Don't Paint with a Broad Brush!

Why U.S. Bank and Insurance Credit Should Not be Bucketed with the Broader Credit Markets, Including High Yield and Leveraged Loan Markets

- U.S. bank and insurance debt is uniquely positioned in comparison to the broader credit markets
- U.S. banks and insurance companies are strongly capitalised and well-positioned to weather recessionary pressures
- Sector consolidation and increased profitability for US banks and insurance companies may drive further performance
- Consequently, concerns surrounding certain debt instruments, especially high yield and leveraged loans, have minimal correlation to bank and insurance issuers
- EJF Capital sponsored securitisations (U.S. banks and insurance) differ from broadly syndicated CLOs

Dear Shareholders,

As a response to recent reports concerning certain credit markets, specifically the high yield ("HY") and leveraged loan ("LL") markets, we wish to underline the key differentiating factors between these markets and the U.S. bank and insurance company debt to which EJF Investments Limited ("EJFI") is exposed.

In recent months, HY and LL markets have come under stress, as regulators have publicly articulated concerns and investors have begun to pull money from these markets. On November 28, 2018 the Federal Reserve expressed its concern in its Financial Stability Report thus, "Asset valuations appear high relative to their historical ranges in several major markets, suggesting that investor appetite for risk is elevated. Spreads on high-yield corporate bonds and leveraged loans over benchmark rates are near the low ends of their ranges since the financial crisis" (FSR, page 9). Such expressions of concern have contributed to negative investor sentiment. According to a January 3rd article in Bloomberg, "It was the seventh straight week of outflows [from mutual funds and ETFs invested in the LL market], all of which exceeded more than a billion each, and the longest negative streak in a year. Last week saw an outflow of $3.5 billion, the largest outflow to date. There has been $15.7 billion withdrawn from loan funds since Nov. 21, [2018] Lipper data show."

How do these clearly negative market developments affect EJFI? Indirectly, credit concerns in one area of the debt markets inevitably affect credit spreads in other areas. But it is important to understand the differences between the HY and LL markets and the U.S. bank and insurance credit markets. As the Federal Reserve observed in the same November Report referenced above, "banks have strong capital positions … and insurance companies have also strengthened their financial position since the crisis"[1] . More specifically, the following two observations by the Federal Reserve in the same report are noteworthy and in stark contrast with the alarm bells being rung in connection with the HY and LL markets:

[1] https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf

- "Leverage at financial firms is low relative to historical standards, in part because of regulatory reforms enacted since the financial crisis. In particular, regulators require that banks— especially the largest banks —meet much higher standards in the amount and quality of capital on their balance sheets and in the ways they assess and manage their financial risks. A greater amount and a higher quality of capital improve the ability of banks to bear losses while continuing to lend and support the economy".

- "Capital ratios for the larger banks are well above levels seen before the financial crisis. . . . Regulatory capital ratios also exceed the fully phased-in enhanced minimum requirements plus regulatory buffers. Banks appear well positioned to maintain capital through retained earnings as profitability has advanced beyond post-crisis lows on account of increased net income and lower tax rates. The scenarios used in the supervisory stress tests routinely feature a severe global recession, steep declines in asset prices, and a substantial deterioration in business credit quality. The results of the most recent stress test released in June by the Federal Reserve Board indicate that the nation's largest banks would be able to continue to lend to households and businesses even during such a severe scenario".

Just this past week, on January 3rd, the Chair of the Federal Deposit Insurance Corporation, Jelena McWilliams, echoed the Federal Reserve's observations in discussing smaller banks with Reuters: "Banks are well capitalized. **Actually, they are superbly well capitalized at this point in time. Nothing that happened in December gave us concern**."[2]

Strong HY and LL performance that led to recent performance peaks was contributed by recent historic low spreads, default rates, and costs of borrowing (due to low rates) fuelled by higher leverage. All these dynamics may be shifting. By way of contrast, smaller U.S. banks and insurance companies which collateralise much of EJFI's balance sheet, benefit from peak capitalisation levels and lower balance sheet leverage as regulatory initiatives and an increasing rate of consolidation have served to materially strengthen the sector in the wake of the Global Financial Crisis. Consequently, current default rates are at recent historic lows and in our estimation are of far lesser concern in comparison to other non-financial corporates, as these institutions have capitalised themselves significantly to absorb losses, even in the Feds' stress tests scenarios.

Indeed, despite certain deregulatory initiatives undertaken by U.S. regulators, we believe that banks and insurance companies remain strongly capitalised to absorb any potential future losses that may occur in a recessionary environment as, in addition to strong balance sheets, underwriting standards in the regulated sector remain robust. Furthermore, we believe another key difference is that higher USD interest rates benefit banks and insurance companies in stark comparison to many HY and LL borrowers which tend to suffer under the pressure of higher debt obligations.

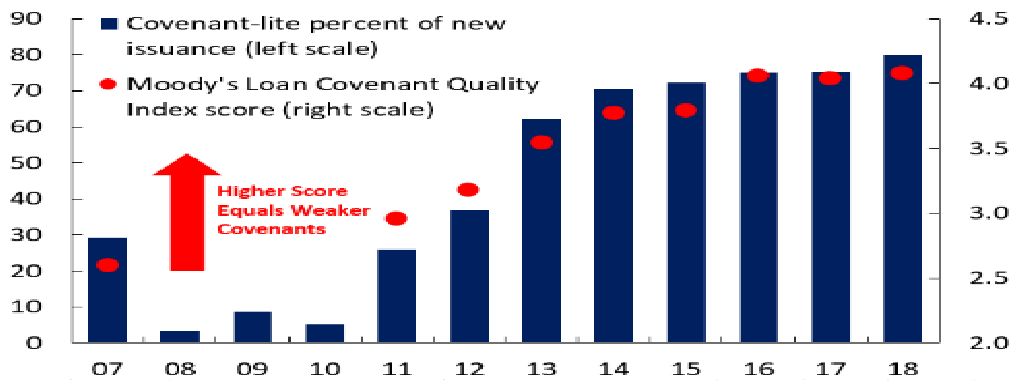
[2] https://www.reuters.com/article/us-usa-fdic-interview/fdic-chair-says-no-concerns-about-us-bank-health-amid-market-turmoil-idUSKCN1OX1OZ

HY and LL Market Concerns:

1) Weakening loan covenant quality since the Global Financial Crises:

   Moody's Loan Covenant Quality Indicator (LCQI) finished 2017 with its weakest yearly score on record, suggesting that leveraged loan investors may face significant future risks. The covenant quality of North American leveraged loans also weakened slightly in the second quarter of 2018, and is close to its all-time record lows, Moody's Investors Service says in a new report.[3] Moody's Loan Covenant Quality Indicator uses a five-point scale, in which 1.0 denotes the strongest covenant protections and 5.0, the weakest. Vanishing covenant protections expose investors to rising risk as they forfeit traditional means of recourse when a borrower comes under financial stress. While we have seen a rapid growth in the HY and LL markets over recent years, we have also witnessed a rise in loosening of covenants. To illustrate, 'covenant-lite' (defined as no maintenance covenants) loans represented less than one fifth of the loan market in 2010. Today, they now account for more than three quarters of the total loan market (please see the graph below).

Less investor protection
The volume of loans with fewer investor protections, known as covenants, has grown in the United States, and quality has weakened.
(percent of issuance)



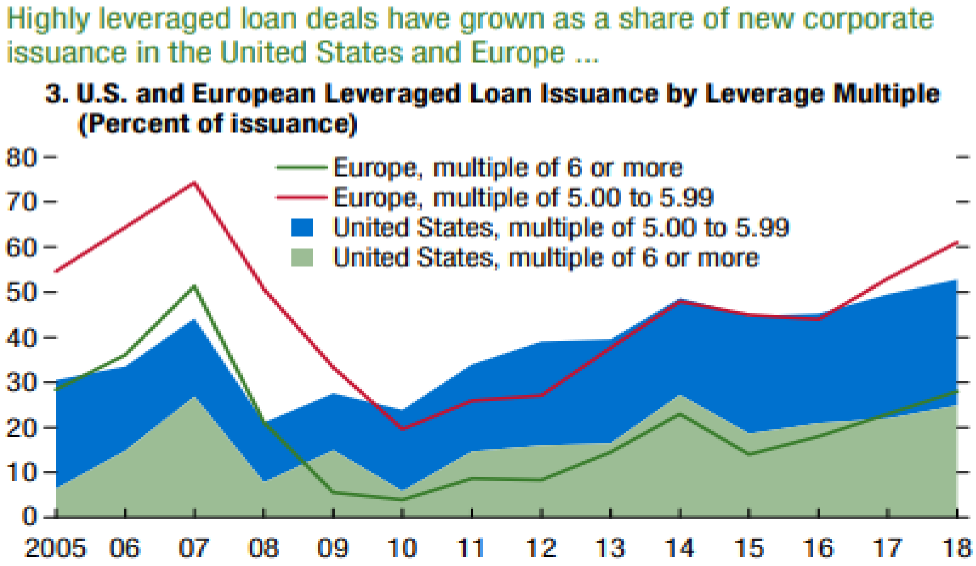
Source: Standard & Poor's Leveraged Commentary and Data; IMF staff calculations; and Moody's.
Note: 2018 data is through Q3. Moody's Loan Covenant Quality Index score is a yearly average; data are unavailable from 2008 to 2010 due to lack of rated leveraged loan issuance.

As such, while these markets have performed strongly, as the rates, credit and macro environments evolve, this may not remain the case.

2) Leverage and rising interest rates:

[3] https://www.moodys.com/research/Moodys-North-American-loan-covenant-quality-nears-record-low-in--PR_390827

We have witnessed a dramatic increase in balance sheet leverage within the HY and LL markets as borrowers have capitalised upon the low interest rate environment and an increased willingness to lend, which has been complimented by the fast-growing CLO markets. The charts below represent the leverage increase as depicted by the International Monetary Fund's Global Financial Stability Report, issued in October 2018.



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While certain borrowers have benefitted from locking in low fixed interest rates, many are exposed to floating rate debt. As we continue to see a higher rate environment in the US, debt burdens could increase while stressing the debt coverage ratio for some borrowers. We understand many of the borrowers should benefit from a robust economy; however, given the tight spread between current default rates and credit spreads in the HY and LL markets, we believe the market is pricing in little margin for error. We are concerned that should default rates tend towards their 15-year average of approximately 3-4%, we could see spread widening across both sectors.

The Federal Reserve also observed in its November 28th Financial Stability Report a linkage between LLs and the growth of CLO issuance:

- "A type of securitization that has grown rapidly over the past year is CLOs, which are predominantly backed by leveraged loans. Amid the general deterioration in the underwriting standards on leveraged loans… gross issuance of CLOs hit $71 billion in the first half of 2018. This pace represents an increase by about one-third compared with the same period last year, and CLOs now purchase about 60 percent of leveraged loans at origination. It is important to continue to monitor developments in this sector"[5].

Finally, we note that there have been suggestions that the calculations used to calculate leverage may, in some cases, have become increasingly lenient. Specifically, Earnings Before Interest, Taxes, Depreciation and Amortisation ("EBITDA"), a broadly used cashflow proxy, is often used in leverage

[4] International Monetary Fund's Global Financial Stability Report, issued in October 2018.

[5] https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf

calculations. There are reports of “add-backs”, being used to inflate EBITDA, and hence optically reduce leverage metrics (LeveragedLoan.com, S&P Global Market Intelligence, 23rd Oct 2018).

Collateralised Loan Obligations (CLOs) in Comparison to EJF Capital LLC (“EJF”) sponsored Bank and Insurance Collateralised Debt Obligations (CDOs):

Underlying Collateral:
Certain CLOs tend to focus on debt issued by leveraged loans and high yield, usually sub-investment grade. EJF CDOs are backed by highly regulated banks and insurance companies, usually investment grade equivalent. Traditionally, banks and insurance companies are more leveraged than credits backed by CLOs as their business models differ. Therefore, banks and insurance companies are heavily regulated especially post the 2008 global financial crisis, as regulators have pushed to ensure similar bank crises do not reoccur.

Leverage:
Traditional CLOs can be leveraged by multiple debt tranches with debt to equity leverage ratios up to 9x-10x. The leverage of EJF sponsored CDOs has been significantly lower, yet able to generate comparable returns in our view.

Reinvestment:
CLO managers can reinvest cash inflows into new loans during an initial period of two to five years. This allows the manager discretion on new assets, while remaining within certain thresholds, and more importantly maintains peak exposure to any potential credit cycle within the reinvestment period. EJF sponsored CDOs are static securitisations with no reinvestment, as cash inflows received are distributed via a waterfall. This allows investors full knowledge of the risk they are exposed to on day one.

Interest Rates:
A rising rate environment tends to increase the debt burden for HY and LL issuers. By contrast, rising rates generally increases the profitability of banks and insurance companies.

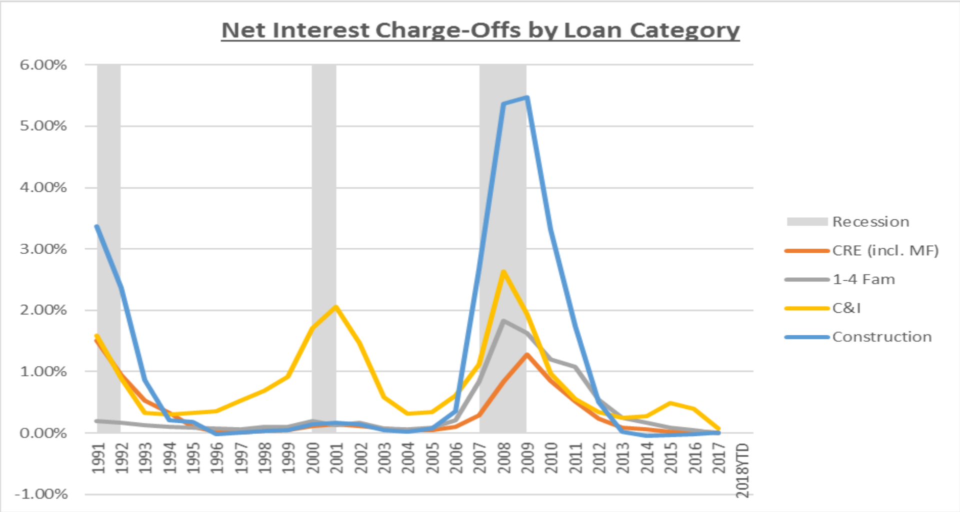
US Banks and Insurance Companies:

The highly regulated banking and insurance sectors have undergone systemic changes post the 2008 global financial crisis and have peak tangible capital ratios supported by attractive deposit franchises.

Due to various, important, regulatory initiatives taken by US regulators, the small and medium sized banks in the U.S. are taking advantage of robust economic growth, rising interest rates and an optimisation of their capital structure. This is serving to drive strong profitability, growth and yet more consolidation, which has created an even stronger sector. We believe this virtuous cycle has much further to run.

Fears of a U.S. economic recession continue to loom while fundamentals remain strong. We maintain our view that US small and medium sized banks and insurance companies offer growth and consolidation opportunity, which offers a unique investment opportunity to investors.

Vitally, while we continue to see banks benefitting from the Regulatory Relief Bill, passed in May 2018 (please click on link to read manager commentary [click here]), we believe asset quality within these banks remains very strong and benign. While the regulation may be incentivising banks to consolidate and grow, we believe they remain very cautious with respect to asset quality. A sizeable amount of small and medium sized banks and insurance companies have little to no exposure to HY or LL. The banks' balance sheets are simple and transparent, with exposure mostly to commercial real estate ("CRE"), single family mortgages, and commercial and industrial loans ("C&I"). Historic data (below charts) shows in an ordinary recession the default rates have been manageable as the borrowers tend to be less leveraged and more conservative in comparison to LL and HY markets.



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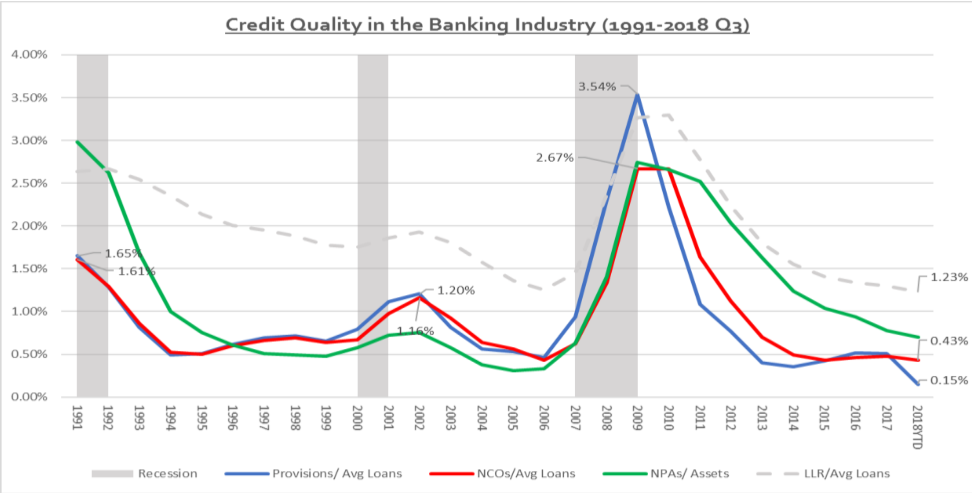
[6] EJF Calculations



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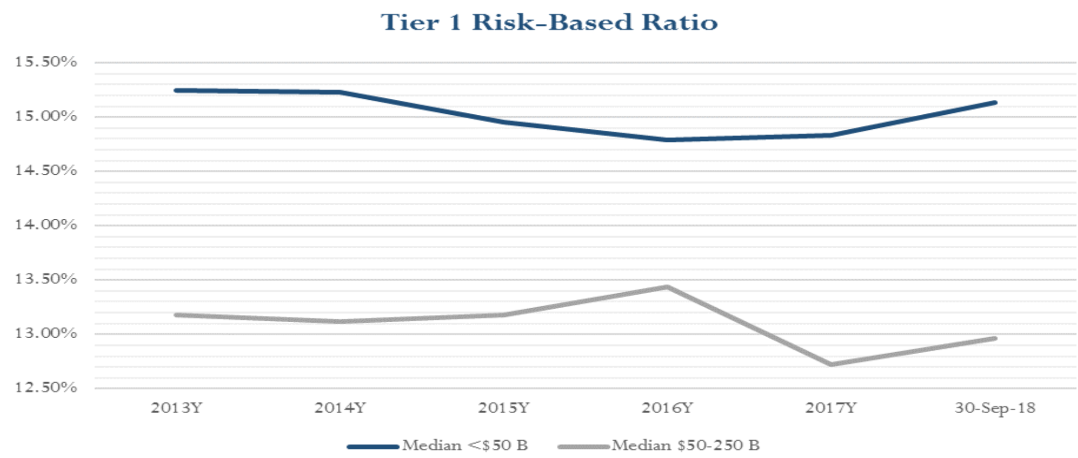
Capital:

Community and regional banks continue to be well capitalized with the median Tier 1 risked based ratio for banks below $50bn being over 15% at Q3 2018 and the leverage ratio (tangible core equity/tangible assets) being over 10%. This compares to 13% and 10% respectively for banks with assets between $50bn and $250bn



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Asset Quality:

Despite small and medium sized banks benefitting from increased loan growth, the average non-performing asset ratio for community banks was just 0.65% in Q3[9]. This represents an historic low. However, we have seen certain lenders see some initial stress in limited, specific areas and asset

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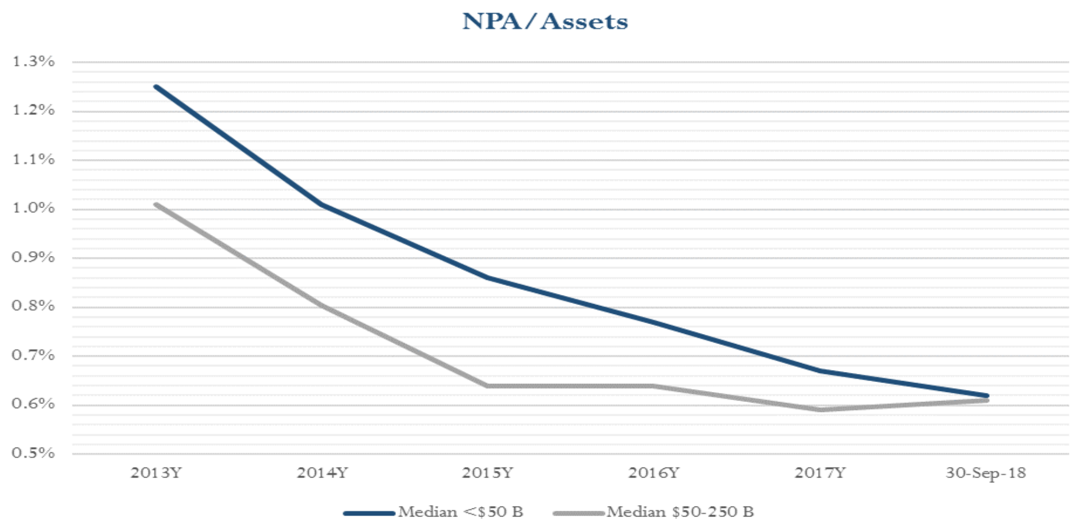
[7] EJF Calculations

[8] EJF Calculations

[9] EJF Calculations

classes, but given the very strong capital ratios the banks possess, we believe these banks are well-positioned to absorb any moderation of the credit cycle. Overall, we see very strong underwriting standards at US banks given they want to avoid the mistakes of the past and that regulation is much tighter in many areas. One research report issued on 7th January 2019 suggests, "a moderate recession" would result in an additional, but manageable, 0.50% in losses on the balance sheets of regional banks. One would expect a similar magnitude of loss increases to smaller community banks.



Conclusion:

While the HY and LL markets have benefitted by strong performance over the past few years, we believe certain characteristics of the sectors suggest they are entering a mature stage. EJFI's exposure to US banks and insurance companies, in our view, represents a different, carefully selected exposure. Banks and insurance companies directly benefit from the rising rate environment and the growing U.S. domestic economy.

These institutions have been through a period of beneficial cleansing and transformation since the Global Financial Crisis, largely driven by improved prudential regulation. We believe they remain in a position to benefit from the strong tailwinds of a robust U.S. economy underpinned by regulatory initiatives that favour small and medium banks.

Thank you,

Neal J. Wilson

Chief Executive Officer

EJF Investments Manager LLC

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