

Dealing with Nonperforming Assets To Preserve Capital Long Term

By Bill Sammon and Ken Segal

As the banking crisis grinds on, community bankers are growing weary of the monotonous stream of negative economic news. The status quo now seems to be a distant memory. Virtually all banks must face five very tough challenges: significant write-downs of government-sponsored enterprise holdings, uncertain net core deposit levels, unprecedented bank stock devaluations, a dearth of liquidity and capital, and continued credit portfolio deterioration.

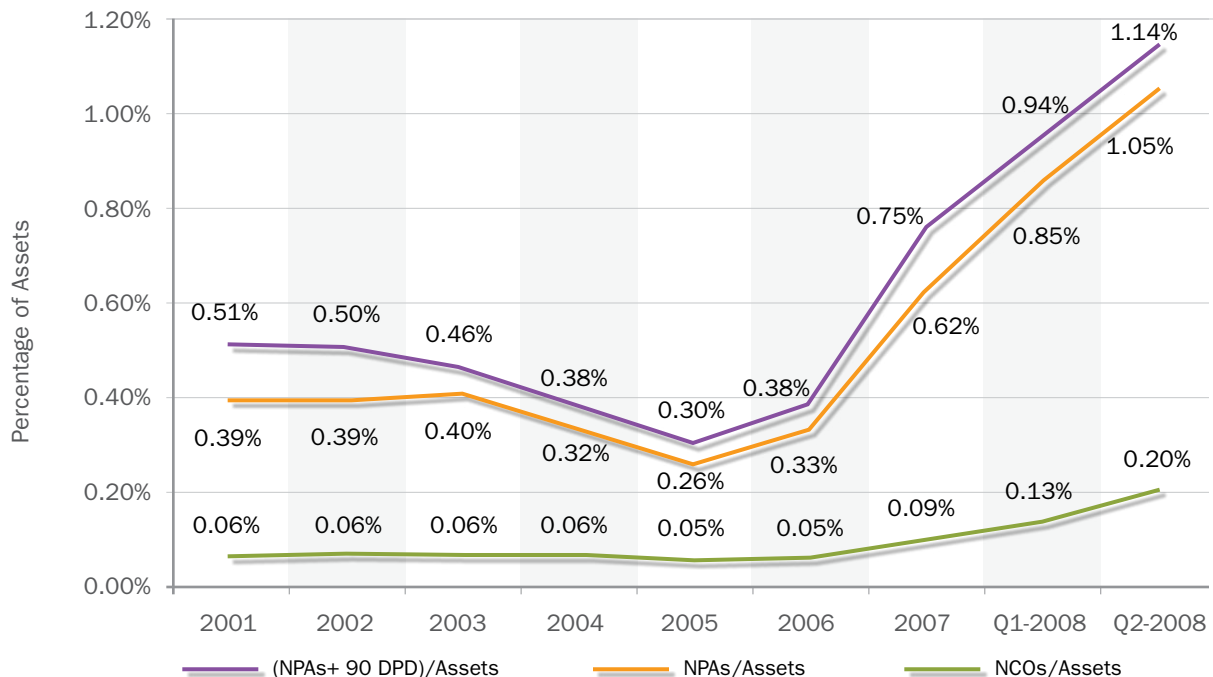
The FDIC's closures of banks—in the double-digits for the first time since 2002—demonstrate that inaction based on eternal optimism of asset appreciation is no longer a viable option.

Over the past several quarters, many community bank executives have reported a significant spike in their nonperforming assets. Based on second-quarter trends, the growth in nonperforming assets continues to far outpace the growth in net charge-offs. Of even greater concern is

FIGURE 1

Source: SNL Financial

NPAs/Total Assets Versus NCOs/Total Assets



the growth of delinquent loan balances—a leading indicator suggesting that nonperforming asset balances should present an ongoing strain for quarters to come.

Figure 1's data represent the ratios of nonperforming assets to total assets, nonperforming assets 90-plus days past due to total assets, and net charge-offs to total assets for publicly traded U.S. banks with assets ranging from \$250 million to \$10.25 billion.

Before our industry can be on the road to recovery, rising nonperforming asset levels must, ultimately, be addressed either through loan work-outs or asset sales, or those assets must be converted to net charge-offs. We use SNL Financial data and discussions with hundreds of bankers, investors, regulators and inter-

ested parties to sort through the current situation and advise our client banks on how to deal with the ongoing crisis.

Banks and savings institutions are structured as regulated and leveraged entities that are entrusted to take in deposits, make loans that will be repaid, manage a net interest margin and generate positive returns to their stakeholders. From an economic perspective, many good lending decisions are required to offset even one bad loan. It is important for banks to rely on credit analysis, recognize potential issues and resolve problem loans as early as possible.

As Figure 2 shows, the surge in nonperforming assets is adversely affecting banks in virtually all regions. The Southeast and the Midwest had been enduring the

Five challenges that all banks must face:

1. Significant write-downs of government-sponsored enterprise holdings
2. Uncertain net core deposit levels
3. Unprecedented bank stock devaluations
4. A dearth of liquidity and capital
5. Continued credit portfolio deterioration.

FIGURE 2

Source: SNL Financial

Median Non-performing Assets / Total Assets (%)

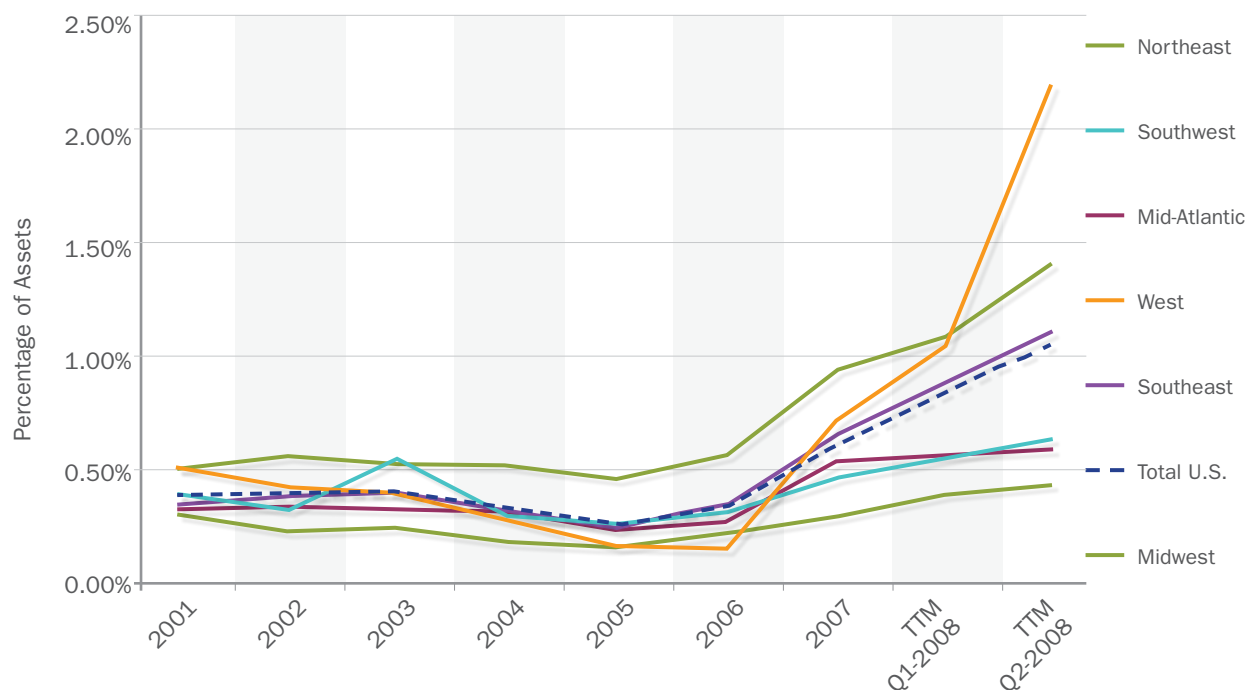
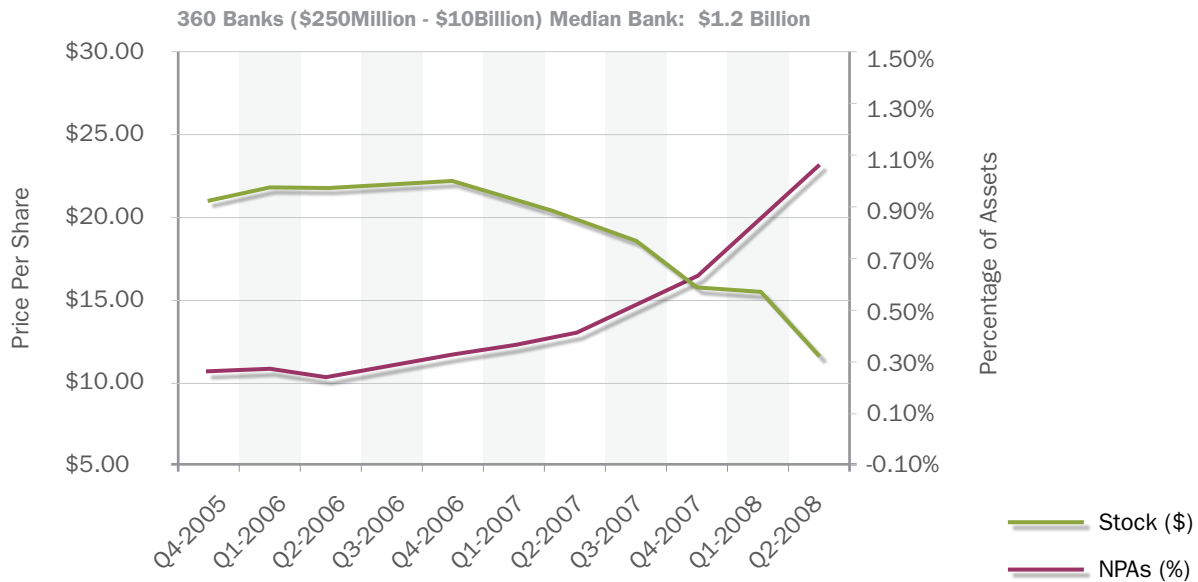


FIGURE 3

Source: SNL Financial

Equity Value Versus Nonperforming Assets



greatest brunt of the economic storm over the last several years, as nonperforming assets in those regions were consistently above the U.S. median (see the blue dashed line in Figure 2).

Of greatest concern, however, are the rapidly disturbing trends in the West, which has experienced a 15-fold increase in

little intent to make the tough decisions is a flawed approach—particularly in the current difficult environment. If banks are to survive and ultimately prosper, they must create proactive game plans, make the tough decisions and tenaciously do what is necessary to ensure their survival.

Do we observe any com-

values are positioning themselves to survive. Surging nonperforming assets industrywide suggest a continued strain on the overall financial system, and the banks that are less aggressive in recognizing their troubled assets and are valuing assets at non-market-driven book values are facing greater scrutiny both internally and externally.

For publicly traded banks, the equity markets offer an objective and impersonal assessment of bank value and health. As Figure 3 suggests, outside stakeholders are valuing banks based on publicly available information on both the bank and its peer group. While the connection is clear, Figure 3 affirms that there remains an inverse correlation between nonperforming assets and the stock price of a bank.

On a national basis, Figure 3 confirms the hypothesis that

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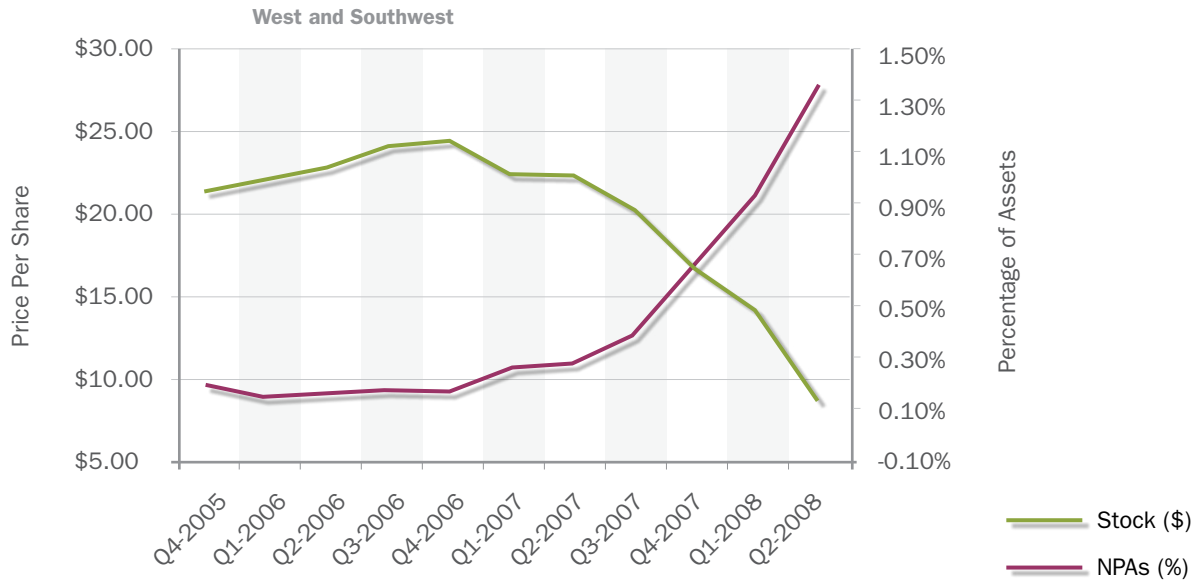
nonperforming assets since 2006 (see the goldenrod yellow line in Figure 2).

Given the rising number of bank failures and regulatory censures and the erosion in both investment and loan portfolios, “evaluating options” with

mon approaches to success? Absolutely.

The banks that recognize their nonperforming assets as early as possible, establish defensible market values for those assets and, ultimately, sell those assets at close to their established market

Equity Value Versus Nonperforming Assets for the West and Southwest Regions



equity values have been negatively affecting banks with rising problem assets. The Western and Southwestern regions of the United States are enduring the greatest level of stress (see Figure 4).

Consequently, many bank executives are better serving their shareholders by proactively addressing nonperforming assets with a greater focus on market rather than book values. Regardless of reported Generally Accepted Accounting Principles (GAAP) equity values, the equity markets already appear to be applying estimates to nonperforming asset values that are reflected in quoted share prices. So the data suggest that greater shareholder value can be created by managing nonperforming assets with relatively less focus on their impact to book equity and more on the arguably more efficient equity markets.

In the ongoing crisis, many banks are facing challenges that are testing their ability to survive. They are struggling to remain solvent, liquid and viable, and most banks now realize that portfolios may get worse before improving.

Now is the time to proactively assess the current and anticipated health of your community bank’s loan portfolio. The banks that can “return to being a bank” will be those that address their problems head-on and aggressively focus on the true valuation and liquidity of their loan portfolios.

So, given the downward valuation of troubled loans and shrinking capital bases, how are banks specifically disposing of their troubled assets?

It is impractical for many banks to withstand the capital charges associated with a complete divestiture of their nonperforming assets. Assuming that those assets range from being slightly

to severely troubled, many banks are opting to divest themselves of their most troubled (and marked down) exposures. By doing so, those institutions are removing their most concerning exposures at market values that are presumably relatively close to their internally marked values.

The ideal result is a reduction in reported nonperforming assets that minimally impacts a bank’s income statement and capital base. **ib**

Bill Sammon is the director of capital markets for ICBA Securities, ICBA’s institutional broker-dealer in Memphis. Reach him at bsammon@icbasecurities.com or (800) 880-4693. Ken Segal is a senior vice president and director of the asset finance services division with Howe Barnes Hoefler & Arnett Inc. Reach him at ksegal@howebarnes.com or (781) 631-2227.