Quarterly Report

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US Government Bailout:

ABC's of TARP – Troubled Asset Relief Program

The US Government's Bailout of the Banking System, unprecedented in size and scope, has a total price tag of over $3 trillion according to the Special Inspector General's report. Public outrage, confusion and fear needs to be tempered with a sensible historical and financial perspective if sound financial decisions are going to be made by individual, families, businesses and governments. This Newsletter will address:

Why did the Government bail out the banks?

Where did our money go?

Will we get our taxpayer dollars back?

Why are banks showing profits when they are still getting money from the government?

In September, 2008 The Federal Reserve embarked on the biggest Bailout Program in history to prevent widespread collapse of the financial system, the ensuing panic, and fallout that was expected to exceed the devastation of the Great Depression of the 1930's.

The types of programs that have been implemented in this bailout, though larger in scale, have been used before. Government bailouts of the past have generally been successful and most resulted in profits for the Government.

There are many indications, including the budding resurgence of bank profitability, that the Great Bailout of 2008 will be generally successful.

Fed Chairmen – Past and Present

Why did the Government bail out the banks?

A brief snapshot of history can help us understand why the Federal Reserve decided to bail out the banks.

The Federal Reserve Bank was created in 1913 to improve the management of banking panics that were happening routinely at the time. After years of academic debate Monetary theory of today blames the Great Depression on policy blunders of the Federal Reserve.

In a 2002 speech celebrating the 90th birthday of Milton Friedman, Ben Bernanke discussed at length the work of Milton Friedman and Anna Schwartz and summarized their work on the impact of the Federal Reserve's monetary policies on the economy. He first cited the raising of interest rates in 1928 as the cause of the stock market crash of 1929.

Charles S. Hamlin
First Federal Reserve Chairman, 1914

In the midst of the Depression, the Fed refused to intervene to help struggling banks. The resulting banking crisis of 1933 in which over 9,000 banks failed and many citizens lost their life savings, worsened the deepening depression and caused widespread economic hardship.

The Congressional response was to implement a series of financial regulations with the objective of protecting the investing public. These laws included the Securities and Investment Advisors Acts, and the creation of the NASD and the FDIC. Another important regulation was the Glass-Steagall Act (1933) which prohibited commercial banks from acting as investment bankers.

Over the years banks and other financial institutions grew in size and political strength. Long-time Fed Chairman Alan Greenspan championed the deregulatory policies of the Fed from 1987 to 2006 He believed that financial markets functioned best when free of regulatory constraints. His tenure at the

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Special

Inspector

General for the

Troubled

Asset

Relief

Program

SIGTARP was created by Congress when they passed the TARP legislation in September of 2008. The SIGTARP acts as a watchdog agency, reporting on the financial transactions of the US Treasury, the Federal Reserve and the FDIC and making that information available to Congress and the public.

Other watchdog agencies reporting on TARP transactions include the Congressional Oversight Panel (COP) and the Congressional Budget Office (CBO). All of these reports are available to the public. Email us if you would like a copy of these reports.

Fed Chairmen – Past and Present

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Fed included the repeal of the Glass-Steagall Act in 1999. This paved the way for Citibank to merge with Travelers and later Smith Barney creating the first of many integrated financial institutions that are "too big to fail."

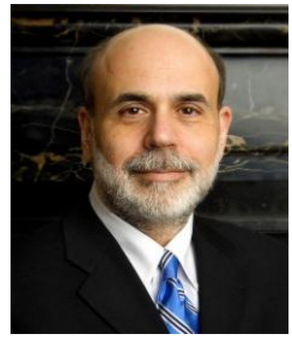
Alan Greenspan also favored the Commodities Futures Modernization Act that was passed in 2000. This is the law that de-regulated the derivatives market and allowed banks to hold highly leveraged derivative positions outside of the customary capital ratios. Even Alan Greenspan, in recent Congressional testimony, admits that these policies set the stage for the collapse of the financial markets in 2008.

Right or wrong, Mr. Bernanke believes that the Fed failed by

Alan Greenspan
Federal Reserve Chairman
1987 – 2006

'I was….partially…wrong'

not taking action "last time" and therefore committed to swift, broad and bold action to support the banking system when the financial crisis hit last year. It was not surprising, then, to see the Fed and the US Treasury advocating for a large scale bailout for the banks. Naturally, as the pendulum swings back in the direction of tighter regulation, we will see Congress enacting a new set of laws designed to protect the investing public.



Ben Bernanke
Federal Reserve Chairman
2006 – Present

'You're right! The Fed caused the Great Depression. We're very sorry. But … we won't do it again.'

CPP – Capital Purchase Program

To prevent widespread financial collapse, the US Government purchased an equity stake in a total of 532 banks across the country for a total of **$198b**. [1] The banks received an infusion of money and the Government received an investment that took the form of ***Preferred Shares*** with a contractual dividend rate of 5% for five years and 9% thereafter. Because the shares carry a fixed rate of dividend, they functions like a loan to the institution. It is the intention of the program for the loan to be repaid (to be "redeemed") as soon as the institution is able. The dividends of 5% are cumulative and must be paid to the Government before the institution can pay dividends to any common stockholders.

Attached to the Preferred Shares are ***Warrants*** which carry an option to purchase a set amount of common stock. Because the Warrants represent an option on the common stock, they have value even when the price of the stock is lower than the option price on the warrant. While subject to some controversy, the market value of the Warrants themselves has been estimated by private analysts at **$8.5 b.** [2]

Although a few institutions received the lion's share of the CPP Investment funds, the program involved large and small banks, healthy as well as unhealthy banks. This was an important policy for two reasons: First, to avoid labeling a TARP participant bank as an unhealthy bank, thereby minimizing public concern that could cause a run on the bank. Second, the equity infusion of CPP to healthy banks was more likely to result in business and consumer lending than the equity infusion to unhealthy banks. Preventing financial collapse and unfreezing the credit markets is the core policy objective of the CPP.

Likely the safest of the whole program, it is entirely possible that the US Government will not lose any money on this program. 32 banks have so far repaid these preferred share "loans" in full, for a total of over **$70b**. [1] Of the largest TARP recipient banks, JP Morgan, Goldman Sachs and Morgan Stanley have repaid their preferred share loans.

Of the banks repaying the preferred share loans, 14

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CPP – Capital Purchase Program

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banks have also repurchased the attached warrants from the Government for over **$20m**. [1] The larger banks have not yet repaid the warrants and one has made plans to sell them in the marketplace instead. Either way, the Government will get its money for the warrants.

Rates of return on the completed transactions, have been calculated by the Congressional Oversight Panel. Despite some controversy over the price the Government paid initially and the repurchase prices, the Government **earned between 8% and 20.3% return** [3] on its investment. These sold warrants represent a small slice of the outstanding warrants and may not be representative of the end result the Treasury experiences. Nonetheless, initial results are good.

Watchdog agencies are monitoring the subsidy costs of the program. Subsidy costs are an estimate of whether the Government paid too much for securities purchased or received too little for securities redeemed. The Congressional Budget Office estimates the subsidy to the banks at **$24b**. [4]

These watchdog agencies are also monitoring whether or not the CPP program achieves the policy objectives of a) preventing bank failures and b) unfreezing the credit crunch and encouraging bank lending. This involves an extensive analysis of the lending practices of all participating banks. This analysis is so far inconclusive.

The impact of this program on the Budget Deficit and on future inflation is a concern. However, if all of the preferred shares are repaid, there is no actual Government expenditure. If the Government makes money in the process, that has a positive impact on both the Budget and future inflation. In general, if the Government is earning 5% on securities it owns while paying less that 1% on its own borrowing, the net impact on the budget deficit is a positive one.

It is reasonable to expect that all, or at least the vast majority of, banks will repay preferred share loans and repurchase the warrants. The US Government is unlikely to lose money on the CPP portion of the TARP Bailout and will most likely earn an acceptable rate of return.

AGP – Asset Guarantee Program

Another type of bailout program is the Asset Guarantee Program (AGP). [1] This program does not involve the government taking an equity stake in a company in return for injecting cash to improve liquidity. It is a program whereby the Government basically backstops or "guarantees" a specifically-identified pool of assets, which continue to be held at the participating bank.

The biggest participant in the AGP is Citibank. The US Treasury, as part of the total $700b authorized TARP Funding, has pledged $5b to "guarantee" a pool of specifically-identified assets owned by Citibank. The asset pool which has been identified and "ring-fenced" has an agreed upon value of $301b. These are the "toxic assets" that have been at the heart of the financial crisis.

This program is a good example of how the scope of the Bailout Programs expands wildly without Congressional approval. While the US Treasury has pledged $5b against these assets, the FDIC has pledged an additional $10b and the Federal Reserve has pledged $220.4b. [1]

According to the terms of this program, Citibank is to absorb the first $39.6b in losses. After that, Citibank will then absorb a maximum 10% of losses while the remaining 90% is absorbed by the US Government: $5b from TARP, then $10b from the FDIC, and the remaining funds coming from the Federal Reserve in the form of a non-recourse loan.

Non-recourse loan is a secured loan whereby the borrower (in this case Citibank) is relieved of the obligation to repay the loan upon surrender of the collateral. That means, should the "ring-fenced" assets become worthless, the US Government will forgive the loan in exchange for the worthless assets.

There is a big difference between this type of program and the CPP Program described above. The potential gain to the US Government under this AGP Program is $7b in (additional) preferred shares plus warrants. The potential loss to the US Government is $235.35b! Furthermore, should the economy recover and the assets do not fail but appreciate in value, there is ***no mechanism*** for the US Government to participate in any profit.

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KEEPING SCORE

Total Public and Private Scope of the Bailout Program: [1]

$3 trillion

Total US Treasury Funds Authorized by Congress:

$700 billion

Total of that amount spent so far:

$328.6 billion

Total of the amount spent that went to the 8 largest recipients of Bailout Funds:

$292 billion

Largest recipients of TARP Funds:

AIG	$70b
Citibank	$50b
Bank of America	$52.5b
Wells Fargo	$25b
JP Morgan*	$25b
Morgan Stanley*	$25b
Goldman Sachs*	$25b
General Motors	$19.3b

Amount of TARP Funds that have been Paid Back:

$70 billion

Dividends received by US Treasury on CPP Preferred Shares (as of June 9):

$6 billion

Money received by the US Treasury for sale of Warrants under the CPP:

$20,285,000

Value of remaining Warrants held by US Treasury according to independent analysts: [2]

$8b

Number of TARP Recipient Banks that have failed:

Zero

* has been repaid

"It is one thing to invest in a bank using public money, with the public sharing in the subsequent health and profitability of the bank, as in the Capital Purchase Program. "

"It is quite something else to ask the public to bear the risks of the bank's "toxic assets" without any hope of sharing in the wealth of a positive outcome as in the Asset Guarantee Program."

"Before banks can be allowed to resume normal profitability, they will have to be removed from the taxpayer's life support system."

---Ann Terranova, CFP™

FOOTNOTES

[1] SIGTARP Report to Congress July 21, 2009

[2] Pluris Valuation Advisors

[3] Congressional Oversight Report July 10, 2009

[4] CBO Report TARP Transactions Through June 17, 2009

[5] WSJ Aug 9, 2009 "AIG Breakup Is Fee Bonanza"

AGP – Asset Guarantee Program

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This program represents the epitome of public risk and private profit.

Participation by B of A in the Asset Guarantee Program (AGP) is currently on hold. In May, B of A announced that it was no longer seeking this assistance.

The PPIP (Public Private Investment Program), another mechanism for supporting "toxic" assets, works similar to the Asset Guarantee Program except that the PPIP creates a marketplace for the sale and purchase of "toxic assets." As part of TARP, the US Government has pledged a maximum of $75b to the toxic asset marketplace. However, through a combination of debt and equity matching, the US Government's role in this program could be as much as $1trillion.

The impact of the Asset Guarantee Program and the PPIP marketplace program on the financial health of this country is unclear. It's success or failure will be judged by historians and economists one day.

What is important right now is that the public engage in a vigorous debate and conversation with elected officials to explore whose interests – public or private – are going to be served.

Recent Bank Profitability

It is extremely confusing for many people to read in the newspapers about recent bank profitability in light of the massive continuing bailout efforts aimed at 'supporting the banks.' Despite the Government's efforts to avoid the stigma of any banks being "bad banks" the wheat is slowly getting separated from the chaff.

There are several commercial and investment banks that have gone through crisis, participated in TARP, repaid TARP preferred share loans, raised private capital and emerged to announce better than expected profitability. These include JP Morgan, Morgan Stanley and Goldman Sachs. Although these firms have yet to settle the matter of the ***warrants***, their increased health and profitability only makes the Government's holdings in these companies more valuable.

Other banks have reported a profitable quarter on the basis of one-time transactions. Bank of America and Citigroup both posted second quarter profits that were reliant on one-time gains.

For Bank of America those gains included sale of shares in China Construction Bank Corp. Losses on the books at Merrill Lynch remain as well as controversy over bonuses and shareholder rights.

Ironically, Morgan Stanley, Goldman Sachs, Bank of America and JP Morgan ***earned over $1b combined from fees related to the dismantling of big bailout recipient AIG.*** [5]

Citigroup, which is currently 34% owned by the US Government, would have logged a $2.4b net loss were it not for a $6.7b windfall from spinning off its Smith Barney Brokerage unit into a joint venture with Morgan Stanley. The Citigroup of a year ago has basically ceased to exist.

Citibank, Bank of America and Wells Fargo Bank are still on life support.

Bank profitability is still good news for everyone. It signals a move off the edge of disaster. What will be most important will be that the Government stops "guaranteeing" toxic assets before sustainable profits remain in private hands. Dividends on preferred shares still have to be paid before the company can pay stockholder dividends. TARP funds will still need to be repaid by Citigroup and Bank of America before they could resume any kind of normal profitable operations.

It will be most important for the Government exit from all types of Asset Guarantee programs before cutting the regulatory apron strings and letting the banks return to normal profitability.