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# BankNews

Serving the Central States

## Feature Story

### Capital Quandary

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Community banks are facing a conundrum. The FDIC, state bank regulators and auditors are pushing these financial institutions to increase capital positions. At the same time, there's significant pressure on banks to lend, at least when government investment is involved. Mark-to-market accounting, the dreaded "M" word that is finally being discussed but is far from being resolved, has weakened many banks' capital structures.

The financial services sector is being vilified for the sins of the few and also for economic circumstances that couldn't have been predicted based on any prior experience. Yet, at a time when capital is sorely needed, the lack of activity in traditional capital markets has severely limited banks' capital-raising options. However, there are budding capital-generating opportunities, some of which aren't from the traditional sources. Forward-thinking community bankers can do themselves a favor by starting to explore alternatives.

The tight controls, high-touch approach to markets and customers and disciplined underwriting practices at many community banks can give them a decided advantage in a difficult economy and a head start in an economic recovery. Thinking ahead about future capital requirements is one way they can help ensure they're well-positioned to participate in an economic recovery.

### The Government

Bankers are well aware the government has sent mixed messages about capital adequacy, lending levels and the preferred use of government capital. The Treasury is offering banks taxpayer capital and telling them to use the funds to lend wisely and help stimulate the economy. The problem is banks have been backed into a corner with regulators demanding greater capital cushions, while mark-to-market valuation adjustments are negatively impacting a bank's ability to raise additional capital, lend money and meet or exceed regulatory capitalization requirements.

### Mark-to-market accounting

was reintroduced in 2007 with the worst possible timing. Just as the real estate crisis began to unravel, FAS 157 was put into place. Of many consequences, one is that FAS 157 is forcing banks and mortgage lenders to try to unload non-performing assets as quickly as possible, at any value, to meet capital adequacy requirements.

Mark Sunshine, president of First Capital, a senior secured lender based in Florida, explained that mark-to-market accounting "... assumes that markets are perfect and efficient. It does not make sense to mark an asset not held for sale, especially when a corporation plans to hold the asset to maturity."

With fair value accounting and other factors driving the hunt for capital, the Treasury's offer of capital through its Capital Purchase Program or the Capital Assistance Program, introduced in late February, provides an alternative, albeit imperfect.

Although many community bankers are ambivalent about government-provided capital, bolstering the balance sheet is compelling, particularly with a lack of funding alternatives. However, even banks that have received or will receive government capital will eventually have to pay it back or replace it.



"For reasonably or well-capitalized community banks seriously thinking about accessing government programs for incremental capital, we would strongly recommend a thorough analysis that addresses not only the full financial impact of taking government money, but also the consequences of associated regulation on areas such as capital management and corporate governance going forward," said Thomas Romano, a partner with Parsippany, N.J.-based McConnell Budd & Romano, a strategic advisor to community banks. "The fact that the rules and conditions continue to evolve also needs to be given serious consideration.

"While the traditional capital markets remain largely frozen, we think now is an appropriate time for bank executives to start thinking about developing sources of private capital, either to strengthen their balance sheet, or potentially replace CPP funding."

## **Private Capital**

One of the more interesting trends we have seen is on the private equity side. While not historically major players in funding the financial services sector, many of these funds and firms recognize the tremendous value opportunities presented by well-run, publicly held community banks whose share prices have been pulled down by the sector's vortex. These firms aren't immune to the markets' downward spiral, yet many have conserved their capital and are positioned to make strategic investments.

Even private equity firms that traditionally take only control positions are entertaining the possibility of making selective non-controlling investments in community banks. A key is to demonstrate to these investors how a bank's basic operation is consistent with their investment criteria. For instance, an equity firm seeking companies that are market-share leaders and have a demonstrable competitive advantage can easily make the logical leap to a community bank that's a local or regional leader and which has a tested ability to build market share and grow revenues, earnings, core deposits and assets. Some private equity firms are keeping an open mind about the size of their positions and financing supported by public sector assurances.

Certain private equity investors are already bank holding companies and understand banking and regulation. For investors who don't know the ins and outs of investing in financial institutions, bankers have the opportunity to start networking and educating about relevant regulatory and bank-specific issues.

"Although bank stocks have been pounded, it's very difficult to establish accurate valuations," said Romano. "A lot will depend on management's ability to explain to potential investors their business model, market opportunities, anticipated return on equity and their asset strength, including the inherent value of investments that may currently be illiquid and under water."

In this regard, community banks have an advantage over larger, more-complicated institutions. Their income statements, balance sheets and business models are more straightforward and easier for non-bank investors to analyze and value. Senior management has direct involvement with lending decisions. If a potential private equity investor has questions or concerns, management can provide a thorough and detailed response. To prepare for these types of conversations with investors, bankers can develop a support network of financial and legal experts.

The Fed's 2008 increases to ownership caps that trigger bank holding company requirements has made the prospect of a meaningful ownership position more appealing to private equity firms. With non-holding company ownership now capped at 33 percent instead of 15 percent, and allowing for 15 percent positions in two or more types of equity to reach that limit, plus as many as two board seats and more dialogue with management, private equity investors may feel on more familiar turf.

Another capital alternative for community banks, especially those with key long-term shareholders who are familiar to management, is to approach those stakeholders about taking an expanded position. Many community banks have these valuable individuals or firms as part of their investor base. Although new equity financing inevitably dilutes all shareholders, those holders may be more amenable to dilution if they are able to expand their positions in the process.

The current economic and capital scene is enough to frustrate even the most optimistic managers. It also presents the opportunity for forward-thinking bankers to examine reasonable alternatives for generating necessary capital.

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