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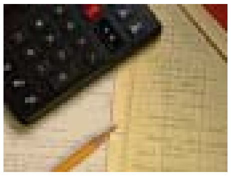

Economics & Financial Markets

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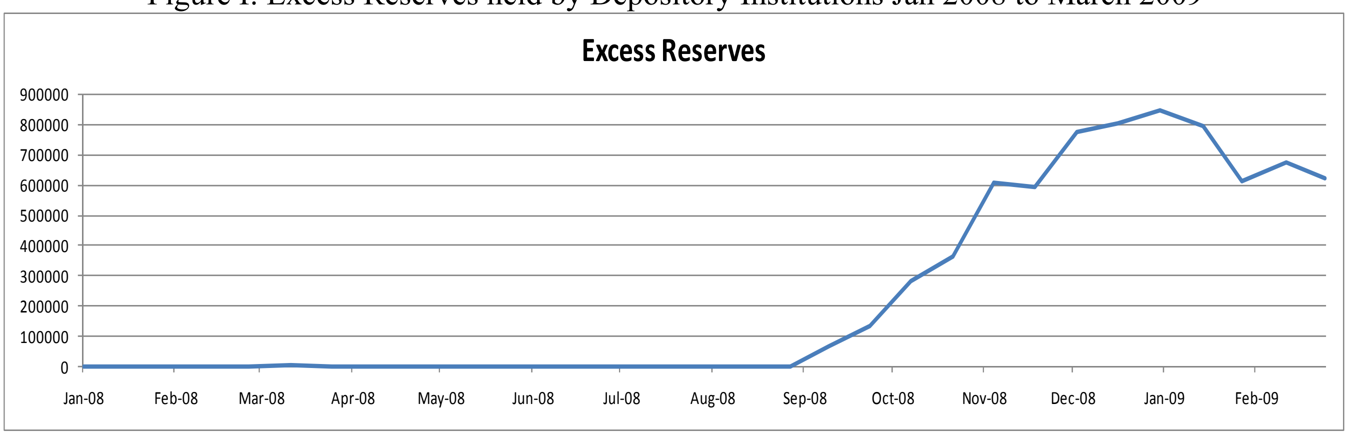
Why Banks are Not Lending TARP Money: and the Necessity of TALF in Creating a Market for the "Toxic Assets."

Figure I: Excess Reserves held by Depository Institutions Jan 2008 to March 2009



Source: Federal Reserve, SISR

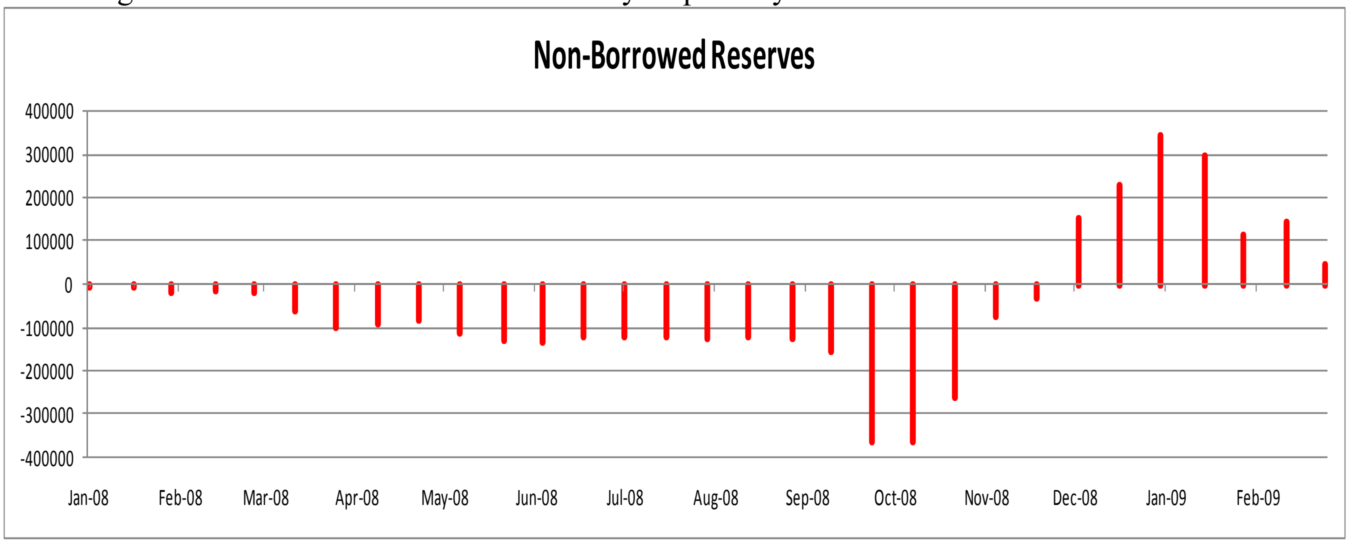
I. Introduction

One of the key concerns regarding the banks over this post crisis period has been that bank are not lending. Figure 1 is posted in all newspapers around the world with the clear indication that lending is not occurring. However, on closer inspection the data does not fully support this contention, and in fact the banks may have actually been acting extremely responsibly, during this crisis. The banks are lending but they are not lending borrowed assets, they are only lending actual assets that they have on their books, which are not borrowed. This is their historical pattern with the current situation simply indicating that they are lending in a slightly more cautious manner than under more normal times, which also is to be expected, since these are not normal time.

II. Responsible or Rational Lending by the Banks

Figure II shows the level of non-borrowed reserves held by depository institutions (those institutions that can hold deposits in contrast to a mortgage bank which cannot accept deposits). What we find is that non-borrowed reserves or actual real reserves i.e. those reserves that are not borrowed, have recently declined to being just slightly positive, only slightly above the early 2008 condition, when banks would run their reserve slightly negative.

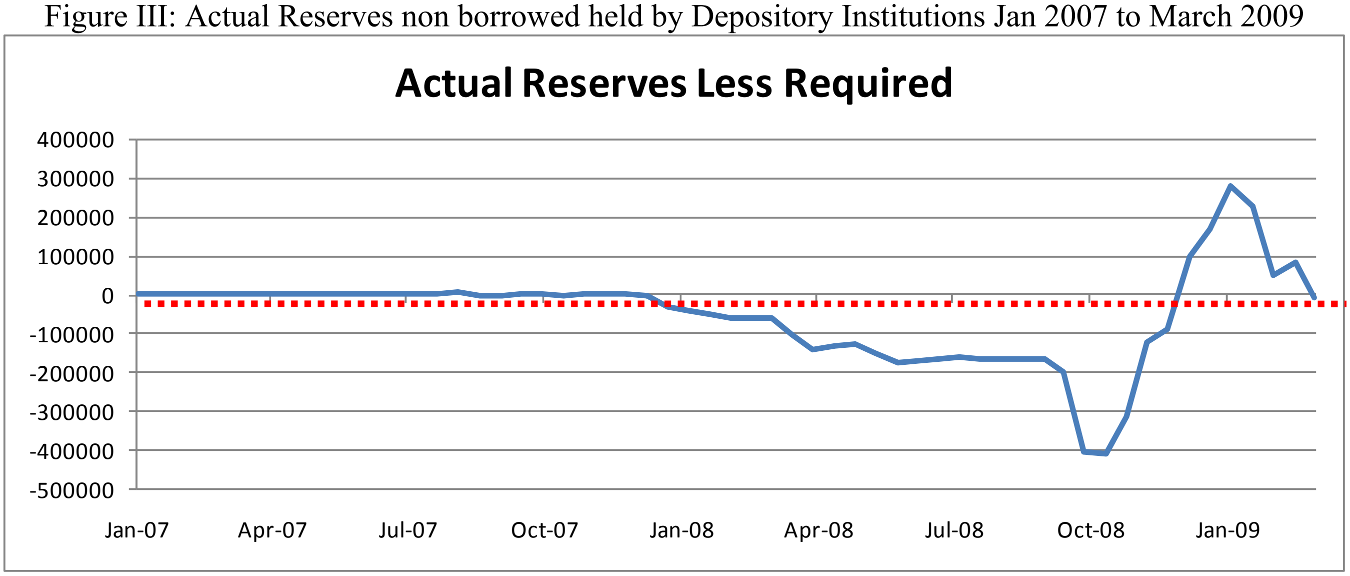
Figure II: Non Borrowed Reserves held by Depository Institutions Jan 2008 to March 2009



Source: Federal Reserve, SISR

This Figure II contrasts with the common chart presented by many including us, showing that banks are hoarding reserves, as shown in Figure I above, and have only recently begun to reduce those excess reserves over what is required by the Federal Reserve.

Figure III: Actual Reserves non borrowed held by Depository Institutions Jan 2007 to March 2009



Source: Federal Reserve, SISR

What we are finding is that the banks are lending, but they are not lending the excess reserves that were supplied to the banking system by the Treasury and Federal Reserve during the crisis. They kept those reserves and have been acting responsibly lending only their actual reserves and not the borrowed reserves as seen in Figure III.

The Figure indicates that lending is occurring in a responsible manner with actual reserves being a small positive as it historically had been prior to the crisis, positive but just above the zero line (the red line). Unfortunately, because of all the loses these banks have recently incurred, the possess fewer actual reserves than they may have had just 15 month ago when all the loses started to pile up. Nevertheless they are lending what they can, but not the new reserves that were supplied by the Federal Reserve and the Treasury, in the hopes of keeping those reserve so that one day they can pay them back. This is perfectly rational behavior, because if the borrowed money is lent out they may not have the cash or the ability to call in those loans and not be able to pay back the loans even if they do not need them. This is perfectly rational behavior again.

Of course there are banks that are in more trouble than other, and they have received capital from the Federal Reserve, but system wide we are finding rational behavior, with the banks' lending their money and not the borrowed money. The banks have been lending responsibly with actual assets and not with borrowed assets that the Federal Reserve encouraged the banks to take during the financial crisis. As these excess reserves go back to the Federal Reserve the excess reserves will look much like they did prior to the financial crisis. The reason why there is less lending currently, is because of the losses that these banks have incurred has reduced their actual reserves which are now lower, and the banks have not increased lending on the borrowed reserves, perhaps for the first time in a while they have acted completely responsibly, and taken this new money acted irresponsibly with it delaying any chance of paying the money back.

This is one of the reasons for the failure of the TARP program. The rational behavior of the bank is not to lend that money and to keep it in tact so that they can someday pay it back. The responsible bank acting rationally will not lend excessively on those excess reserves provided to the banking system. The banks need to repair their balance sheets with their capital not borrowed capital.

III. The Problem with TARP

The problem and one of the reasons that the banking system has had such huge losses is that many of their old loans are not performing and the banks needed to take write downs on those loans, placing some banks in virtual bankruptcy if not for the TARP assistance. When TARP increased the reserves of Banks the banks sensing trouble and started to act responsibly lending only on their actual assets and not on their borrowed assets that came from the Federal Reserve or the Treasury.

A. TARP

The Tarp Program initially was intended to remove the toxic assets from bank balance sheets. That approach particularly in a lame duck administration appeared difficult to orchestrate. The net effect was an attempt to capitalize the banks with additional assets. TALF 1 used this approach exclusively and even provided liquidity to banks that claimed they did not need the additional capital.

The logic for the change is somewhat simple, if a bank or other Major Corporation, prior to the crisis, experienced trouble they would either sell assets bringing in additional capital, or do a secondary or private placement in order to raise capitals. The U.S. Government only stepped in when the banks were in sufficient trouble that no serious investors were willing to take the risk of adding capital to the troubled banks. The program was much less complicated and given the urgency of the problem it certainly bought the system sufficient time to work the other issues out.

The process was simple, clean and performed with a high degree of efficiency. Companies like American International Group (AIG), Citi Group (C), and Bank of America (BAC) even came back for more needed capital. The system appears to be working in that no major financial institution currently appears to be on the brink of failure and the announcement from Citi that they are likely to be profitable is further evidence of the success of the TARP program. .

B. Why banks are not Lending the TARP Money

What is happening is very similar to a family that has a garage next to their house but not attached that burns down. The garage burned because of lighting and the responsible home owner's insurance claim was denied because lighting is an act of God. The city then comes to the home owner and says you need a garage for community safety because we do not want cars in driveways or on the street at night.

So the city says that they will lend you money to rebuild your garage. You say no I do not want the money because I cannot afford to pay the interest that you are asking. The city says you must take the loan, and you must have your car in the garage by midnight everyday if you take the money. The homeowner says I do not want the money, and often times to keep my family happy I provide them a bonus and we go out to a late movie.

The city gives the homeowner the money and insists that it be taken and tells the family that the family bonus can no longer be given, and they need to be home by midnight because the city wants responsible citizens home and asleep by midnight. The homeowner takes the money but does not build the new garage, and is holding the money until the city says it will accept the money back and the family can have their monthly bonus of going to a late movie.

This is why TARP has not increase lending, because the banks do not feel that the borrowed money belongs to them. Of course TARP was set up because without it banks would have failed, but system wide the banks are now acting responsibly and lending only their actual capital and not the borrowed capital. This is what the charts above indicate and that for a change the banks are acting fully rational and acting extremely responsibly.

IV. The Solution – TALF I, II and the Public-Private Investment Fund

On CNBC last week one of the commentators asked what is going to happen to the '**toxic assets on the bank balance sheets.**" The respondent said the administration had not decided yet! The implication was clear the Treasury and Federal Reserve were still muddling through this process. We believe that the response was not fully accurate in that the TALF and the Public Private Investment Fund is likely to be the vehicle for this transaction.

<u>TALF I</u> we believe is the program that ultimately will deal with the 'toxic assets" after a market value is created for those assets. The TALF program was originally set up on November 25, 2008 within the Federal Reserve with 200 B in assets with the mandate to: "lend up to $200 billion on a non-recourse basis to holders of certain AAA-rated backed by newly and recently originated consumer and small business loans. The FRBNY will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS."

<u>TALF II</u> was expanded on February 10 to 1 Trillion dollars, and "could broaden the eligible collateral to encompass other types of newly issued AAA-rated asset backed securities, such as commercial mortgage backed securities, private-label residential mortgage-backed securities, and other asset backed securities…The Board's objective in expanding the TALF would be to provide additional assistance to financial markets and institutions in meeting the credit needs of households and businesses and thus to support overall economic growth in the current period of severe financial strains."
The TALF programs we believe are the first steps in creating a market and creating a basis of value for these troubled assets, while enabling the banks to use some of those assets as capital for lending purposes.

<u>The Public-Private Investment Fund:</u> will be the vehicle for moving these toxic assets off the balance sheets of banks and with private funds in conjunction with government capital backing once a market can be made and a value placed on them. The TALF will help create a market value and the Public Private Investment Fund will purchase these troubled assets that are currently frozen and have a limited market i.e. level 3 assets on the balance sheets of banks.

V. <u>Conclusion</u>

Assuming all this is correct the TALF program will take the 'toxic assets" on the banks balance sheets and slowly begin to find a market for those assets. Once those assets are viable and tradable the bank will recognize them as their own assets and not "funny money from the Fed" and will lend that money. That is the way we SISR expect this process will play itself out, and the country will emerge from this box.

The fact that this is not fully perceived with extreme clarity perhaps takes us back to the noise in Washington where many are focused on "earmarks" or whatever, and missing the big picture. Sometimes it is better this way to just let the party go on in two arenas: the functioning one and the nonfunctioning arena, and hopefully the functioning arena will get the job done. In fact, the system may well be set up this way for one agency (the Federal Reserve) to have the ability to work efficiently and independently, and the other (Congress) to represent diverse group interests: is that not the definition of a pluralist government that the Congress strives to be.

Once the banks feel that the assets from TALF fully belong to them they will begin to lend in their normal pattern of business. All the indications are that they are currently lending at near normal rates of lending with an expected degree of caution. This is what the data indicates, rationality and caution, but in no way hoarding or irrational behavior.

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