

## Q&A: Griffin Financial's Joseph Harenza and Richard Vader

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By Bobby Raines

SNL Financial spoke with Griffin Financial Group LLC's CEO and senior managing director Joseph Harenza and Richard Vader, a senior managing director at the company, about the impact that recent government action is likely to have on banks.

Harenza has worked on mergers and acquisitions and capital formations for more than 25 years, advising on more than 300 M&A transactions. Vader recently joined Griffin — a boutique investment bank specializing in several industries including financial services and private equity — after stints at Keefe Bruyette & Woods Inc., Alex Sheshunoff & Co., Kidder Peabody & Co. Inc. and First Boston Corp. He has served as senior adviser on more than 45 mergers and acquisitions and 25 securities offerings.

What follows is an edited transcript of the conversation.

**SNL Financial: The government has committed \$125 billion of its \$250 billion equity program to nine banks. Where do you think the rest will the rest go?**

**Harenza:** I think the term the Treasury secretary used was “systemically important banks,” which we would read to mean larger super-regionals that actually have distressed assets. The rest would meander down to regional and community banks.

I don't know if you noted it, but they have an interesting concept built into the rules that they put out in the term sheet. The amount of the preferred to be purchased is limited to not less than 1%, nor more than 3% of risk adjusted assets, capped at \$25 billion. So there is a protection built into the term sheet that keeps the program from giving \$100 billion to Goldman Sachs [Group Inc.]. But it would be limited to not less than 1% of risk weighted assets. That would mean, generally, for a \$1 billion bank, that's maybe a \$10 million investment. We think it's interesting that although there is a maximum, there is no minimum. There is no limitation. In the release there is a hint that they may limit it, but again it's limited to between 1% and 3%, but there's no dollar limit. I think there's flexibility to take it down to even a bank with \$100 million in assets.

**SNL: What did you think of the terms of the preferred stock program? They seem pretty favorable compared to, say, Warren Buffett's recent investment in Goldman Sachs.**

**Harenza:** We've kept track of that. Not so much Warren Buffett's investment in Goldman, but we took a look at the TPG [Inc.] investment in [Washington Mutual Inc.] and the Corsair [Capital LLC] investment in [National City Corp.] and a few others. When you take a look at these terms, the coupon is low, below market, which is an indirect federal subsidy for banks.

We think it's a hell of a program, and we think the lower coupon and the fact that it's nonvoting is super. The problem for a lot of community banks is going to be size, that 1% limit.

The price of admission is the restrictions on the growth of dividends and the repurchase of other equity because the government is precluding that contractually. You can't increase your dividend or repurchase shares while that preferred is outstanding.

**Vader:** The dividend's escalation from 5% to 9% is intended, I think, to motivate people to get them out.

**Harenza:** What they're really trying to do is to get the company to get that investment out. The government is saying, “We're going to put the money in, but we hope that market conditions improve so that you have the money to take it out.” But on the other side of the coin, that preferred investment is 100% transferrable, and the company has to put a shelf registration statement up and give the government piggy-back rights.

The other price of admission from the community bank's perspective is the restrictions on executive compensation that the officers of the company have to agree to in order to get the direct investment from the government.

**Will this program have an impact on the market for private capital raises?**

**Harenza:** I don't think we really know the answer to that, but intuitively we still have an oversupply of capital, in this country and globally, chasing a decreased pool of financial assets. The problem is that that money is sitting on the sidelines because it has a concern that the banks in this country are a) insolvent and we don't know it, and b) illiquid and therefore c) prone to failure and insolvency. These folks want to invest money but they are afraid on the one hand and lack confidence on the other. It seems to me that this bailout legislation, taken as a whole, with particular emphasis on the direct investment that the Treasury is now permitted to make in the entire banking sector, should have a positive impact on investors.

I think the government is doing the right thing. They got nine big banks to raise their hands and say “I'll play,” which I think is going to go a long way to get other banks, super-regionals and small banks, to play.

When you focus on the other things that are going on here, I think all of the steps taken so far — and maybe I'm being Pollyanna-ish — should bring investors back to the market over a period of time.

**Vader:** I think we've given very short shrift to the FDIC's announcements. They are going to guarantee senior subordinated note offerings by banks. They'd assess a 75-basis-point credit fee, but that I think is an inducement for banks to term out short-term borrowings or refund high coupon borrowings at the lower FDIC guaranteed rates.

I think that was a major concession. I think it was very targeted to provide relief to banks at the expense, possibly, of holding companies. Holding companies own stock in banks. The FDIC insures banks. And by the FDIC taking a senior position in a bank it puts them ahead of all holding company creditors, including common stockholders.

## What impact will the government's actions have on M&A?

**Harenza:** This preferred [stock], even though it is cumulative, is Tier 1 capital by pronouncement of the Treasury. That's tremendous. That \$25 billion of capital going on to let's say [Wells Fargo & Co.]'s balance sheet or [Citigroup Inc.]'s balance sheet would not only facilitate covering losses, and provide them with liquidity and the ability to grow loans organically. It will permit them to grow loans and to grow the balance sheet externally by M&A.

When you take this \$25 billion capital injection into these large banks, together with the totality of all these other initiatives and the indirect subsidy that comes from the section 382 IRC relief the Internal Revenue Service put on the table during the Wachovia and Wells Fargo and Citi fight, that creates a tremendous ability for those banks to grow over the next two or three years by acquisition. I could be wrong, but I can see that, together with changing industry landscape, spurring further consolidation at the top.

The stuff that has taken place in the last month or two put something like 34% of U.S. deposits in the hands of the top three or four financial institutions. I think we're going to see more of that. I think we all hope it will spur banks to lend to Main Street, and to commercial and industrial accounts, but I think it may have the consequence of spurring another round of consolidations.

**Vader:** At the bank level, I think bankers are going to have to get comfortable with the balance sheets of both buyers and sellers to see if they want to proceed to a transaction, assuming there are no financial urgencies that have to be addressed. And then you have the issue of valuation. The stock price of many banks is greatly diminished, and the corresponding price expectations probably haven't changed all that much, so I think we're going through a transitional period where urgencies are addressed first and then necessities are addressed later.

If we get some clear understanding of what loans are good or bad through the September and December accounting cycles and we see some stability and improvement in stock prices, then we'll see acquisitions. However, there are fair value accounting and purchase accounting changes in the works that might be an impediment to an acquisition.

**Harenza:** You know the Congress made it clear that the SEC has the authority to modify GAAP, and we do have an SEC white paper that came out that I think will help M&A and purchase accounting.

I think it's tough for the Treasury the SEC and all the other regulators to walk away from fair value accounting. There's a sense among economists that one of the causes of this banking crisis has been

the lack of transparency and the subjectivity that relates to reserve setting on one hand, and on the other hand we are moving rapidly towards a U.K. and international set of accounting principles.

## Big banks have grabbed most of the headlines recently. How will recent events impact the smaller banks?

**Harenza:** Two weeks ago saying that the plan they rolled out would not work because it did not address the capital issues, and a lot of the other people were saying that too. But I think the government finally got it from a macroeconomic perspective. I think what they're doing with the large banks is helping, but I think one of the unintended consequences will be the big banks will get bigger and will have a continuing increase in size and scale in discrete geographic markets around the country. This will continue to make the competition for deposits and assets in those markets more intense, disadvantaging smaller institutions in those markets. They're going to get bigger. They're going to get badder. They're going to get stronger. They're going to be able to have the market power and monopoly power to increase the cost of deposits to take deposit share, and they will go down-market to cannibalize loan growth in those markets at the expense of community banks.

## Wouldn't additional consolidation in the banking industry create more institutions that are "too big to fail?"

**Harenza:** The 'too big to fail' problem, now you get at that moral hazard issue. I'm not a philosopher, but I think that moral hazard piece is right on. I think that [Lehman Brothers Holdings Inc.] and Mr. Fuld proved that big banks can fail. One can say that they're not a bank, but they owned a thrift. But remember, they were levered at 30 to 40 to one, and banks can't do that. I think the fact that the investment banks are now migrating toward a banking model and towards banking charters, which will restrict their ability to lever, bodes well for the system going forward.

I think what we've just been through proves the old rule about being too big to fail is not true. You can be big and fail. Look at WaMu; and Wachovia was apparently closer than one would think. You can have a pretty good balance sheet, but if you have a liquidity crunch, bingo, you can go down. I think you're going to see that as the big guys migrate to a banking charter that takes away a lot of the risk of failure. We do now know from this experience, and I guess we arguably should have learned it back in the '30s and maybe again in the '90s, but you can be big and you can even have capital, but if you don't have liquidity, you're never too big to fail. Liquidity is the key. *i*