

How Will TARP Affect Liquidity?

Like many of you, we at BT Capital Partners have tried to gain a greater understanding of the recent (and ongoing) financial turmoil that seemingly has affected all participants in the world economy. Although the turmoil and subsequent US government action has been on everyone's mind, few in the media are able to analyze the situation as well as our friend Jim Wheeler, a partner at Powell Goldstein. Jim is active in the business community, and specializes in transactions involving financial institutions and the areas of mergers and acquisitions, corporate finance, and business law.

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We asked him to share his thoughts on the present situation, and he obliged by presenting his view of how the US federal government's recent actions will affect liquidity. He has prepared the following article for our readers.

When the Treasury Department announced its ambitious, and (as we go to press) still-evolving, Emergency Economic Stabilization Act of 2008 / Troubled Assets Relief Program / Capital Purchase Program ("TARP"), the legislation claimed as its two chief aims (1) the restoration of confidence and stability in the financial system and (2) to provide liquidity to the marketplace.

The jury is still out, and is likely to remain out for some time to come, as to whether we have indeed restored stability or confidence in our existing financial system. The failures of several pillars of the financial community, from Lehman Brothers and Wachovia on down the line, and the wild volatility of the stock market seem to indicate that, at best, we still have quite a bit of work to do in order to restore confidence and stability. We should also figure in the effects of the proposed tax structure of the new administration, which will almost certainly slow growth, at least in the short term.

But what of liquidity? Everyone, from George W. Bush to the small business owner, is adamant that they expect banks receiving TARP payments to use the new capital to lend money into the system, to spur growth, to point us to a resolution of the current financial crisis. Although a noble goal, the reality of the situation poses a number of problems.

The primary problem with opening up the coffers for lending, of course, is that general economic conditions have damaged many businesses, making them poor candidates for credit-worthy loans.

An equally important factor that has not received much press is the paradigm shift in lending caused by the deleveraging of Wall Street. With all of the large Wall Street investment banks now conspicuously absent from the landscape, we have lost all of those major lenders who leveraged their assets 40:1 and who were willing to aggressively price car loans, credit card receivables, and home mortgages, based on their model of packaging them and selling them, without regard to credit quality, since they were backed with credit default guarantees. Those packages and re-sales are no longer viable. All of the capital that was available just months ago is no longer available, and most eyes are turning to the banks who are lining up to receive the TARP capital payments as the likely suspects for injecting capital into our economy.

Although our crystal ball is a little hazy, we certainly see deleveraging, coupled with the loss of some of the more aggressive lenders, such as Wachovia and Washington Mutual, causing the pricing pressures that many smaller banks have felt for years to be alleviated. We have heard, however, that aggressive pricing has continued to pop up in pockets, offered by banks desperate for deposits.

Compound deleveraging and serious scaling back by many aggressive banks with the complete re-thinking of the banking industry, and we predict that we have witnessed the end of The Borrower Era. New loans will necessarily be written more carefully, be more heavily documented, carry tougher capital and covenant requirements, and carry higher interest rates.

Even the most optimistic projections point to a prolonged recession stretching out over years rather than months. Banking regulators are repeating the adage that Capital is King and we can't disagree with that. Hoarding capital for the long winter seems to be a prudent business plan. Although we may have a better understanding once the TARP applications get further down the review to approval cycle, the deadlines for which will soon be extended for privately held banks, there are no current official requirements for the use of proceeds and it does not seem practical for many banks to voluntarily deplete a large percentage of capital on lending.

In order to successfully navigate these turbulent economic waters, I recommend turning to finance professionals, such as BT Capital Partners, for support. When credit is in short supply, an advisor is especially important to help you optimize your capital structure, obtain external financing, and understand your options when contemplating the sale of your business.

TARP KEY POINTS

- Managed by Treasury Secretary through newly-created Office of Financial Stability.
- Overseen by Federal Reserve Board, FDIC, Comptroller of Currency, Director of the Office of Thrift Supervision, and Secretary of Housing and Urban Development.
- A total of \$700 billion was authorized. \$250 billion are immediately accessible. The next \$100 billion is authorized by the President. The remainder is authorized by Congress.
- Treasury must take warrants for non-voting stock or senior debt from participating companies.
- No new golden parachutes for participating companies.
- FDIC insurance increased from \$100,000 to \$250,000 through December 31, 2009.