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Bank Nationalization Hysteria

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The market is all wet on the issue of bank nationalization. The government has repeatedly said that it ***strongly prefers*** to leave our largest banks in private hands, rather than "nationalizing" them. But the market doesn't believe this, relentlessly pounding the securities of our largest banks before recently backing off. A much better-than-expected earnings forecast from Wells Fargo also helped sentiment. Nevertheless, Wall Street wants the government to state unequivocally that it will never nationalize our largest banks.

Let's be clear about what "bank nationalization" means. The most reasonable definition involves the government taking total ownership and control over a bank, and all its operations and policies. Based on this definition, many of our largest banks are already ***partially*** nationalized. This is because via TARP funding, the government owns stock warrants that can be converted at any time into partial ownership in our largest banks. Indeed, the government has begun asserting increasing control over bank policies either covertly or overtly via conditions tied to TARP capital infusions.

The market is treating total bank nationalization as something unprecedented, and wants the government's promise not to go there. The reality is that we have had a regulatory structure in place for many years to nationalize banks, if necessary. The purpose of the FDIC is to take complete and formal control over weak/insolvent banks, protect the depositors up to FDIC insurance limits, and manage the banks until they can be sold off. This is why the government cannot state unconditionally that it will never nationalize our largest banks, because ***conceivably*** they could need so much more capital that politically the government would have to assume total control and ownership in exchange for any such massive additional capital infusion. Perhaps Fed Chairman Bernanke's reassurance that it is both unnecessary and undesirable to assume "formal" control refers to the typical form of bank seizure by the FDIC, but it does not mean the government will under no circumstances functionally reach the same result.

However, partially nationalizing our largest banks ***by necessity*** to stabilize our financial system does not mean that the government ***wants*** to move towards total nationalization. In fact, despite the sometimes inconsistent messages coming out of Washington, anyone who moves

Inside This Issue:

past the hysteria to analyze the government's actions can see that our government is trying very hard to avoid full nationalization of our largest banks.

The government's TARP money was originally given in exchange for straight preferred shares and some stock warrants convertible into common shares. Upon close analysis, the government clearly treated bank investors with kid gloves. The preferred shares required the banks to pay a below-market dividend, and the warrants would convert into a relatively small ownership position. It is significant to note that the government chose a security with a capital structure position that is subordinate to bondholders, equal to other straight preferred shareholders, and with stock option rights that were only mildly dilutive and harmful to the common shareholders. Common shareholders should have been very pleased with this arrangement given capital was not available on such favorable terms or in such large amounts from any other source at that time. Taxpayers, on the other hand, had legitimate reasons to complain as they received below-market consideration for supplying the capital.

Under the new Capital Assistance Program (CAP), the government continues to show restraint. Several features of the required convertible preferred security evidence the government's investor-friendly approach. For example, the conversion price of the preferred is set at a 10% discount to the closing stock price of the bank for the 20-day trading period ending on February 9, 2009. The fact that **at the time of announcing CAP**, the market prices of bank stocks had generally dropped a great deal below the conversion price made this conversion option very valuable to the banks, as it put a floor on the sale/conversion price of their stock that was considerably **above** the then market price. Just as importantly, the conversion is at the option of the issuer (i.e. the bank) rather than the government. This means the bank can convert (or functionally sell common stock to the government to extinguish preferred shares) at prices higher than what was available in the market at the time of the CAP announcement. Moreover, the timing of conversion is again up to the bank, meaning the bank is in control over the timing of common share dilution. These terms are unusually favorable to the banks. It is true that the convertible preferred requires "mandatory conversion," which means it must be converted within a set period of time, but the deadline is years away, giving banks plenty of time to do what is in their best interest. The fact that big bank shares have since generally appreciated above the conversion price does not negate the government's benign intent at the time of the CAP announcement to treat big banks favorably.

The market got it wrong again by slamming the deal reached on February 27, 2009 between the government, Citigroup and some of the other preferred shareholders. The market rashly concluded that the government was being punitive to bank investors by converting part of its preferred shares into common stock to dilute the existing common shareholders, pressuring Citigroup to suspend dividend payments on all preferred shares, and reserving for itself the special right to convert part of its preferred shares to trust preferred securities that pay a higher dividend and are more senior in the capital structure. The bitter taste from the ill-conceived destruction of Fannie/Freddie preferred stock by the government seemed to return with a vengeance, as investors assumed the government never learned from that fiasco.

The market missed the point entirely. Exactly which investors were hurt by this deal? Let's start with Citigroup's bondholders. It is difficult to see how they were hurt by this deal; in fact they benefited greatly. First, potentially up to $52.50 billion worth of preferred shares will no longer require dividend payments, not to mention the suspension of the common stock dividends as well. That leaves more cash for servicing the bonds. Further, the government's new position as a much larger common shareholder and a holder of trust preferred securities continue to remain below the bondholders in the capital structure. The government has no interest in hurting Citigroup bondholders, as evidenced by the FDIC's very successful (and recently extended) program to subsidize the low-cost issuance of unsecured senior bank debt via the corporate bond market.

The preferred shareholders, at first glance, looked like they got a raw deal, as their dividend payments were suspended. But this is a far cry from what happened with the holders of Fannie/Freddie preferred shares. Unlike that case, the Citigroup preferred shareholders have the right dollar-for-dollar to convert their shares into common stock ownership on the same terms as the government. Also, to the extent that Citigroup's common stock eventually recovers, the preferred-turned-common shareholders have unlimited upside in how much they might gain. It is true that the conversion price was less than ideal from the preferred shareholders' viewpoint, because it was above the market price prevailing at the time of the announcement. Nevertheless, it was still lower than the CAP standard, which was set at a 10% discount to Citi's closing stock price for the 20-day trading period ending on February 9, 2009. If it appears like the "little guys" got hurt here, it is noteworthy that some of the biggest institutional investors who hold preferred shares, such as the Singapore Government, Prince Alwaleed Bin Talal Bin Abdulaziz Alsaud, Capital Research Global Investors, Capital World Investors and other large institutional investors have agreed to go along with converting their preferred stock.

It is true that the existing common shareholders are the most negatively affected by this deal. However, the issue is not whether these shareholders were hurt by the deal, but whether they would have been hurt ***more*** in the absence of such a deal. As for this question, the answer is much more unclear. First, in the absence of such a deal to boost the common equity, confidence could have continued to spiral downwards, leading to a bank run (like WaMu) or the exodus of trading partners or customers (a la Lehman). In that event, Citigroup common shareholders would likely have ended up with nothing. Second, the common shareholders no longer have to pay dividends on up to $52.50 billion of preferred securities. At 5% to 8.5% annually, that is a lot of money saved. Third, while the remaining unconverted preferred shares of the government will earn a higher dividend rate of 8%, the rate is still below-market. Such trust preferred securities are therefore beneficial to the common shareholders, who would have to pay more in the market to get this financing. So while this deal dilutes the existing common shareholders, it provides them with financing at below-market rates, boosts the company's common equity cushion to instill more confidence, and reduces the prospect of bank runs or trading partner or customer exodus that could otherwise completely wipe out the common shareholders.

The market should stop fearing that the government is intent on full nationalization of our largest banks. If it does so, it will be by necessity, not by choice or preference. Whether it will be forced to nationalize fully depends entirely on how much more capital the banks might need, whether it is available from private investors, and at what cost. The government has been playing a game of "whack-a-mole," in which its actions often solve one problem, while simultaneously creating other unintended and unwanted consequences. It needs to do a better job attracting private capital, which is fleeing from the banks right now. Announcing new and more stringent stress tests meant to instill confidence had the opposite effect of discouraging private capital, as it raised the prospect of further need for capital and possible dilution.

Even in the best of times, the question of capital adequacy is highly complex, and not subject to definitive determination. This is because the answer depends on assumptions about the future: how much will the banks make absent reserve additions and write-offs, how much worse will the housing market and unemployment get, how will deteriorating credit card delinquencies and commercial real estate markets worsen the situation etc.

An already imprecise and difficult process of determination has been further complicated by several factors. First is a poorly drafted, though well intentioned, fair value accounting standard (a.k.a. "marked-to-market rule") that works pretty well under normal conditions, but is unworkable for assets in inactive markets or markets with only occasional activity that is conducted by desperate sellers unloading non-comparable assets. Thankfully, the SEC recently granted some relief and clarification on the application of this rule, potentially boosting asset values on bank balance sheets and giving a more accurate representation of real capital strength over time. Second, as Fed Chairman Bernanke mentioned, the suspension of the "uptick" rule against shorting may have created unintended negative consequences. Many banks have applied the fair value accounting rule by marking their assets to structured finance indices that are thinly traded and very easily manipulated downwards without much capital by those who short the indices. The reinstitution of the uptick rule might ameliorate this situation. The SEC is currently considering reinstating the uptick rule.

The government does not want full nationalization of our largest banks; their actions show they are bending over backwards to avoid it, while appeasing taxpayers that the government is not completely giving banks a free ride. Bank investors will be well served to more critically examine their position within the capital structure, as the effect of creeping nationalization is very different depending on the type of security owned. Even the common shareholders, who are clearly getting diluted and hurt, might end up better off than in the absence of the government's capital and actions.