

# Today's AFS Market Overview

October 2008

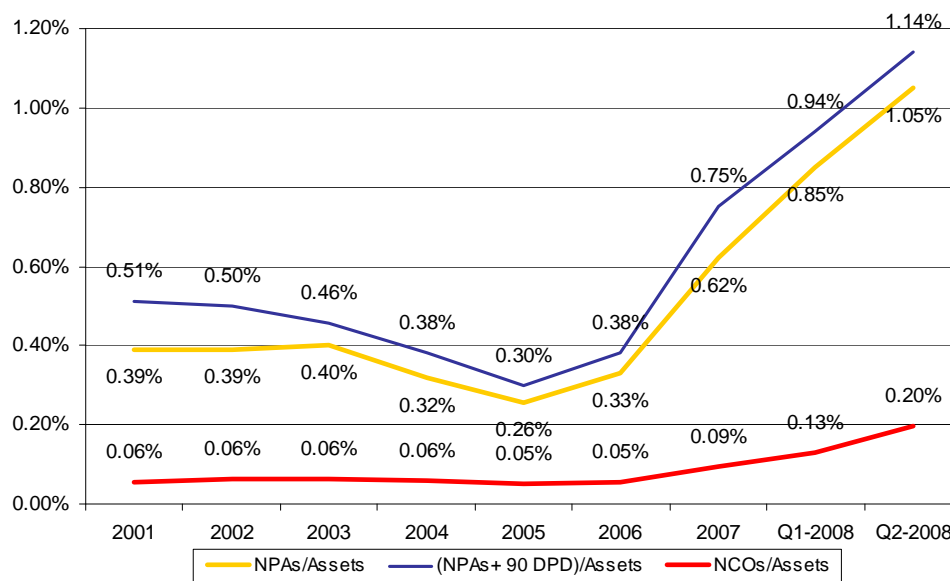
***“He's still alive. They hit him with five shots and he's still alive!”***  
*-- Virgil “the Turk” Sollozzo from The Godfather*

As we enter the closing quarter of 2008, Mr. Sollozzo’s quote could easily be in reference to bank executives who recently concluded meetings with their regulators, board of directors, funding partners, or major shareholders. Yes, *The Godfather* is an epic tale of capitalism, honor, the “art of the deal”, and the inevitability that not all business dealings perform as expected. Unfortunately, we are not at the movies, and the picture playing out in front of us is not on the big screen, but in the very real global economy.

As the current banking crisis continues to permeate throughout every square block of our country, many bankers are fatigued to hear the latest economic news and the status quo seems to be a distant memory. All banks, including *Asset Finance Service’s (AFS, a division of Howe Barnes Hoefer & Arnett)* core community bank clients face very tough decisions with regard to the following issues: significant write-downs of GSE (government sponsored enterprise) holdings, uncertain net core deposit levels, bank devaluations to unprecedented levels, a dearth of liquidity and capital, and credit portfolios that continue to deteriorate. FDIC’s closure of 13 banks at this point in 2008 has demonstrated that inaction based on eternal optimism of asset appreciation is no longer a viable option.

Three months ago, we reported a significant spike in NPAs from our sample of 360 publicly traded community banks. At that point, second quarter NPA levels were not available, but senior bank executives indicated a continued upward trend – the Q2-2008 data supports this ongoing deterioration in credit quality. Based on second quarter trends, the growth in non-performing assets (“NPAs”) continues to far outpace the growth in net charge-offs (“NCOs”). Of even greater concern is the growth of delinquent loan balances – a leading indicator that suggests that NPA balances should be enduring ongoing strain for the coming quarters. The following chart is derived from SNL-sourced data of publicly traded banks across the U.S. with assets ranging from \$250 million to \$10.25 billion.

**NPAs/Assets vs NCOs/Assets**



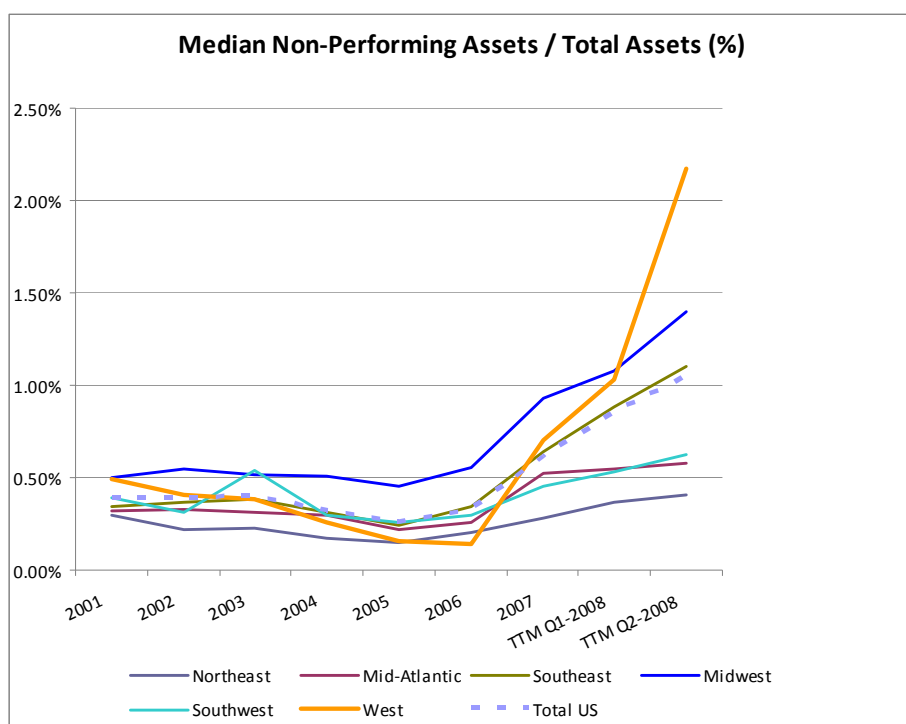
Source: SNL Financial

Rising NPAs must ultimately abate either through loan work-out, asset sales or be converted to NCOs before our peer group can be considered on the road to recovery. This *AFS Market Overview (3<sup>rd</sup> Quarter 2008)* uses both SNL data and the compilation of hundreds of calls with bankers, investors, regulators, and interested parties to sort through the current situation and to advise our client banks how to deal with the ongoing crisis.

***“What did he say, badda-beep, badda-boop, badda-boop, badda-beep, he wants us to send Michael to hear the proposition and the promise is the deal is so good we can't refuse.”***  
*-- Sonny from The Godfather*

Banks 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. It takes many good lending decisions to offset even one bad loan. While the Corleone family had a unique approach to limiting loan delinquency and loss severity, banks must rely more on credit analysis and recognizing potential issues and resolving problem loans as early as possible.

As the following SNL-sourced data suggests, the ongoing surge in NPAs is adversely affecting banks in virtually all regions. The Southeast and the Midwest had been enduring the greatest brunt of the economic storm over the last several years, as regional NPAs were consistently above the U.S. median (the blue dashed line in the chart below). Of greatest concern, however, is the rapidly disturbing trends in the West that have incurred a fifteen-fold increase in NPAs since 2006 (thicker gold line in the chart below).

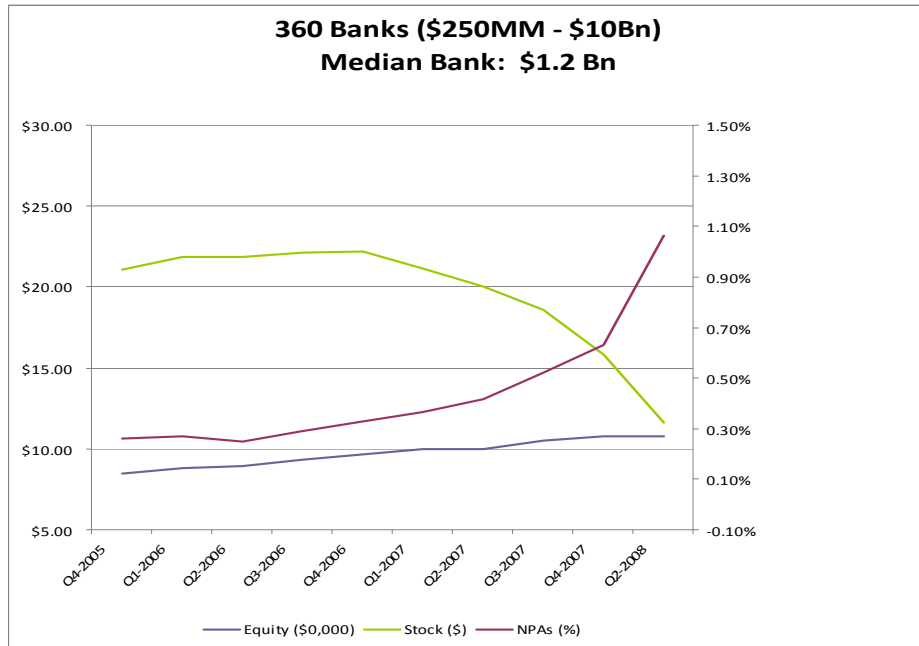


Source: SNL Financial

Given the unprecedented volume of bank failures, regulatory censures, and erosion in both investment and loan portfolios, “evaluating options” with little intent to make the tough decisions is a flawed approach – particularly in the current environment. The banks that should survive and ultimately prosper are those that create proactive game plans, make the tough decisions, and tenaciously do what is necessary to ensure that they can and will survive. Does *AFS* observe any common approaches to success? Absolutely. The banks that recognize their NPAs as early as possible, value these NPAs with defensible market values, and are disposing of these exposures within a magnitude of these values are positioning their firms to survive. Surging NPAs suggest continued strain on the system, and the banks that are less aggressively recognizing their troubled exposures and are estimating values with a bias toward non-market driven book values are facing greater scrutiny both internally and externally.

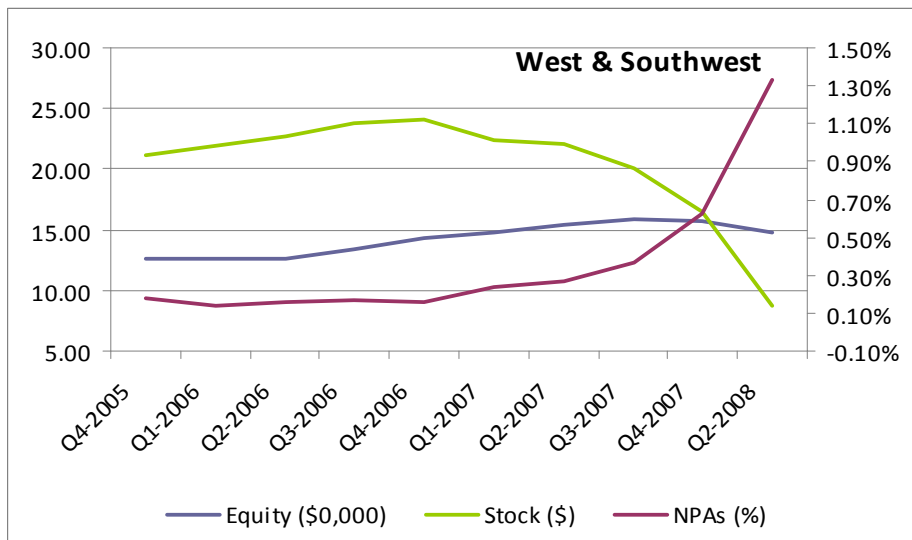
***“You're taking this very personal. Tom, this is business and this man is taking it very, very personal.”***  
*– Sonny from The Godfather*

Ever the pragmatist, Sonny calls it like he sees it. Fortunately, for our publicly traded banks, the equity markets offer a similarly objective and impersonal assessment of value and health. As the following SNL-sourced data suggests, outside stakeholders are valuing banks based on publicly available information on both the bank and their peer group. While simple in nature, this chart affirms the notion that there remains an inversed correlation between NPAs and the stock price of a bank.



Source: SNL Financial

On a national basis, the above chart confirms the hypothesis that equity values have been negatively affecting banks with rising problem assets. On a regional basis, both the Western and Southwestern United States are enduring the greatest level of stress.



Source: SNL Financial

Consequently, many bank executives are better serving their shareholders by proactively addressing NPAs with a greater focus on market than book values. Regardless of reported GAAP equity values, the equity markets appear to be already applying estimates to NPA values that are reflected in quoted share prices. So the data suggests that greater shareholder value can be created by managing NPAs with less focus on their impact to book equity and more on the arguably more efficient equity markets.

***“But, now you come to me and you say ‘Don Corleone, give me justice.’ But you don't ask with respect. You don't offer friendship. You don't even think to call me Godfather.”***

*– Don Corleone in The Godfather*

Don Corleone's approach to business is straightforward, but his demand for respect is a parallel to the respect required to handle today's difficult decisions - particularly to address Non-Performing Assets. Regulators understand the difficult times that face global, regional, and community banks but ignoring the problem has not proven to be an obvious formula for successful interaction to date. In the current crisis, banks are facing challenges that are testing their ability to survive. Bank executives cannot reshoot a scene or compose an ending out of *A Wonderful Life*. Many banks are struggling to remain solvent, liquid, and viable. The realization is firmly setting in that portfolios may get worse before improving. Now is the time to proactively assess the current and anticipated health of your 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.

Given the seemingly daily stream of poor economic news, many bankers are fatigued, impacted by this protracted downturn, and are concerned about the uncertainty that the future holds. In response, we crafted this issue of *Today's AFS Market Overview* to be informative yet entertaining. The references made to this great American classic film are intended as a means to relay our most recent findings with a bit of hyperbole and to generate a few smiles.

So, given the downward valuation of troubled loans and shrinking capital bases, how are banks specifically disposing of their troubled assets? It's impractical for many banks to withstand the capital charges associated with a complete divestiture of their NPAs. Assuming that NPAs range from being slightly to severely troubled, many banks are opting to divest of their most troubled (and marked down) exposures. By doing so, the banks 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 NPAs at a minimum of impact to a bank's income statement and capital base.

In order to optimize the execution and values of these dispositions, banks are seeking the advice of advisors like the *Asset Finance Service* division of *Howe Barnes Hoefler & Arnett*. Liquidity may be tight and sale economics may not be as predictable as in the past but *AFS* remains successfully diligent in serving our clients in a host of asset classes. From selling portfolios for gains to advising on the best strategies for NPA divestitures, *AFS* remains committed to creating successful, market-driven solutions for our clients.

***The Asset Finance Services division of Howe Barnes Hoefler & Arnett provides loan portfolio assessment, advisory and brokerage services as well as expertise in valuing and trading an array of consumer and commercial loan assets for community banks.***

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