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EJF Capital's 2022 Thematic Outlook

Executive Summary

EJF Capital LLC ("EJF" or "we") believes that 2021 revealed four thematic trends about the future in financial services:

- The revolutions in fintech and blockchain technologies are fundamental to the financial services industry and, as importantly, now at a tipping point. Innovation only becomes revolutionary when it transitions into widespread adoption. *(Page 1)*

- Accompanying our first observation that a tipping point has occurred in the fintech revolution is our strongly held view that the regulatory machinery of the federal government will begin to regulate blockchain technology, if not in 2022 then within the next few years. *(Page 3)*

- The revolutions in fintech and blockchain technologies will accelerate the consolidation of the banking industry in the U.S., with regulatory resistance to consolidation only affecting the largest regional banks. *(Page 5)*

- Finally, we believe that the tangible steps taken by Congress in 2021 to promote the interests of communities underserved by capital and financial innovation over the past four years will not be a fleeting mission of the federal government. Instead, we believe that this bipartisan focus on addressing wealth and income disparities will continue, in particular with the goal of increasing access to capital. *(Page 5)*

At EJF, we believe these four powerful trends will create significant investment opportunities in 2022 (and beyond). Many of our strategies will be implementing various aspects of these themes in portfolio positioning (if appropriate to the strategy) as we see this new regulatory environment unfold. Rarely is there a technology shift this substantial and, at EJF, we are determined to be at the forefront of these shifts in the financial services and regulatory landscape.

Dear Investor:

At EJF, we have reflected on 2021 to make several thematic projections. We will focus our 2022 outlook on our areas of expertise: regulatory direction and its impact on the ever-evolving financial services sector.

The sweep of history will certainly mark the year 2021 as a transition period for COVID-19. It would be foolish to declare that the COVID-19 pandemic is over. But one can confidently assert that the disease is becoming endemic as new variants emerge. We would argue that many of the disruptions COVID-19

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brought forward in 2021 will have long-term implications for the financial services sector. As Niall Ferguson observed in his new book, *Doom*:

> Pandemics, like world wars and global financial crises, are history's great interruptions. Whether we consider them man-made or naturally occurring, whether they are prophesized or strike like bolts from the blue, they are also moments of revelation.[1]

The revelations of 2021 that inform 2022, we believe, are four-fold. First, the revolutions in financial technology ("fintech") are fundamental and, as importantly, now at a tipping point. Innovation only becomes revolutionary when it transitions into widespread adoption. Consider the historical corollaries of several earlier innovations in history: the telegraph, the railroad and the rise of the internet in the late 1990s. In the early 18th century, it was widely known that electric currents could travel long distances over wires. Early systems to convey information through electric currents over wires were proposed as early as 1774. But it was not until both the system (the Morse code) and the infrastructure was developed did it revolutionize communication. In 1843, the government appropriated $30,000 for a telegraph line to be connected between Washington, DC and Baltimore, Maryland to evaluate the new technology's feasibility. By the late 1840s, all major US cities were connected by telegraph; San Francisco was connected in 1861, and in 1866 a cable was laid across the Atlantic Ocean connecting America to Europe.[2] When the tipping point was reached, widespread adoption and a multiplier impact resulted, affecting everything from shipping to the bond and stock markets in New York and London.

The development of the railroad experienced a similar revolution once a tipping point was reached. The use of rails to haul freight (16th century technology) once united with steam engine technology (1804 in Wales) eventually led to the proliferation of the railroad in Europe and the United States. In 1830, there were 23 miles of railroad tracks in the United States; by the Civil War thirty years later, over 30,000 miles of track had been laid, and by 1900, almost 200,000 miles.[3] And when the communication revolution of the telegraph was deployed to advance the logistics of the railroad, from single track to dual track lines, the speed and efficiency of the railroad synergistically expanded the telegraph communications network.[4]

Finally, the rise of the internet in the 1990s can be said to have followed a similar pattern of invention, technological advance, networking and a tipping point of widespread adoption. The first suggestion that a network between individual computers could be established was floated by an MIT professor in 1962.[5] The first physical connection of a computer on what would become internet 1.0 took place at UCLA seven years later, with computer connections added to UC Santa Barbara and the University of Utah shortly thereafter.[6] Once the open architecture network concept was combined with Ethernet technology, heavy-duty routers, and the increased production and widespread adoption of PCs, internet 1.0 evolved from

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[1] Niall Ferguson, "Doom: The Politics of Catastrophe," (Penguin Random House 2021), p. 383.
[2] John Steele Gordon, "An Empire of Wealth" (Harper Collins 2005), 154-57.
[3] Id., 146-48, 235.
[4] Id., 157.
[5] Lerner, Paul "A Brief History of the Internet", 1997
[6] Id.

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university conception to the internet 2.0 it is today, ubiquitously used on PCs and mobile phones and adopted worldwide by individuals and companies alike.

The remarkable revolutions instigated by the telegraph, the railroad and the internet are being re-lived through blockchain technology. This technology represents the "rails" of the current and future emerging payment systems, digital currencies and trade settlement, as well as a "trustless" means to move value in the broader global economy. Notably, blockchain technology provides opportunity to invest in its infrastructure layer, capturing upside from increasing adoption. This is an important differentiation compared to the internet, where investors could buy shares in the application layer companies (e-commerce merchants or web search providers), but could not profit from the underlying protocols such as HTTP or TCP/IP. Otherwise, the parallels of revolutionary change are unmistakable and 2021 signaled, in our opinion, the tipping point in which widespread adoption and cultural confidence in blockchain technology converged and paved the way for Web 3.0. Young and old across the globe use blockchain technology to buy and sell stocks, transfer money across borders and purchase art. In our estimation, the design of blockchain technology may be so disruptive as to allow new payment systems, completely outside the money transfer system, with safe and reliable, immediate and cheap frictionless payments. The embrace by El Salvador of Bitcoin as its official currency and the role that digital currencies currently play and could potentially play in immigrant remittances in countries such as Guatemala (remittances represented almost 15% of its GDP in 2020) speaks volumes to the efficiencies of blockchain technology and its increasingly widespread adoption.[7]

The evidence of the tipping point taking place in 2021 is unmistakable. In 2015, it is estimated that only 1% of Americans held or had owned digital currencies. By 2021, that percentage was 16%.[8] According to crypto.com, currently the number of people globally holding digital currencies doubled to about 220 million.[9] The total value of digital currencies held by those people more than doubled in 2021 from $1 trillion to $2.2 trillion. And, most remarkably, and most relevant for the banking industry, the total amount of money on so-called decentralized finance or "DeFi" blockchain platforms (also known as "total value locked"), which are used for borrowing and lending digital currencies as well as replicating other traditional banking and capital markets products, rose from $19 billion to $243 billion.[10] According to the research firm IntoTheBlock, the Ethereum network processed more than $2 trillion of transactions in every quarter of 2021.[11] We believe the tipping point has been reached.

Accompanying our first observation that a tipping point has occurred in the fintech revolution is our strongly held view that the regulatory machinery of the federal government will begin to regulate blockchain technology, if not in 2022 then within the next few years.[12] In the last Administration, the

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[7] https://guatemala.un.org/es/142704-remittances-contribute-achievement-sdgs
[8] Paul Vigna, "NFTs and SNL: Crypto Keeps Burrowing Into the Mainstream," December 31, 2021.
[9] Id.
[10] Id. See also, Campbell Harvey, Ashwin Ramachandran and Joey Santoro, "DeFi and the Future of Finance," (Wiley 2021).
[11] Id.
[12] See Paul Kiernan, "The $2 Trillion Cryptocurrency Market is Drawing Interest From Investors, Scrutiny From U.S. Regulators," January 2, 2022.

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only real tangible regulatory step forward (since reversed by the Biden Administration) was that an online-only fintech company could operate without physical branches through a regulated bank. In 2020, Brian Brooks, the Acting Comptroller of the Currency, allowed the Office of the Comptroller of the Currency to issue a charter to such a bank.[13] This decision is consistent with our view that the federal government will eventually seek to use banks and other payment intermediaries subject to regulatory oversight (such as PayPal and ApplePay) as the means to explicitly permit blockchain technologies to proliferate. This is the paradox of regulation. Once the regulatory state "blesses" a technological breakthrough by way of regulatory action, the technology becomes the standard by which widespread adoption and proliferation accelerates. Just as the federal regulation of the railroad industry beginning in 1884 did not slow down the proliferation and dominance of railroads -- and in fact resulted in the standardization of such matters as rail width and time zones -- so too will federal regulators and Congress ultimately "bless" and begin to standardize blockchain technology. Regulatory action, in our view, will allow the Federal Reserve to issue a digital currency backed by U.S. dollars (which will enhance the long-term hegemony of the U.S. dollar, particularly given China's stance against blockchain digital currencies), explicitly approving closed payment systems utilizing blockchain rails, and allowing and promoting securities transactions to be settled using blockchain technology (which the US Securities and Exchange Commission ("SEC") already has done on a limited basis).[14] Although regulatory action can stifle future innovation, it rarely does. Rather, our observation is that the direction of travel is a future of concrete governmental adoption of the fintech revolution. In November, the Biden Administration clearly indicated that it would like to regulate stablecoins (digital assets designed to maintain a stable value relative to the U.S. dollar).[15] Notably, the SEC under Chairman Gary Gensler has brought a number of enforcement cases against initial coin offerings and in December explicitly stated his views of the future of regulation of blockchain-related transactions: "Few technologies in history, since antiquity, can persist for long periods of time outside of public policy frameworks."[16] The convergence of the regulatory state with the fintech revolution is already underway with the emergence of chartered banks that serve as a segue between various disruptive technologies. Furthermore, given the importance and global relevance of these developments, we believe there will continue to be regulatory activity and associated innovation in other geographies, with Europe and the Middle East being of particular interest to us. EJF has focused on banks and financial institutions that are leaders in facilitating the infrastructure and transition from traditional to digital currencies, decentralized payment architectures, and seamless transaction integration for consumers and retail operations.

Our third thematic observation is that the revolutions in fintech and blockchain technologies will accelerate the consolidation of the banking industry in the U.S., with regulatory resistance to consolidation

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[13] See https://www.forbes.com/sites/jasonbrett/2020/11/17/exclusive-occ-chief-brian-brooks-says-payments-charter-is-ready-more-crypto-banks-coming-soon/, See also https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-6.html
[14] See https://www.sec.gov/divisions/marketreg/mr-noaction/2019/paxos-trust-company-102819-17a.pdf, see also https://www.reuters.com/technology/cryptocurrency-firm-paxos-apply-clearing-agency-license-2021-04-06/#:~:text=April%206%20(Reuters)%20%2D%20Cryptocurrency,in%20which%20Credit%20Suisse%20(CSGN.&text=The%20trades%20marked%20the%20first,in%20the%20U.S.%2C%20Paxos%20said .
[15] The President's Working Group of Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, "Report on Stablecoins"
[16] Wall Street Journal CEO Council, December 12, 2021.

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only affecting the largest regional and money center banks. The steady drum beat of bank consolidation has been a recurring theme since the 2008-09 Global Financial Crisis, where we saw an average of 5% of banks being merged out of existence each year up until the 2020 onset of the pandemic. When the pandemic hit the shores of America that year, the merger activity expectedly decreased as banks instead sought to raise low-cost debt as a buffer to the unknown. In 2021, the aforementioned widespread adoption of digital currencies and online banking by the public underscored a need of existing banks to embrace non-branch technology solutions. Banks understand that they must either adopt technology innovation or agree to merger with another bank to achieve the scale necessary to be able to do so. This recognition, and the ready availability of capital, reignited merger activity in 2021 with 208 banks being merged out of existence.[17] We would expect this activity to continue unabated for the foreseeable future. Senator Elizabeth Warren (D-MA) and her protégé, Rohit Chopra at the Consumer Financial Protection Bureau ("CFPB"), have encouraged greater scrutiny of bank mergers by the FDIC, but that scrutiny does not apply to sub-regional sized banks, where the vast majority of merger activity takes place. Although it has been our view that regulators want a floor on the number of banks in the economy for competitive reasons, however the consolidation of the industry will be an unrelenting theme for years ahead.

Our last outlook observation for 2022 is one related to social change. We believe that the tangible steps taken by Congress in 2021 to promote the interests of communities underserved by capital and financial innovation over the past four years will not be a fleeting mission of the federal government. Instead, we believe that this focus on wealth and income disparities will continue, in particular in the area of access to capital. The most tangible step in 2021 along these lines was the creation of the Emergency Capital Investment Program ("ECIP") program, which allowed minority depository institutions ("MDIs") and Community Depository Financial Institutions ("CDFIs") to obtain access to permanent capital at rates below that available in the open market to other financial institutions (approximately 0.5% to 2%). The creation of this program, for which EJF strongly advocated, reflects a breakthrough understanding on the part of Congress that access to permanent capital, not deposits, has a multiplier impact on the communities and people that MDIs and CDFIs serve. We believe this program will do what it was intended to do: decrease the level of inequality in our country one loan and one resulting job created at a time. The ECIP is being accompanied by other initiatives, including the Federal Deposit Insurance Corporation's decision to sponsor and facilitate a Mission Driven Bank Fund by encouraging private institutional investors to put up capital to invest in financial institutions serving communities like those MDIs and CDFIs serve. Significantly, our opinion is that the desire to promote access to capital in such communities is bipartisan in nature and therefore will be part of a multi-year movement. Although the ECIP program was included in the Consolidated Appropriations Act of 2021 signed into law by President Biden, the Act received bipartisan support with many Republicans in the House and Senate supporting it along with their Democratic colleagues.[18] This very laudatory bipartisan action followed another such intentional bipartisan action with the creation of the Opportunity Zone Fund program included in the Trump Administration's 2017 Tax Cut and Jobs Act. Although not without its critics, the Opportunity Zone Fund program has resulted in an estimated $75 billion of investments in some of the poorest census tracts

[17] S&P Capital IQ Pro as of 12/31/21
[18] See https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program

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in America and was supported by a broad bipartisan coalition led by Senators Corey Booker (D-NJ) and Tim Scott (R-SC).[19]

Finally, we believe that there has also been a breakthrough understanding among federal government officials that technology can also be part of the solution for communities underserved by access to capital.[20] Banks and non-bank lenders alike are increasingly adopting technology that facilitate making loans to a broader group of people and many such tools decrease the friction costs associated with last-generation underwriting as well as physical branch-based lending. Again, although there are critics of such technology, EJF believes that the direction of travel is their continued adoption and regulatory acceptance as necessary for the financial services ecosystem. That is in part why EJF's SPAC, EJF Acquisition Corp., elected to enter into an agreement in September to acquire Pagaya Technologies Ltd., a Tel Aviv based technology company which uses artificial intelligence to increase the breadth of loans made by its bank and non-bank partners.

At EJF, we pride ourselves on seeking every day to provide our clients with not only attractive financial performance, but actionable intellectual capital. We hope that you have found this 2022 Thematic Outlook a thoughtful consideration of broad regulatory and investment trends we anticipate in the future.

We wish you and your families a happy and healthy New Year.

Neal J. Wilson
Co-Founder and Co-CEO

[19] See https://www.scott.senate.gov/media-center/press-releases/new-report-75-billion-committed-to-opportunity-zones

[20] See https://www.forbes.com/sites/jasonbrett/2020/11/17/exclusive-occ-chief-brian-brooks-says-payments-charter-is-ready-more-crypto-banks-coming-soon/

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