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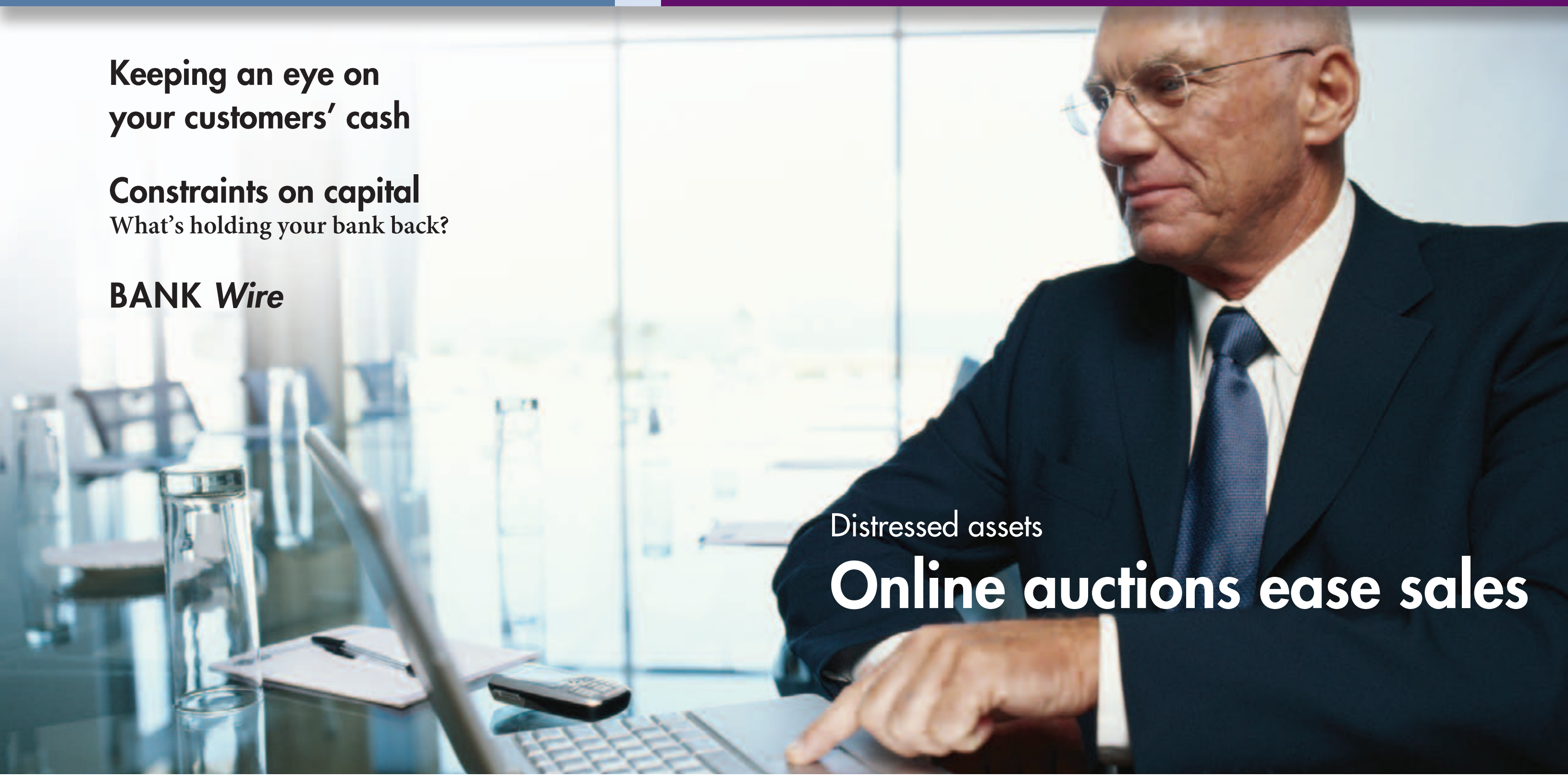

Keeping an eye on your customers' cash

Constraints on capital
What's holding your bank back?

BANK *Wire*

Distressed assets
Online auctions ease sales

P&G Associates

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Distressed assets

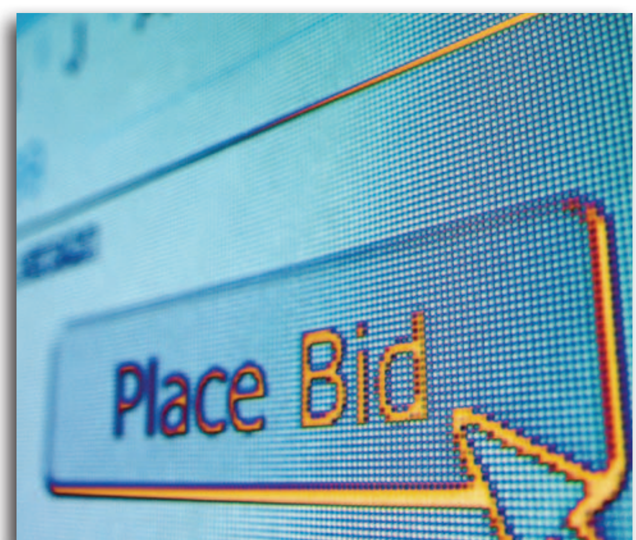
Online auctions ease sales

If your bank is looking to sell troubled loans to improve its balance sheet, consider online auctions as a part of your strategy. These auctions can streamline the sales process and expose your bank's distressed assets to a large pool of potential bidders.

But this sales avenue is no panacea for your balance sheet problems. Online auctions require careful due diligence. Alternative solutions, such as discounted payoffs or sales to borrowers, may be more effective for your bank.

Who's holding them?

Many Web sites offer fee-based online auctions for distressed loans, including firstfinancialnet.com, esloansales.com and bigbidder.com. And apparently there's no shortage of investors interested in buying these loans. According to intermediary Jones Lang LaSalle, which runs jll.auction.com in partnership with Real Estate Disposition, LLC, it sold $200 million of primarily nonperforming notes in May, with average recovery rates of more than 50% of the aggregate unpaid principal balances.



And online auction house DebtX.com reported that it sold a $306 million portfolio of mostly nonperforming multifamily loans on behalf of HUD, recovering 48% of the unpaid principal balance. DebtX also conducts auctions on behalf of the FDIC.

Some intermediaries permit sellers to conduct self-directed sales of individual loans or pools of loans.

How does it work?

Acting as intermediary, the auction house allows investors to register on its Web site and apply to become approved bidders. Banks and other sellers post information about their loans — loan documents, borrower financial information, appraisals — in a secure "data room." Investors conduct due diligence using this information and bid on the loans they're interested in purchasing.

Intermediaries typically e-mail auction alerts to prospective buyers and provide other marketing services. In addition, some intermediaries permit sellers to conduct self-directed sales of individual loans or pools of loans. This gives the sellers access to an online marketplace of qualified buyers while allowing them to set the sale's timing and other terms.

How can you minimize your risk?

Online auctions can be a cost-effective strategy for selling distressed loans, but they still require a relatively long lead time to solicit potential buyers and allow for seller and buyer due diligence. Exercise caution when selecting loans to put on the auction block. Investors choose the specific loans they bid on, so after the auction your bank may end up with the worst loans of the bunch.

Also review the intermediary's standard sale documents carefully. Don't hesitate to ask for modifications of the seller's representations and warranties, the buyer's assumption of liabilities for the purchased loans or other provisions that can give you extra protection.

Finally, be sure to conduct your own due diligence. To reduce your liability, make sure the files you post to the data room are complete and well organized. Review each loan, with the assistance of your legal and financial advisors, to identify potential breaches of representations and warranties. Then make the needed modifications to the sales documents.

Explore your options

Online auctions can be a valuable tool for selling distressed assets, but it's important to evaluate other options, each of which has certain advantages. For example, if feasible, a bulk sale of your portfolio can make it easier to sell your least desirable loans as part of the price for acquiring more attractive ones. And don't overlook sales or discounted payoffs to buyers, which often produce greater returns. Working with the borrower also can limit your liability because no third parties are involved. ▲

Keeping an eye on your customers' cash

A statement of cash flow can reveal clues about an existing or prospective borrower's performance, especially the owner's ability to manage cash. The statement also can help you assess the business's creditworthiness and associated risk rating by looking for year-to-year variations.

Obtaining current financial information from borrowers — and properly analyzing it — is more important than ever in light of today's regulatory environment. Banks need to regularly evaluate a borrower's ability to repay.

Charting how the cash flows

Always a component of audited financial statements, the statement of cash flows also might be available from other financial statement presentations, such as a compilation or borrower-prepared statement. It consists of three sections:

Cash flows from operations converts the business's accrual net income to cash provided or used by its operations. All income-related items flow through this part of the statement, such as net income; gains (or losses) on asset sales; depreciation and amortization; and net changes in accounts receivable, inventory, prepaid assets, accrued expenses and payables.

Cash flows from investing activities, the second section of the statement, is a primary indicator of solvency. If a company buys or sells property, equipment or marketable securities, the transaction shows up here. This section might reveal that a company is reinvesting in its future operations — or divesting of assets for emergency funds.

Cash flows from financing activities, which is the last section, reveals your customer's transactions with investors and lenders. The section shows the company's ability to access cash via either debt or equity. It also indicates how the company leveraged its balance sheet to avoid cash crunches — one indication of how well it might navigate through a sluggish economy.

Pinpointing changes

The statement of cash flows shows changes in balance sheet items from one accounting period to the next. Make sure you inquire about significant balance changes. For example, if accounts receivable were $2 million in 2008 and $3 million in 2009, the change would be reported as a cash outflow from operations of $1 million. That's because more money was tied up in receivables in 2009 than in 2008.

An increase in receivables is common for growing businesses, but a mounting receivables balance also might signal cash management inefficiencies.

An increase in receivables is common for growing businesses, but a mounting receivables balance also might signal cash management inefficiencies. And an aging schedule might reveal significant, potential loss write-offs. This is important information if you're a lender that relies on accounts receivable as collateral. Be specific with the type of business you're analyzing; in some cases — in a retail operation that's dependent on cash sales, for example — receivables shouldn't grow.

Also beware of businesses that continually report negative cash flows from operations. When operating outflows consistently outpace operating inflows, it's time for intervention.

Getting help

Let's say you spot cash shortages in the statement of cash flows, and you suspect your business customer is struggling operationally. This can impair repayment ability, which hurts the business's credit risk rating with the bank, and subjects the bank to higher reserve balances and added regulatory scrutiny. Regulatory exams have reinforced the need for banks to evaluate the adequacy of current financial information of borrowers on a periodic basis, irrespective of their prior payment history.

You may wish to advise your borrower to consult with their CPA or an accountant to identify the trouble areas and provide suggestions to help improve cash flow. A change in business operations may be a hard pill for an entrepreneur to swallow. But in the short term, you'll likely help your customers find some hidden sources of cash.

Adding value

In a service-oriented, "value-added" marketplace, community bankers who help their loan customers find sources of hidden cash are worth their weight in gold. And your customers surely will appreciate seeing their cash flowing more smoothly. ▲

Constraints on capital

What's holding your bank back?

Managing capital is a challenge for most community banks. Regulatory requirements, though complex, essentially strive to ensure that a bank's capital is sufficient to cushion the blow of unexpected losses. That's done by requiring a bank to maintain specified ratios of capital to risk-weighted assets.

A struggling economy affects bank capital on both sides of the equation: It hurts earnings, which reduces capital, and it increases the level of risk associated with many assets. In addition to general economic considerations, several factors have a direct impact on bank capital levels.

Downgraded securities

Downgraded investment securities have an immediate impact on capital. Ordinarily, the federal banking agencies' risk-based capital rules allow banks to determine the capital requirements for these securities based on credit ratings from nationally recognized ratings organizations. As the rating goes down, the risk increases — and more capital is required.

But special rules apply to direct credit substitutes, including certain mortgage-backed and asset-backed securities. If they're unrated or rated more than one grade below investment grade (that is, lower than BB), a ratings-based approach is no longer an option. Instead, the bank must use a different approach, which usually results in significantly higher capital requirements. A security with a below investment grade rating could be subject to a capital requirement that requires as much as a dollar of capital for every dollar of security owned.

Deferred tax assets

Banks with large loan loss provisions or net operating loss carryforwards often record significant deferred tax assets (DTAs) on their financial statements. DTAs and liabilities generally arise because of differences in the timing of income and expense recognition for tax and financial reporting purposes.

DTAs can have an impact on a bank's capital. Under Generally Accepted Accounting Principles (GAAP), a bank can record a DTA so long as it demonstrates that it's more likely than not that the tax benefits will be realized. It may have to write down a DTA — thus reducing capital — if doubts about future taxable income make realization of these tax benefits less likely.

In addition to accounting rules, regulatory capital standards limit the amount of net DTA a bank can include in Tier 1 capital to the lesser of 1) the amount the bank expects to realize within one year based on its projected future taxable income, or 2) 10% of its Tier 1 capital.

“Onboarding” of off-balance-sheet assets

Accounting standards finalized in 2009 changed the accounting treatment of certain structured finance transactions using special purpose entities and certain loan participations. Previously, banks used these transactions to keep certain assets off-balance-sheet. But now they may have to be moved back to the balance sheet, which can have a negative impact on capital.

For community banks, the biggest concern is the potential impact on loan participations. Under the new accounting standards, loan participations no longer qualify for sale accounting treatment if the participating bank’s principal is repaid before the originating bank’s, or vice versa.

In other words, unless cash flows from the loan repayment are divided proportionately according to the participants’ ownership shares, the originating bank must report the entire loan on its balance sheet. Even though the bank legally sold that portion of the loan to another institution, this action increases its capital requirements.

Impact of Basel III

In September, the Basel Committee on Banking Supervision reached an agreement on tough new capital and liquidity rules — known as Basel III — designed to make global financial systems safer. The agreement is expected to be approved at the November G20 meeting.

The agreement would have a significant impact on bank capital requirements. Among other things, Basel III would:

- Increase minimum risk-weighted capital ratios,
- Add a leverage ratio as a second test of capital adequacy,
- Eliminate certain “soft” capital, including subordinated debt, and
- Exclude certain balance sheet items from capital, including deferred tax assets and ownership interests in insurance companies.

Is your bank on the verge of going public?

Often, the most effective way to raise capital is to issue new stock to investors. But before you do so, check SEC reporting requirements. Even if your bank never makes a public offering of its stock, SEC rules deem it to be a public company if it has more than $10 million in assets and 500 shareholders.

Even for a small community bank, it’s not unusual for the number of shareholders to grow to more than 500 over the years. If that happens, the bank would need to register with the SEC, file annual and quarterly reports, and comply with the SEC’s proxy disclosure rules, all of which involve significant expense.

Basel III’s impact on community banks depends on whether the United States adopts the new standards — and, if so, whether this nation exempts smaller banks from any of the requirements.

Assess your situation

In light of the many constraints on capital today, all banks should conduct a capital-adequacy assessment. Once you know where you stand, you can explore options for boosting your bank’s capital by reducing risk or raising new capital.

One strategy is to sell new stock to investors, but you’ll need to watch out for potential SEC reporting requirements. (See “Is your bank on the verge of going public?” above.) Additionally, your tax and financial advisors can help you assess your capital position and, if necessary, design a capital restoration or strengthening plan to protect your bank in the coming years. ▲

B A N K
Wire

Bank reform — the good, the bad and the assorted

The Dodd-Frank Wall Street Reform and Consumer Protection Act made sweeping changes to U.S. banking law. Many of these changes affect the nation's largest banks. For community banks, some changes help, and some may hurt.

The good

The act benefits smaller banks by improving FDIC coverage, eliminating competitive disadvantages and tightening capital requirements for larger banks. Changes include:

- Basing FDIC assessments on assets rather than domestic deposits, which is expected to reduce assessment rates,
- Permanently increasing deposit insurance coverage to $250,000,
- Imposing strict consumer protection requirements on nonbank competitors, administered by the new Consumer Financial Protection Bureau (CFPB),
- Toughening liquidity standards for the largest banks, and
- Extending through 2012 unlimited deposit insurance coverage for certain non-interest-bearing transaction accounts.

The law also exempts small bank holding companies (those with less than $500 million in assets) from a provision that excludes trust-preferred securities (TruPS) from Tier 1 capital. The exemption also applies to TruPS issued before May 19, 2010, by holding companies with less than $15 billion in assets.

The bad

Several provisions may increase the burden on community banks by limiting their ability to cover the cost of certain services or increasing their compliance costs. Changes include:

- Exempting auto dealers from CFPB jurisdiction;
- Imposing compensation restrictions on publicly traded community banks, giving shareholders a nonbinding vote on executive pay (note that the SEC has the authority to exempt smaller institutions); and
- Authorizing the Federal Reserve Board to cap interchange rates for debit-card issuers. Card issuers that, with their affiliates, have less than $10 billion in assets are exempt.

The act also subjects mortgage lenders to heightened liability for failing to verify a borrower's ability to repay a loan. There is a safe harbor for "qualified mortgages" that meet certain requirements, including points and fees that are less than 3% of the loan amount.

Interstate branching: A mixed bag

The act relaxes restrictions on interstate branching, which can help or hurt community banks, depending on their circumstances. While banks will be able to set up *de novo* branches in other states (subject to restrictions), the act — by eliminating this barrier to entry — exposes banks to increased competition in their home states.

Planning ahead

Your financial advisor can help you sort through the requirements that apply to your bank. Start planning now to reduce the cost of possible fines and other expenses later. ▲

P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

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