



Welcome to the Government Spending Bubble

"America is more communist than China is right now. You can see that this is welfare for the rich. This is socialism for the rich."

—Jim Rogers

In our view, this quote by Jim Rogers needs to be slightly altered in that the government's actions over the last eight weeks are welfare principally for the *Wall Street* rich. The last eight weeks have proved to be a time period of such historic proportions that even we could not have anticipated these once-in-a-lifetime events surrounding the financial markets occurring at such a rapid pace. Events have unfolded that have altered the landscape of the global financial system. Once the preeminent free market economy in the world, the U.S. has recently resembled more of a government-run financial system. What began as a localized crisis in the subprime market 18 months ago has now morphed into a crippling global financial crisis, the likes of which we clearly have not seen since the Great Depression. Although the housing market and a massive over extension of credit over the last 12 years is the root cause of this current financial turmoil, the genesis of the problems surrounding our financial system go back further and are ones which we have long opined upon. At the core of these problems is the toxic mix of Wall Street and Washington, which first led to the Internet bubble, then to the credit and housing bubble, and now to what may become a governmental spending bubble at the worst possible time.

Unfortunately, this toxic relationship between Wall Street and Washington is not subsiding and, in our view, is diverting the government from taking more constructive actions to fix this global economic crisis. Our fundamental problem with most of the actions taken to date by the Treasury and Federal Reserve is with their almost myopic focus in addressing the problems of Wall Street and the largest banks. We clearly understand the systemic risk that some of these institutions pose to the U.S. economy. **However, the Fed has continued to take an overly passive approach with many of these financial behemoths and does not seem to understand that, regardless of their actions, they will not resurrect the credit creation role that Wall Street has played over the last 15 years.** To be more succinct, there is no hope of resurrecting the structured finance markets anywhere close to their former volumes or underwriting standards that Wall Street has used. **The whole shadow banking system, the asset backed securitization market and the levered loan market is dead (as we wrote in our *Industry Update* earlier this year) and will not be returning anytime soon.** Therefore, it is our opinion that the primary focus for Washington should be reviving the broader economy and recognizing that it is the housing market, the consumer, and the rapidly deteriorating labor markets that are the key drivers to the deteriorating credit environment and overall economic weakness. As it pertains to the financial service sector, it is our opinion that the primary focus for Washington should be reviving the entire commercial banking system from the community banks to the large super regional banks, which, if their balance sheets can be shored up, can continue to originate and underwrite credit. **Lastly, policymakers need to recognize that they cannot prevent a recession and that their only hope is to alter the degree and length of this recession. Instead of irrationally spending money in an unproductive, haphazard manner, the Fed, Treasury, and Congress need to protect the federal government's own balance sheet in order to allow it to continue to have options as the recession deepens.** This is vital in order to prevent a collapse of global confidence in the U.S. dollar as well as the government's financial health, which, if lost, would cause a material spike in long-term rates at absolutely the worst time.

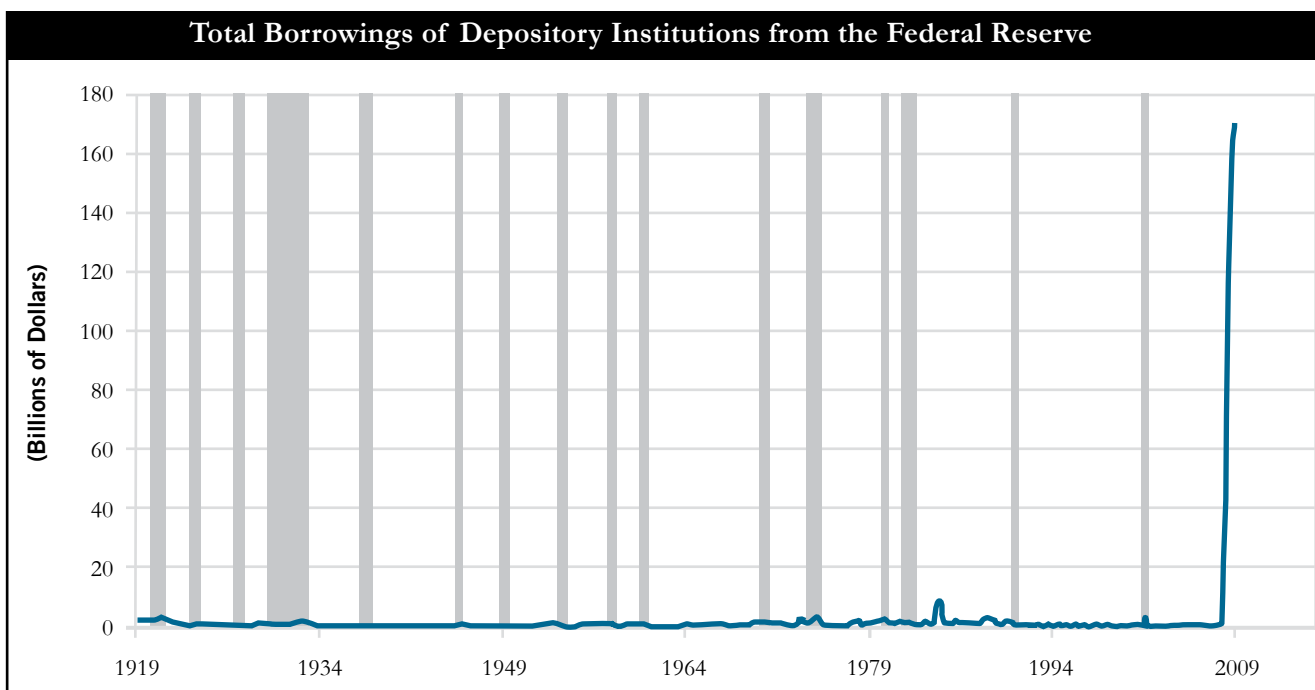
Recent Actions Taken by the Fed

Let us first examine the actions that the Fed has taken since this crisis started in mid-2007. The first set of actions was an aggressive set of interest rate cuts which took the Fed funds rate from 5.25% to 1% from September 2007 through October 2008. As global capital and credit flows continued to be restricted, even in light of the interest rate cuts, the Fed started creating numerous facilities for the investment banking and commercial banking industries to draw upon. These facilities include the Term Auction Facility (TAF—auctions funds to depository institutions from the discount window, the size of which the Fed announced may double to \$900 billion by year's end); the Term Securities Lending Facility (TSLF—which provides investment banks up to \$200 billion of direct access to borrow from the federal coffers at an extremely low rate of less than 1%); and, the Primary Dealer Credit Facility (PDCF—an approximately \$70 billion overnight lending facility available to investment banks at the primary credit rate of 1.25%).

Obviously, these facilities were primarily directed at the investment banking community because of the funding problems they were experiencing and due to the fact that commercial banks have always had access to the Fed's balance sheet through the discount window. For any commercial banker, it must be galling to see that the investment banks were provided this access when it is the commercial banking industry that has to carry 10% of its non-interest bearing demand deposits with the Fed and is thus the ultimate provider of the Fed's balance sheet.

Therefore, the very entities that have been disintermediating the banking industry over the last 30 years and were at the center of causing the subprime mortgage and credit crisis have in one fell swoop gained immediate access to the Fed's balance sheet.

This is particularly disturbing given that the investment banks have operated with a complete lack of regulation. These firms have not had to maintain any minimum capital or reserve requirements, nor have they had to bear the costs of any regulatory examinations and oversight, or absorb the costs and social responsibilities placed on the banking industry—such as the Community Reinvestment Act (CRA) and the Bank Secrecy Act (BSA), just to name a few. There are so many instances of failures by the Fed and other regulatory agencies to properly regulate Wall Street over the last 12 years that they are hard to list. Consequently, while it will be important to reexamine the entire regulatory oversight framework in the near future, we find it more important to address current actions and their consequences in light of the crisis we are facing today. In our opinion, the Fed should have early in this crisis aggressively forced a massive recapitalization of the money center and investment banks if they wanted access to the Fed's balance sheet. Still, today, companies such as Citigroup, Goldman Sachs, and Morgan Stanley continue to pay billions of dollars in common stock dividends, even in light of only having a tangible capital-to-assets ratio of 2.2%, 3.9%, and 3.2%, respectively. No other banking institutions would be allowed to continue to pay common stock dividends while being deemed “inadequately



(Note: Shaded areas indicate U.S. recessions as determined by the NBER; Source: Federal Reserve Bank of St. Louis)

capitalized” by the regulators’ own standards. Further, while each of these companies have raised capital, as you can see from their respective capital levels above, they are still below the banking industry’s average and would not be considered “well capitalized,” again, by the regulators’ own standards.

On top of all of these actions that the Treasury and Fed have taken, another significant step benefiting the investment banks was granting Goldman Sachs and Morgan Stanley bank holding company status. Further, they now intend to grant bank holding company licenses to non-bank financial companies—such as they have already done with American Express. This will now allow these investment banks and non-bank financial companies to have full access and benefits to garner federally insured deposits and borrow directly from the discount window as well as numerous other protections. Again, it must be disturbing for bankers to know that they will now have to compete in the depository market with these two giant entities and potentially others. This has already caused meaningful depository pressures for the entire banking industry, which only further cripples the entities that are in a position to provide credit to the broader economy. Lastly, to no great surprise, the day after these investment banks were granted their bank holding company status, the FDIC immediately raised banks’ deposit insurance costs. While we fully understand the need to have an orderly deleveraging process for the investment banks, it makes no sense to us, however, why such great resources are being provided to these companies. **Simply put: the investment banks should be forced to either raise significant private capital—even if it is on very dilutive terms—and/or to be shrunk back slowly into the business model in which they existed prior to the mid-1990’s, when they carried little to no balance sheet risk and, instead, were investment banking and capital market service providers.**

The Bankruptcies

The next step taken in the past six weeks was the (re)nationalization of Fannie Mae and Freddie Mac. Without question, the Treasury was left with no other options than to stabilize and insure these entities’ guarantees on approximately \$5.4 trillion dollars of MBSs. On this account, we believe the Treasury’s approach was right by providing Fannie and Freddie each with \$100 billion of preferred equity capital and for taking warrants for 80% of the common shares. It is unfortunate that these companies were allowed to massively leverage their capital base and go out on the credit risk spectrum. Fannie and Freddie clearly played a significant role in the housing bubble over the last six years, and you can thank key Democrats in both the House and Senate who blocked any attempt to reform

these GSEs. Just as the investment banks lavished money on both the Clinton and Bush administrations and the Democrats and Republicans in the Senate and House in order to gain protection from any regulatory control, Fannie and Freddie did likewise and became a huge funding source for most Senate and House Democratic campaign members. The GSEs, once they were nationalized, were mandated to be shrunk over the next three years. Unfortunately, the Treasury has decided to reverse course and has now instructed Fannie and Freddie to buy \$40 billion of troubled mortgage paper a month. Obviously, this is a back door attempt to buy mortgage assets without the scrutiny placed on the Troubled Asset Relief Program (TARP). As a result of this action, it is our anticipation that the Treasury will have to provide even further capital infusions into the GSEs within the next two years.

The next shoe that dropped was the collapse of Lehman Brothers and AIG. As credit losses and write-downs mounted for Lehman Brothers, along with sky-rocketing funding costs, it could no longer remain solvent unless the Treasury provided it with a significant capital infusion. Fortunately, on this one, the Treasury got it right. **Contrary to former CEO Richard Fuld’s insistence that Lehman Brothers’ failure was a result of short-sellers, the simple fact is that many potential buyers had an opportunity to review Lehman Brothers’ books and records, and decided that the assets had significant embedded losses and the credit risk was far too great to absorb—even if buying the company for one penny. In fact, even the bond holders have been destroyed and it is now estimated that the recovery rate on Lehman Brothers’ bonds will be between 8 to 13 cents on the dollar, which is where they have recently traded. This illustrates the toxic waste dump that Lehman Brothers was allowed to become.** The very next day, it was AIG’s turn. In this scenario, the Treasury realized it could not allow AIG to fail because of the \$440 billion in counterparty risk that this company posed to the credit default swap (CDS) market. AIG’s financial tentacles were pervasive throughout the entire capital markets and its collapse would have been profound. As a result, the Fed provided AIG with an \$85 billion loan and the Treasury took warrants on 80% of the company’s outstanding shares. Unfortunately, it is our opinion that the Fed will probably, in the end, take losses on the credit line provided to AIG. Furthermore, if the CDS market had originally been on an exchange—with parties having to post collateral—that it would not have been necessary for the Treasury to put taxpayers’ money at risk.

The Mother of All Bailouts

As the financial crisis deepened, the Treasury and Fed proposed the biggest financial bailout since the Great

Depression—the TARP. Originally, the Treasury and Fed panicked and rushed to propose an ill-conceived plan to purchase troubled mortgages and homes—a plan which has now, thankfully, been abandoned (consistent with our analysis of the TARP as originally proposed). Given that we have already presented our analysis of the TARP’s original proposal and that there were fundamental problems at every level—how the Treasury would price the mortgage assets purchased, manage the troubled mortgages and Real Estate Owned (REO) properties, and, ultimately, dispose of these assets—it is no longer relevant and, thus, we will not address it further here.

We *would*, however, like to discuss the TARP Capital Purchase Program (CPP), which will permit the Treasury to inject up to \$250 billion (from the already approved \$700 billion bailout amount) into “qualified financial institutions” (QFIs), whose eligibility is determined by the Treasury in consultation with the appropriate federal banking agency. The government has bought equity stakes totaling \$125 billion in nine of the largest U.S. banks and will potentially deploy the remaining \$125 billion in several hundred banks and thrifts. In exchange for these capital injections, the Treasury will receive senior preferred equity shares paying an annual dividend rate of only 5% for the first five years and receive warrants on 15% of the outstanding shares at an exercise price to be determined by the 20-trading day average of the bank’s stock. **Clearly, the government is providing capital at a cost far below what the capital markets would provide today.** In fact, we find it rather interesting that Warren Buffett—a private investor—recently received preferred shares paying a 10% dividend yield on his investment and warrants covering 100% of his preferred shares at a discount to the current share price of both Goldman Sachs and General Electric, whereas taxpayers—public investors—will only receive half of his rate and substantially less equity upside, despite assuming greater risks and providing larger equity stakes in a wider range of troubled financial institutions. We would also like to point out that other federal governments, as part of their respective capital injection programs, will receive substantially higher dividend rates. Furthermore, they are instituting far more onerous conditions, such as cutting dividend payments on common stock and, in many cases, replacing the management teams that were responsible for these companies’ failures. It is more than odd that the Treasury has not required that the QFIs stop paying common stock dividends and has not, for some reason, demanded a more senior position in the capital structure of these financial institutions which would place

the taxpayer on a higher rung on the ladder in the case of a bankruptcy.

While we are clearly in support of the Treasury allocating a substantial portion of the \$700 billion to inject capital directly into the banks (which we argued for them to do in our analysis of the TARP as originally proposed), we are, however, troubled by the lack of conditions placed on the new capital and the unfavorable economics to the taxpayers. Further, while it is too early to tell, we are also concerned that—much like almost all of the Treasury’s actions to date—the latest initiatives are also driven to benefit the financial giants and that the federal government will not be as open or nearly as forgiving with the regional and community banks which are critical to driving small business in the U.S. A prime example of how the Treasury is almost solely focused on assisting the investment banks and large money center institutions is its new policy to guarantee for three years all bank debt that is maturing between October 14, 2008 and June 30, 2009. This action was not intended to help the overall banking industry because regional and community banks have almost no outstanding debt obligations (other than FHLBB advances and repurchase lines) and the larger superregional banks have very few debt maturities during the time frame that the Fed will provide its guarantee. All one has to do to understand the Treasury’s intention is to look at the debt maturities of Goldman Sachs, Morgan Stanley, Citigroup, and Bank of America. Unfortunately, far too much of our economic policy and approach in dealing with this crisis is, again, designed to benefit a few large players...not too surprising given that Treasury Secretary Henry Paulson came from the CEO position of Goldman Sachs before his arrival at the Treasury in June 2006. Sadly, given the limited resources that our federal government has to address the largest financial crisis since the Great Depression, if they continue to poorly allocate the country’s resources, it is our opinion that it will leave the economy in a rapidly declining pattern which, ironically, will ultimately destroy the financial services industry and economy as a whole.

Our Suggestions to Solve this Crisis

Again, while we can appreciate the daunting position in which the federal government finds itself during this historic financial crisis, it is vital that policymakers conduct any future actions in a prudent and well thought-out manner while protecting taxpayers as much as possible. Policymakers should be careful not to overstrain the country’s already suffering financial condition, particularly as we are only a little more than three years away from

2012, when the first year of the Baby Boom generation begins to turn 65 and receives Social Security and Medicare benefits. This milestone will have a profoundly negative impact on future deficits due to the accounting gimmicks Congress has used by taking in the revenues from Social Security but not accruing the future expense obligations. Again, to reiterate, if policymakers are not careful with deficit spending, the country could be left in the very worst position whereby foreign investors no longer feel comfortable buying Treasury debt and, as a result, interest rates at the mid and longer part of the yield curve (i.e., 5 to 30 years) begin to skyrocket. It is important for investors to understand that the Fed has not controlled the long-end of the interest rate market for well over a decade, which was clearly visible from 2004 through 2006, when the Fed raised its target rate from 1% to 5.25%, and yet long rates barely moved. Therefore, it is our view that the stimulus provided needs to achieve the maximum affect and to address the root causes of this crisis.

Again, thankfully, the federal government has now stated that it will not purchase troubled mortgages and homes as part of its bailout program—consistent with our analysis of the TARP as originally proposed. Notwithstanding the government’s reverse course of how to dispense the TARP funding, if we were at the Treasury and Fed, here are some of the proposals we would explore.

- *Focus on targeted federal infrastructure projects that will stimulate employment, help to achieve higher rates of productivity, provide long-lasting and beneficial impacts on society, and attack the other twin deficits the country has had for numerous years—namely, the staggering trade and capital account deficits.* A prime example of such a focus is our antiquated (1960’s) national air traffic control system. Massive amounts of fuel and time are wasted by planes circling in the air or sitting on runways due to this outdated system. By upgrading this system using a GPS-based model, it would help our bankrupt airline industry, remove the stress and strain on travelers and airline employees, and increase the productivity of all those who travel, while also substantially reducing the use of fuel. Another such project would be enhancing mass transit—particularly in the Northeast and the Western corridors of our country. There is no reason that the U.S. should have a second-world mass transit system when every other developed, or even developing countries (like China), have or are building state-of-the-art mass transit systems for their populations. Again, building high-speed, light rail systems on the East and West Coasts would stimulate job creation, increase productivity for those people and

companies that transact business up and down the coast lines, and vastly reduce fuel consumption, as more people opt to use mass transit rather than drive their own automobile. Obviously, achieving a material reduction in oil demand would help attack this country’s single greatest cause of our massive trade and capital account deficits. Lastly, these programs would provide tangible, long-lasting benefits to society.

- *Fully embrace clean and alternative energy solutions.* Even though the price of oil has now started to collapse as the global economy is contracting, this country cannot take its eye off of the eventual critical goal of reducing our heavy reliance on foreign oil. Many of the renewable energy projects will require the federal government to provide a substantial initial capital injection in order to get these projects underway. There would be numerous benefits to society if we can develop effective wind, solar, and hydro energy. First, it could help the U.S. capture a new cutting-edge technology sector, which would help stimulate job growth internally and spawn a new export driven sector for the U.S. economy. By embracing a plan such as the one T. Boone Pickens has proposed, it would create tens of thousands of jobs to develop wind farms throughout the central part of the country and solar fields throughout the Southwest. Second, it would have a huge lasting impact on reducing the U.S.’s demand for foreign oil and, thus, shrink the massive transference of wealth from the U.S. to other parts of the globe—again, helping to shrink our trade and capital account deficits. Third, obviously, by shrinking the U.S.’s demand for oil, it would further collapse the price of oil, which, in turn, would provide a huge beneficial effect for the American consumer. The enormous savings for the U.S. consumer would then have a beneficial impact on all parts of the economy, as the consumer would have more cash flow to pay and manage their debt obligations. Fourth, the environmental benefits, without question, would be meaningful to the health of the population and to combat global warming. Lastly, there are numerous geopolitical benefits by not having to be so dependent on the Middle East and countries such as Russia, Nigeria, and Venezuela. There are numerous other projects such as the ones cited above that could have equally beneficial impacts.
- *An issue that the Treasury and Fed should have immediately addressed, and yet still have not accomplished today: regulating the CDS market and forcing it onto an exchange where it would provide pricing clarity and, most importantly, force participants to post collateral.*

Most people are unaware that the CDS market is a \$55 trillion ticking time bomb embedded in our financial system, which, again, was created by Wall Street. Wall Street has fought endlessly against this market being regulated because of the billions of dollars in fees it has garnered due to the CDS market's explosion in size and the enormous profit margins created by to a lack of clear pricing. To date, it appears that the SEC is only trying to create a central clearinghouse in order to have all trades properly accounted for and documented. However, this still does not address counterparty risk without meaningful amounts of collateral being posted nor does it give participants in the market a clear view on pricing, which only causes abuses and distortions. The CDS market needs to be radically shrunk and, as long as participants can take billion dollar bets without posting meaningful cash collateral, it will continue to cause enormous risk for the entire global financial system.

- *Altering immigration laws in order to attract the world's best, brightest, and wealthy.* The U.S. should provide permanent visa status and/or a fast track to citizenship to those foreigners (once they have been fully vetted from an extensive background check) that make a direct investment of at least \$1.5 million into a U.S.-based business and create a certain number of jobs, or, those that buy and hold two homes totaling \$1.5 million in value. Canada had a similar program leading up to the 1997 "handover" of Hong Kong from the United Kingdom to China—which resulted in an economic boom for western Canada as Hong Kong citizens capitalized on the offered incentives. Such an initiative in the U.S would help to address the massive inventory overhang in residential real estate and help to stimulate the economy. This country has always benefited from hard-working immigrants with an entrepreneurial spirit and it is time that we, again, make the U.S. the preeminent destination for the brightest, most ambitious, and most driven business leaders and entrepreneurs in the world.
- *Policymakers need to ensure that they do no further harm by their actions.* Many initiatives that have already been taken and proposals that are on the table will only make matters worse. To illustrate a few, the government should stop sending out stimulus checks. These checks provide no long-lasting benefits—as the money often gets spent unwisely and tends to only benefit Chinese and Japanese exporters—while continuing to put strains on the U.S. federal budget. Even more troubling proposals are ideas such as allowing local bankruptcy judges to "cram-down" mortgages (i.e., allowing the changing of terms

and reducing the principal balance of a mortgage). If this idea passes through Congress, mortgage rates in very short order would increase by 300 to 400 basis points, which would only further destroy the housing market. There is a reason why mortgage rates have always been substantially lower than other forms of debt, and that is due to the inability of bankruptcy judges to alter the terms of a mortgage contract. The argument made by some legislators is that they would only allow cram-downs for mortgages which have already been originated during a particular time frame of the housing bubble. However, do these legislators really believe that lenders would ever trust Congress again? We doubt not. Finally, an idea which appears to be picking up momentum is to stop foreclosures all together. The repercussions of this action will be profound. For example, those borrowers who are struggling financially, yet have remained diligent in paying their mortgage on time, will watch as their neighbors not only remain in their homes—despite the fact that they have stopped making payments—but also have their mortgage balance reduced. This potential nationwide scenario will only propel further defaults. For anyone who would question whether this would occur, all you have to do is look at the web sites which help borrowers default on their mortgage and receive a reduction in their mortgage rate or principal balance, whether they have the financial resources or not. This would also establish a horrible long-lasting precedent in which no one is accountable for their imprudent decisions. **The next President and Congress have to accept that there will be enormous pain as the economy deals with the correction of the credit and housing bubbles and if they make imprudent decisions for political expediency, it will only result in a far greater economic disaster.**

- *Finally, the federal government must learn that "bigger is not better" with regard to financial institutions.* Instead of allowing ever-increasingly larger financial institutions to be created, the regulatory agencies and the anti-trust department must work diligently in order to significantly lessen the risks associated with the large investment banks and money centers. These companies must be shrunken and, by no means, should the national 10% depository cap be lifted to allow the financial giants to become even larger and pose even more systemic risk to the economy. Further, the giant financial companies should be held to higher instead of lower standards, which allowed these firms to take unwarranted and unchecked risks. For example, **why were the biggest financial institutions allowed to leverage themselves at ratios two and three times that of community banks? Further, these companies**

should not be allowed to continue paying common stock dividends until they have capital ratios that at least meet the standards to be deemed well-capitalized and have positive earnings. Had the federal government limited the risk that the large investment banks and money centers could take and held them to the same standards as the rest of the banking industry, much of this financial crisis could have been averted.

Just as in the Great Depression—which was caused by collapsing asset values and a decelerating economy—policymakers, at that time, in their attempt to be constructive, took actions which only compounded the economic problems the country was already facing. **Policymakers in the next Administration and Congress must not succumb, again, to the influence of those large financial institutions which put this country in this precarious position in the first place—and, to the next Administration, we plead**

that no more former executives from Goldman Sachs be appointed Treasury Secretary. Therefore, it is vital that the interests of the U.S. taxpayers be put ahead of those large financial institutions—something which has rarely occurred during the last two decades. As for the remaining \$450 billion earmarked for the TARP (the original \$700 billion less the recently announced \$250 billion CPP)—a program designed as welfare for the Wall Street rich—it could instead serve as a solid stepping stone for funding public projects in order to improve our infrastructure, energy reliance, and collapsing labor markets. These initiatives could have untold positive implications across our economy, geopolitical dynamics, and environment... thus benefiting millions of people instead of the select and privileged few. If ever there was a time to draw upon the ingenuity, creativity, and hard work which have made America so great and to reestablish this country as the leader of the free market economy, now is that time.



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