

THE BANK INVESTOR – NOVEMBER 2008
A Monthly Update for Financial Institutions***Treasury's Capital Purchase Program: Implications for Depository Balance Sheets***

The severity of the credit crisis has prompted unprecedented global government intervention over the past several months. A cornerstone of the U.S. Government's response to the crisis is the Troubled Asset Relief Program (TARP). At inception the plan was to, as the name implies, purchase "troubled assets" from financial institutions. However, in the ensuing weeks from the legislation's passage, the Treasury introduced a component of the TARP called the Capital Purchase Program (CPP). With this program, which constitutes \$250 billion of the \$700 billion TARP, the Treasury will make preferred stock investments in financial institutions in an effort to strengthen balance sheets. By doing so, it is hoped that there will be improved credit availability to U.S. consumers and businesses. The program may also be used to facilitate the acquisition of troubled financial institutions.

When the Treasury announced the program on October 14th, it revealed that half of CPP was to be allocated to nine institutions, including Bank of America, Citigroup, JP Morgan Chase, and Wells Fargo. Since that time, other institutions have announced their involvement in the program. The deadline for institutions to apply for participation is November 14th. The following is a brief overview of the program's terms. Additional detail is available at the websites of the Treasury Department, www.treas.gov, and the federal bank and thrift regulatory agencies.

CPP Overview:

- Senior perpetual preferred stock will be purchased that ranks senior to common stock and pari passu with existing preferred shares (other than preferred shares which by their terms rank junior to any existing preferred shares).
- Minimum subscription amount is 1% of risk-weighted assets and the maximum amount is the lesser of \$25 billion or 3% of risk-weighted assets.
- The dividend rate would be 5% annually for the first five years and then step to 9%. Dividends are cumulative if issued at the holding company level. Dividends are non-cumulative if the preferred stock is issued by banks which are not subsidiaries of holding companies.
- The shares will be callable at par after three years, but may be redeemed prior to that period with proceeds from a qualifying equity offering of tier 1 perpetual preferred stock or common stock.
- Participating institutions must agree to conditions on the following: dividend payments during the period of the government's investment, share repurchases, and executive compensation.
- Treasury will receive warrants in conjunction with the preferred investment with an aggregate market value equal to 15% of the amount of the senior preferred investment.
- The Federal Reserve Board adopted an interim final rule that permits the Treasury's senior perpetual preferred stock purchase to be included, without limit, in a bank holding company's tier 1 capital. Non-cumulative perpetual preferreds issued at the bank level qualify as tier 1 capital as well.

Interim Assistant Secretary for Financial Stability Neel Kashkari noted in his Congressional testimony on October 23rd that qualified and interested publicly-held financial institutions should submit their applications to their primary regulators. He also indicated that Treasury is working to finalize and publish legal documents so private banks can participate on the same economic terms as public banks.

Refer to page 4 of this report for Stifel Nicolaus Fixed Income Capital Markets disclosures and analyst certifications.

In recent years, community institutions (\$10 billion or less in assets) typically raised capital through issuing trust preferred securities. The dislocation in the credit markets has caused that funding source to largely dissipate. With the initial 5% dividend rate, the CPP appears to provide institutions an opportunity to raise tier 1 capital at a reasonable cost. Unlike trust preferreds, whose dividend payments can be tax deductible, the dividend payments on the CPP will not be tax deductible. Assuming a 40% tax rate, the tax-equivalent cost of the funding would be 8.33%, which compares favorably to where recent trust preferred issues have priced.

As we noted earlier, some institutions may use the program to facilitate M&A activity. PNC Financial Services Group, Inc. announced a \$7.7 billion participation in the program and at the same time announced the purchase of National City Corporation. However, those institutions not employing the capital for M&A activity may find that that the investment needs to be levered significantly in order to generate a reasonable return on the preferred stock. At the end of the second quarter of 2008, the average Tier 1 Leverage Capital ratio for all FDIC insured community institutions was roughly 9.9%.¹ While it may not be necessary to lever at the current industry average of roughly 10:1, institutions will likely need to grow the balance sheet significantly to achieve a healthy ROE and level of income sufficient to cover the dividend payment requirement for the preferreds.

In Figure 1, we compare the earnings profile for a participating institution applying no leverage as well as leverage factors of 5:1 and 10:1. Although the funding will likely be deployed in a mix of loans and securities, for the purposes of this example we assume that only securities are purchased and 3-year bullet repo funding is utilized to supplement the capital injection. Originating or purchasing loans and utilizing core deposits would widen the spread achieved, but would also necessitate provisions for loan losses and considerably more overhead expenses. In the example, the securities yield equals 5.98%, which is the current level for 30-year 6% FNMA TBA pass-throughs.² With the cost of 3-year bullet repo funding currently at 3.78%,³ the net spread equals 2.2%. The analysis calculates the incremental ROE generated from the preferred stock investment, without consideration of other sources of income or expenses.

Figure 1 - Profitability Comparison of Different Leverage Levels

Income Statement - No Leverage		
Interest Income	\$100 of securities @ 5.98% Yield	5.98
Interest Expense		0.00
Net Interest Income		5.98
Taxes	@ 40%	(2.39)
Net Income		3.59
Return on Preferred Equity		3.59%
Cost of Preferred Equity		5.00%
Preferred Dividend	\$100 of preferred stock @ 5%	5.00
Contribution to Retained Earnings		(1.41)
Income Statement - 5:1 Leverage		
Interest Income	\$500 of securities @ 5.98% Yield	29.90
Interest Expense	\$400 of repo funding @ 3.78%	(15.12)
Net Interest Income		14.78
Taxes	@ 40%	(5.91)
Net Income		8.87
Return on Preferred Equity		8.87%
Cost of Preferred Equity		5.00%
Preferred Dividend	\$100 of preferred stock @ 5%	5.00
Contribution to Retained Earnings		3.87
Income Statement - 10:1 Leverage		
Interest Income	\$1000 of securities @ 5.98% Yield	59.80
Interest Expense	\$900 of repo funding @ 3.78%	(34.02)
Net Interest Income		25.78
Taxes	@ 40%	(10.31)
Net Income		15.47
Return on Preferred Equity		15.47%
Cost of Preferred Equity		5.00%
Preferred Dividend	\$100 of preferred stock @ 5%	5.00
Contribution to Retained Earnings		10.47

Sources: Bloomberg Finance L.P. and Stifel Nicolaus Fixed Income Trading as of 10/28/08

¹ Capital data provided by FDIC Statistics on Depository Institutions.

² Source: Bloomberg Finance L.P. as of 10/28/08.

³ Source: Stifel Nicolaus Fixed Income Trading as of 10/28/08.

Refer to Page 4 of this report for Stifel Nicolaus Fixed Income Capital Markets disclosures and analyst certifications.

As shown in the example, applying no leverage generates a level of net income that is insufficient to cover the required dividend payment and produces a meager 3.6% ROE. When a 5:1 leverage factor is applied, the dividend payment as a percentage of net income is 56% and the ROE is 8.9%. On average over the past few years, the dividend payout ratio has been in the high 30% area and the ROE has been 9% to 11% for all FDIC insured banks.⁴ Increasing the leverage factor to 10:1 produces the highest level of net income, the dividend payout ratio declines to a more reasonable level of around 32%, and the ROE becomes a robust 15.5%.

Institutions planning on participating in the program should expect to have the funds available for deployment in the near term. As noted earlier, the application deadline is November 14th, and Assistant Secretary Kashkari stated in his aforementioned testimony that "Treasury intends to fund the senior preferred shares purchased under the program by the end of this year."⁵ With the example demonstrating the need to leverage the investment, institutions planning on participating should be developing strategies that include sourcing wholesale and retail funding. It will likely take a period of time to identify lending opportunities of a sufficient scale to achieve profit goals on the CPP. In the interim, it may be necessary to deploy a higher level of the funding in securities than is ultimately desired. It will be important to structure the investments in a manner that not only provides a reasonable return today, but also provides the cash flow and liquidity necessary to achieve the desired lending/investment mix as lending opportunities occur over time. Please contact your Stifel Fixed Income Sales representative to request assistance in developing custom analysis and strategies for participating in the CPP.

Craig Thornton, CFA
Vice President, Senior Analyst
443-224-1224

⁴ Source: FFIEC UBPR Peer Group Data Report for all banks in the nation as of 6/30/08.

⁵ Interim Assistant Secretary for Financial Stability Neel Kashkari Testimony before the Senate Committee on Banking, Housing, and Urban Affairs on October 23, 2008.

Refer to Page 4 of this report for Stifel Nicolaus Fixed Income Capital Markets disclosures and analyst certifications.

Additional information is available upon request.

Stifel, Nicolaus & Company, Incorporated makes a market in the aforementioned securities as at the date of issuance of this research report noted at the top of page 1 of this report.

Stifel, Nicolaus & Company, Incorporated has managed or co-managed a public debt offering for FannieMae, FreddieMac, the FHLB and/or the FFCB within the past 12 months.

Stifel, Nicolaus & Company, Incorporated has received compensation in the past twelve months, or expects to receive compensation in the next three months, for investment banking services from one or more of the borrowers mentioned in this report.

The Fixed Income Capital Markets trading area of Stifel, Nicolaus & Company Incorporated owns debt securities of the borrower or borrowers mentioned in this report.

For distribution to institutional clients only

The information contained herein has been prepared from sources believed reliable but is not guaranteed by Stifel Nicolaus & Company, Incorporated and is not a complete summary or statement of all available data, nor is it to be construed as an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of investors. Employees of Stifel Nicolaus or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed within. No investments or services mentioned are available to "private customers" in the European Economic Area or to anyone in Canada other than a "Designated Institution". Stifel Nicolaus and/or its employees involved in the preparation or the issuance of this communication may have positions in the securities or options of the issuer/s discussed or recommended herein. Securities identified herein are subject to availability and changes in price.

Readers of this report should assume that Stifel Nicolaus or one of its affiliates is seeking or will seek investment banking and/or other business relationships with the issuer or issuers, or borrower or borrowers, mentioned in this report. Stifel Nicolaus' Fixed Income Capital Markets research and strategy analysts ("FICM Analysts") are not compensated directly or indirectly based on specific investment banking services transactions with the borrower or borrowers mentioned in this report or on FICM Analyst specific recommendations or views (whether or not contained in this or any other Stifel Nicolaus report), nor are FICM Analysts supervised by Stifel Nicolaus investment banking personnel; FICM Analysts receive compensation, however, based on the profitability of both Stifel Nicolaus (which includes investment banking) and Stifel Nicolaus' Fixed Income Capital Markets. The views, if any, expressed by FICM Analysts herein accurately reflect their personal professional views about subject securities and borrowers. For additional information on investment risks (including, but not limited to, market risks, credit ratings and specific securities provisions), contact your Stifel Nicolaus financial advisor or salesperson.

I, Craig Thornton, certify that the views expressed in this research report accurately reflect my personal professional views about the subject securities or issuers and that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in this research report.

Refer to Page 4 of this report for Stifel Nicolaus Fixed Income Capital Markets disclosures and analyst certifications.