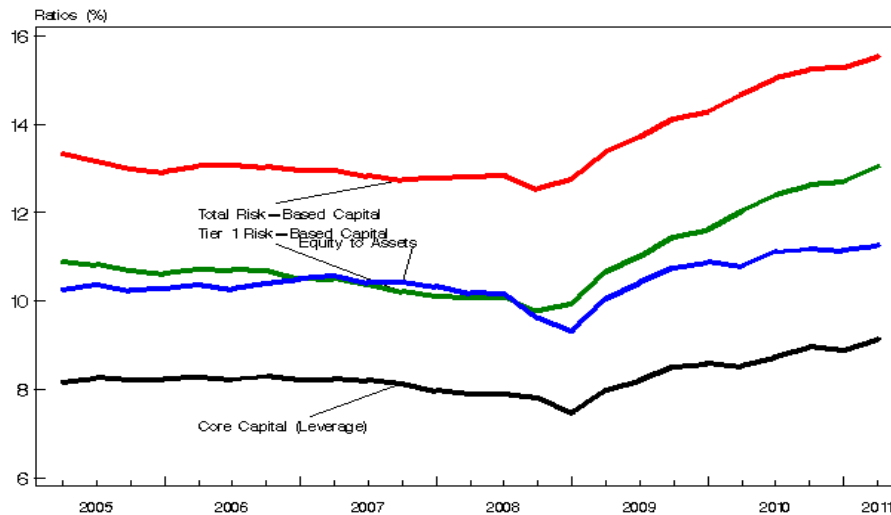




Since the onset of the financial crisis, commercial banks have greatly increased their capital ratios, on average. As such, most banks are better able to withstand unanticipated loan losses and other earnings shocks. However, given the regulatory focus on Tier 1 capital, banks no longer can easily raise capital in the form of Trust Preferred securities or other hybrids, such that capital growth will largely come from retained earnings and new common equity offerings. Not surprisingly, the primary investors for community banks are existing stockholders, directors, employees and ‘friends of the family.’

**Capital Ratios
2005 – 2011**



Problem banks under pressure to increase capital ratios face a terrible dilemma. First, they must firmly demonstrate that management has fully recognized all potential losses from problem loans to where the bank will generate profits in the future. Second, even if management successfully demonstrates that problem loans have peaked, selling stock to new investors substantially dilutes existing owners. This raises the question of whether current owners are willing to accept the dilution and potentially sell a controlling interest to the new investors. If not, the alternative is to muddle through until economic conditions improve and the bank returns to earnings before depleting its capital. It is a bet that the bank will survive without additional capital. Finally, unless the bank gets a large capital infusion, it will still experience slow growth (if any) and be forced to reduce operating expenses until the asset quality problems disappear.

Breaking News

- **The federal budget deficit totaled \$43 billion in June with the Congressional Budget Office estimating that the annual deficit would exceed \$1.3 trillion for the fiscal year ending in September. Interest on federal debt totaled \$386 billion for the first 9 months of the fiscal year.**
- **Moody's placed U.S. government debt, currently rated Aaa, on review for a possible downgrade due to the rising possibility that the debt ceiling will not be raised.**
- **California's Treasurer, Bill Locklear, indicated that the state may immediately issue \$5 billion in revenue anticipation notes and arrange bridge loans from banks in anticipation that the federal debt ceiling may not be raised and bond markets may freeze.**

Deal of the Day

Senate Minority leader, Mitch McConnell, proposed a bill that would increase the \$14.3 trillion federal debt ceiling by \$2.5 trillion. The bill would require President Obama to specify \$2.5 trillion in spending cuts but Congress would not have to formally approve the cuts. If passed, the Senate would not be making the hard decisions necessary for spending and borrowing reform but would be 'kicking the can down the road.'

In a presentation to Congress, Fed Chairman, Ben Bernanke, stated that 1) economic weakness might prove more persistent than expected and deflation might re-emerge, 2) Congress must raise the debt limit by August 2, 3) the Fed might pursue a third round of quantitative easing (bond purchases) labeled QE3, and 4) the Fed might consider lowering the rate (currently 0.25%) it pays on the banking system's reserves. In short, the economic recovery is must slower and weaker than anticipated and the Fed may take additional steps to lower rates further.

Economic News

Morgan Stanley forecasts stronger economic growth in the second half of 2011 citing four catalysts: 1) increased motor vehicle production, 2) declining gasoline prices which will lead to increased consumer spending, 3) increased capital spending associated with the loss of business expensing in December 2011, and 4) an increase in real net exports. The cumulative effect will be to increase annual GDP growth to an estimated 3% for 2012.

Upcoming Events

- **Tomorrow, the European Banking Authority (EBA) will release the results of formal stress tests for 91 large banks located in 21 countries. The results will presumably signal which banks need to raise capital to maintain long-term viability. Many of the banks and local politicians have argued with the EBA that some assumptions underlying the tests are unreasonable. The EBA is concerned that the results might not be credible without rigorous modeling of adverse economic conditions.**
- **The Bureau of Labor Statistics releases data for the June CPI and core CPI (excluding food and energy) tomorrow.**
- **The Federal Reserve reports the Industrial Production Index and Capacity Utilization Index for June. Industrial production measures the real (physical) output of factories, mine and utilities. Capacity utilization indicates how much slack (unused productive capacity) there is in the economy. The consensus forecasts are for modest increases in both indexes.**