S. economy.

At Signature, we believe the U.S. banking system is now better positioned to move forward than the European financial system, which entered the financial crisis with higher leverage levels and is working through varying capital injection plans. Many of the European financial companies outgrew their domestic markets through global acquisitions and increasing leverage. This now represents a tremendous recapitalization challenge to their home countries and will impact sovereign credit ratings and currency valuations.

Currently, Signature funds are positioned cautiously with a respectable cash positions. We are identifying attractive opportunities in both equity and credit markets. While we expect negative headlines to continue for some time, we believe global risk aversion may already be at its peak, and if so, we should see a return to more normalized financial markets in the months ahead.

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