

## The Bureaucrat & The Academic

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### Driving the Financial System to Collapse???

**Richard X. Bove**

Vice President Equity Research  
Financial Sector  
[rbove@rochdalesecurities.com](mailto:rbove@rochdalesecurities.com)  
813.909.1111

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### Lack of Business Acumen

Tim Geithner, the head of the Treasury is a bureaucrat. He has actually bragged on television that he has never held a position of responsibility in a bank or a brokerage firm. Ben Bernanke, the head of the Federal Reserve, is an academic. He has never held a position of responsibility in business. Both men are undeniably very bright but

- Neither has ever developed understanding of how a business works from the inside.
- Neither has taken risk in a commercial setting.
- Neither has had to understand how to develop a business plan in an environment of competing business interests.
- Neither has ever had to understand the meaning of a contract.
- Neither has had to understand the importance of private property in a commercial setting.
- Neither has ever been involved with long-term planning for a business enterprise.
- Neither has ever had to function as a working capitalist.
- However, both are skilled politicians.
- Both are willing misuse the power of their positions to force the private sector to bend to their demands.

The academic has performed unusually well in understanding the nature of the financial crisis and its potential impact on the economy. He has taken actions at a time of extreme stress that helped avert a financial collapse. Whether these were his ideas or those of a business man, Henry Paulson, the head of the Treasury at the time will be unknown. What is known is that in the fourth quarter of 2008, the concerted actions of the Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation prevented a run on bank debt from succeeding in breaking the system.

However, the challenge has now changed. Mr Bernanke is facing a crisis of either his own making and or that of the new Treasury Secretary Timothy Geithner. This time there is no business man to assist them in their decision making – only more academics and bureaucrats. Moreover, if the crisis that the government created is not handled properly it will rekindle the run on the banks and crash the financial system. What is very alarming in this situation is that the government has eliminated all options and is plunging ahead toward what could be a fatal denouement.

### The Nature of the Problem

What has been done to create such hyperbole on my part? The answer is the stress test on banks.

The bureaucrat and the academic apparently decided that they could solve the problems of the banking industry by creating a test that would define which banks in the country were well capitalized and which were not. Then they would give the poorly capitalized banks six months to bring their capital up to required levels or face serious consequences.

To insure that the markets would accept the results of the stress test, the bureaucrat and the academic decided that these banks would be forced to meet capital standards in a stressed environment one that has never existed in the post war period. The test would be conducted using depression-like economic standards. In addition, if press reports are correct (more on this later) the bureaucrat and the academic have thrown away 35 years of work by the 95 nations and the Bank of International Settlements in determining what capital is in the banking system in order to pander to the latest fad in the financial markets known as tangible common equity.

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Moreover, to insure public backing (remember that these are two politicians first and whatever else they are second) the bureaucrat and the academic have apparently set up a hotline to the *Wall Street Journal*. Thus, daily, the *Journal* communicates their message concerning the stress test to the public (Presumably, the *Journal* pays back the Treasury for this privileged status by writing articles like the one entitled [How the Treasury is Easing Stresses](#)). Based on feedback from these articles, the bureaucrat and the academic delay the results of the stress test, change its structure (according to *Journal* reports), and try to figure out a way out of the dilemma that they have created before they crash the banking system. This is government by press. Politicians understand how to do this; business people generally do not.

### Why Is This A Problem?

#### Keeping Audits Private

First, one might start with almost 150 years of banking regulation in the United States. One key tenet that was evident in this whole period was that audits of banks were to be kept secret. When problems were detected they were to be solved by interaction in the banking industry itself or later by government intervention and regulation. A reading of Bray Hammond's *Banks and Politics in America* detailing the early history of this country's banking industry provides answers as to why this technique developed. It was understood that by revealing negative results of banking audits, one could crash the nation's financial system.

The regulatory system begun with the National Banking Act, as amended in 1866, the Federal Reserve Act of 1913, and the creation of the Federal Deposit Insurance Corporation in 1933 has worked unusually well for the past 75 years. It withstood a crisis of greater magnitude than the current one in the period from 1988 to 1991. In this 3 year period, 1 ¼ banks failed every day, but the system held. It held even though 2,304 banks failed from 1986 to 1992. There were no such things as stress tests in that period. The nation relied on the then current system of banking regulation and it worked magnificently so that by 1993, the system was funding growth in the United States economy again.

Therefore, the first problem with the stress test is the test itself. It replicates that work already being done by the banking regulators. However, most important, it repudiates the concept that banking audits are to be kept private. The bureaucrat and the academic are overseeing a process whereby daily unsupported attacks are being made on individual banks under the guise of terms like "knowledgeable people say ..." They are trying to fix a system, maintaining silence, that is not broken and in the process they could ruin what was working.

#### *Forcing Funds To Flee*

What the bureaucrat and the academic fail to understand is that when they publicly attack a bank by indicating that it is undercapitalized they will be signing that bank's death warrant. They have pledged that no major bank in the United States will be allowed to fail. Understand, and understand this well, the government cannot back that pledge. It is bankrupt by any measure that one would care to use. It cannot prevent the failure of a trillion dollar plus institution.

What is worse is a comment in today's *Wall Street Journal* (the apparent unofficial organ of the United States Treasury):

"The tests will predict each bank's potential losses in certain categories under dire economic scenarios."

If the bureaucrat and the academic understood how markets worked they would understand that if the government indicates that a bank or a given sector of the economy is in trouble, money will flee that sector. If the government says that bank XYZ is troubled and bank ABC is in solid condition, money will flow from the designated weak bank to the designated strong bank breaking the weak bank. Gresham's Law comes into play here. This is not "Bad money drives out good" it is: "Money will flow to safe banks."

However, the quote from the *Journal* above suggests an even worse problem. Implied in this quote is that the United States is about to designate certain sectors of the economy as troubled and in risk of failure. If the government does this it will cause the collapse of those sectors of the economy. Remember when the ill-advised Senators stated that banking industry might have to be nationalized, it caused a run on the banks. If the government now starts pointing at segments of the economy and suggesting that they could fail, money will flee and those segments of the economy will fail.

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### *Delusional Thinking*

The *Wall Street Journal*, presumably speaking for the bureaucrat and the academic, states:

“The strong preference is for banks in need of fresh capital to raise it either through private investors or selling assets, officials say.”

Let’s think about this. The government has forced the banks to effectively eliminate their dividends beggaring millions of the elderly who live on these dividends. It has forced the dilution in common equity of at least one of these institutions. It has demanded that two others make acquisitions to stave off a financial crisis and then began attacking these institutions for not having adequate capital. It has broken its contract with the banks on TARP. It is destroying any concept that there is such a thing as inviolate private property in banking.

It is about to label a number of banks with Hawthorne’s scarlet letter (not “A” sewn on the breast pocket but “Bad Bank” sewn on their financial statements). Possibly, it may call these banks the Hester Prynne banks. It is going to go further by labeling sectors of the economy as high risk.

What does it expect after this series of actions? It expects private investors to flock to these institutions and give them money or better yet to buy the troubled assets of these institutions. Or, maybe it thinks the banks will sell their good assets keeping the bad ones and then attract new investment dollars for the bank now overloaded with bad loans. Only a bureaucrat or an academic could think this way.

### **Economic Scenarios**

Usually when a business person creates a budget for the future, s/he considers a range of possibilities. Maybe s/he does not go as far as to do a Monte Carlo simulation, but there is generally a good, bad, or neutral bias to the projections.

This is not being done in the stress test. There are two outlooks being utilized – bad and worse. Thus, the name stress test is used. However, by only arguing that negative developments can occur the bureaucrat and the academic are suggesting that there is no other possible result. They are implicitly suggesting that the economy cannot improve. By forcing the Hester Prynne banks to raise more capital they are driving the economy to weaken.

There is reason to think that there is another outlook besides bad and worse. The recent GDP figures imply that inventory building is a growing possibility. This would lead to more capital spending and the rehiring of laid off workers. The sharp drop of interest rates in the high yield markets suggests that money is being attracted to risk investments again. Most big banks are profitable.

Into this plausible scenario of an economic recovery step the bureaucrat and the academic with their argument that the only outlooks are bad and worse. The last time this happened was in 1938, when the Federal Reserve stepped in to raise reserves on bank deposits short circuiting the recovery that had begun in the Depression. I can see absolutely no difference between the Fed’s actions in 1938 and the demand that banks raise capital in a recession.

The bureaucrat and the academic are risking destroying the Obama Presidency with their folly. If the President understood this he might call this exercise off and reinforce the methods of regulating banking of the past 75 years. However, again, we are dealing with yet another academic.

### **Fads and Banking**

In the first quarter the 49 largest banks in the country reported a pretax profit of \$12.9 billion. This profit was achieved despite the fact that the industry also recorded a \$47.7 billion loan loss provision. Thus the industry’s pretax pre provision earnings (this is all cash by the way) was \$60.6 billion. The argument being made by the government in its bad and worse forecast is that the provision portion of this combination will grow wiping out the pretax portion. Moreover the argument is being made that the pretax portion is not sustainable.

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### A More Positive Outlook

In a 62 page review of the quarter's results (see *Look Beyond Loan Losses; You Will Like What You See* dated April 28, 2009) I have tried to point out that the outlook for pretax is sustainable and the outlook for loan losses is not. The basis of this argument is that banks are going to maintain stable earning assets; increase their net interest margins after two quarters; increase their non-interest income; and reduce their non-interest expenses. All of this is happening. It is not accounting gibberish it is real earnings developing from real events in the financial world.

The outlook for loan losses is going to be driven by the outlook for the economy. If one uses a bad or worse view this outlook is not likely to be very good. If, however, one takes into account the developments suggested above, the outlook brightens considerably and loan losses flatten out. Unless one is convinced that a depression is coming, one would have to concede that the economy must recover.

Consider the simple mathematics if this happens. At present, the loan loss provision is 78.7% of the pretax pre provision number. Pretax jumps by 23.2%, if the reserve build falls by 25% -- i.e., simply because banks stop adding money to their reserves at the same rate as last quarter (if the reserve build stopped altogether pretax would jump by 92.8%).

If earning assets grow by 4%, margins increase by 10 basis points, non-interest income increases by 15%, and non-interest expenses grow by 4%, along with the 25% drop in the reserve build, bank pretax earnings for these 49 companies jumps by 86.2%.

<b>Category</b>	<b>1st Q 2009</b>	<b>Recovery</b>	<b>Change</b>
Earning Assets	\$8,623,372,137	\$8,968,307,022	4.0%
Net Interest Margin	3.11%	3.21%	3.2%
Net Interest Income	\$68,045,174	\$71,966,088	5.8%
Reserve Build	\$18,429,085	\$13,821,814	(25.0%)
Net charge off	\$29,294,678	\$29,294,678	0.0%
Credit Income	\$20,321,411	\$28,849,596	42.0%
Non-interest income	\$78,263,702	\$90,003,257	15.0%
Non-interest expense	\$78,729,139	\$81,878,305	4.0%
Pretax income	\$19,855,974	\$36,974,549	86.2%

The bureaucrat and the academic refuse to consider this possibility. Plus, they communicate their lack of belief in any positive developments through the stress test. Yet, recent developments would argue that the positive outlook may be the most likely result.

### TCE

The argument over the relevance of tangible common equity will go on forever. What I find to be most disturbing is that the willingness of the bureaucrat and the academic to accept this metric is contrary to all of accounting policy that has been established by the Bank of International Settlements over the past 35 years. The United States Congress signed an accord agreeing to accept these policies as did 95 other nations.

However, the *Wall Street Journal*, presumably speaking for the Treasury, states that a 4% TCE ratio is required. Why? Where did this number come from? How was it developed and/or tested? My suspicion is that the number was simply pulled out of the air with no thought or study. The government simply wanted to look tough. This is, of course, not the way to run a business.

Thus, as we have seen, not only are the bureaucrat and academic willing to throw away 150 years of banking regulation, apparently they are also willing to ignore the international accords signed by the United States government. You might wonder why anyone would grab at the latest fad to set public policy. The answer, of course, is because there is a total lack of understanding, in this case, as to how the banking industry operates but an arrogance of being willing to set rules despite this lack of understanding.

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### Potential Outcome

On Thursday, next, the government will reveal the results of its stress test. It will label some banks as being undercapitalized. These banks will then have to deal with a run on their debt and be forced to go the government for more money. It will create a problem for the financial system and the economy – unless the government has the sense to already give the Hester Prynne banks the capital they supposedly need before making the announcement.

Following this event, banks will contract and build their liquidity. Their primary goals will be to get rid of the government in their businesses. The very last thing they will do is extend credit to the economy. They will liquefy as quickly as they can. This will create an opportunity for the investment bankers who will aid in the liquefaction of the banking industry. The potential growth in the economy will be set back

Then the government will extend its witch hunt for more Hester Prynne banks. It will find hundreds more who cannot meet the stress test demands of bad or worse outlooks among the 8,300 not yet tested. Possibly 150 or more will fail. The government will then seek to create totally new regional banking institutions that will consolidate the weak banks less their bad loans. The government will take over ownership of the troubled assets and over a period of years sell them at a profit to the private sector – assuming the government does not come up with more techniques to strip funding from the economy.

This is a dangerous time. What makes it so upsetting is that the industry, the financial system, and the economy are showing positive signs and the government with its bad and worse outlooks is now interfering with the process.

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**Rochdale Securities LLC**  
**750 E. Main St., 7th Floor**  
**Stamford, CT 06902**  
**Main 203.274.9100**

### Management

### Trading

**Dan Crowley**  
 President  
 djc@rochdalesecurities.com  
 203.274.9101

**Kevin Cassidy**  
 Senior Vice President  
 Chief Operating Officer  
 kjc@rochdalesecurities.com  
 203.274.9116

**Kris Talgo**  
 Senior Vice President  
 Trading Co-Head  
 klt@rochdalesecurities.com  
 203.274.9125

**Hal Tunick**  
 Senior Vice President  
 Trading Co-Head  
 ht@rochdalesecurities.com  
 203.274.9124

### Analyst Team

**Richard X. Bove**  
 Vice President Equity Research  
 Financial Sector  
 rbove@rochdalesecurities.com  
 813.909.1111

**Jaison T. Blair, CFA**  
 Sr. Equity Research Analyst  
 Hardlines Retailing  
 jblair@rochdalesecurities.com  
 203.274.9161

**Hayley B. Wolff**  
 Sr. Equity Research Analyst  
 Consumer - Leisure  
 hbw@rochdalesecurities.com  
 203.274.9160

### Merger Arbitrage and Special Situations

**Barry D. Kaplan**  
 Merger Arbitrage and  
 Special Situations  
 bdk@rochdalesecurities.com  
 203.274.9121

### Institutional Sales

**Hal Tunick**  
 ht@rochdalesecurities.com  
 (203) 274-9124

**Trey Bauer**  
 tbauer@rochdalesecurities.com  
 (203) 274-9137

**Patrick Burke**  
 prb@rochdalesecurities.com  
 (203) 274-9127

**Allen Jordan**  
 anj@rochdalesecurities.com  
 (203) 274-9120

**Joseph Bove**  
 jab@rochdalesecurities.com  
 (813) 963-2999

**Andy Massey**  
 apm@rochdalesecurities.com  
 (813) 963-2888

**David Miller**  
 dmiller@rochdalesecurities.com  
 (203) 274-9131

**Niall Morrissey**  
 nmm@rochdalesecurities.com  
 (203) 274-9130

**Robert Camardo**  
 bc@rochdalesecurities.com  
 (203) 274-9122

**Pete Doehla**  
 pkd@rochdalesecurities.com  
 (203) 274-9128

**Jeff Wicker**  
 jdww@rochdalesecurities.com  
 (925) 253-1030

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