

RESOURCE CENTER

May 05, 2008

The Silver Lining: Selling Troubled Assets

From The Bear Companies

By Mindi H. McClure

At first glance, the picture appears bleak. An increase in community bank nonperforming assets (NPAs) could potentially trigger significant credit losses validating recent declines in bank stock prices and mounting regulatory pressure to address problem assets. However, there is a silver lining: There may be no better time to clean up bank balance sheets and bolster capital levels. Shareholders and regulators are pricing in and managing to accommodate a substantial credit downturn. Though it seems counterintuitive to take a loss on any asset, investors and regulators generally reward those institutions that recognize issues early for their realistic, credible view of the market. Prompt execution of a troubled asset resolution plan can help banks emerge from the credit cycle positioned for growth.

The Current Climate

It appears that community banks are not going to dodge the credit bullet like they did in during the post-Sept. 11 slowdown. Community bank NPAs are already creeping up to levels not seen since the early 1990s. The number of banks with NPAs greater than 2 percent has increased fivefold to 960 since 2005. Construction and land development loan portfolios of some lenders are deteriorating quickly. The stocks of publicly traded community banks are down 30 percent, and regulators are becoming increasingly focused on asset quality.

Community banks, while most appear to have avoided investing in subprime loans, have plenty of speculative residential, commercial and land development loan exposure. Since 2001, community bank loan portfolios dedicated to this type of activity have nearly doubled from 8 percent to 15 percent nationwide; community banks in high-growth markets like California, Florida and other high-growth states have much higher concentrations in these loans. It's not uncommon for an individual bank to have as much as half of its loan portfolio invested in development deals.

Regulators such as the Comptroller of the Currency are expected to require banks to downgrade assets, increase loan loss provisions and reassess capital adequacy. Banks are encouraged to make realistic judgments based on sound credit administration practices. Indeed, many banks that received good marks in their 2006 regulatory exams are already feeling the heat of regulatory pressure in their 2007–2008 exams.

A Troubled Asset Resolution Plan

Management teams across the country and particularly in high-growth markets are wrestling with various asset resolution strategies. If a buyer can be found, a bulk sale at a significant discount might clean up the balance sheet, but consideration may also be given to an in-house resolution strategy that might produce a higher recovery rate. These are weighty issues that most community bank management teams and boards have not had to discuss since the late 1980s and early 1990s. But before dismissing those discounted bids for distressed loan portfolios, it's helpful to calculate the hard and soft costs, as well as to consider the reputational issues associated with an in-house resolution plan.

Hard Costs

- **Margin erosion.** Every nonperforming asset continues to have to be financed either with the banks deposits, borrowings or equity. Nonperforming loans create a significant drag on the margin and the bottom line. For example, if a \$1 million loan that yielded eight percent becomes nonperforming and takes two years to resolve, the missed income to the bank is \$160,000, or 16 percent of the original principal balance of the loan. Meanwhile, the cash outflow for the interest cost to fund the asset continues unabated.
- **Expenses.** The cost of foreclosing on nonperforming loans varies widely by jurisdiction and other unforeseen factors, including the personality of the borrower. Legal, consulting, appraisal, maintenance, taxes, security, brokerage and other expenses are not insignificant and can cost upward of 10 to 20 percent of the value of the loan before factoring in bank employee costs.

These costs, while expended with the best of intentions, can add up quickly and can easily translate into a 20 to 30 percent cost center relative to the net realizable value of the nonperforming asset. In this context, a discounted bid seems more palatable.

Soft Costs

- **Time management.** If management and loan officers are spending time focusing on problems, it's possible they are

letting other essential tasks slip, like developing new relationships and managing good accounts.

- Capital allocation. Every nonperforming asset has a capital requirement. The capital supporting bad loans is, by definition, not supporting new lending.
- Expertise gap. Most banks do not have the expertise in-house to efficiently manage multiple and/or complex defaulted assets.

Reputational Issues

- Customer relationships. Acting as a collection agent, while essential for the bank to work out its own loans, may destroy long-term relationships with future potential customers. A bank with a significant level of lingering problem assets may be viewed by customers as a weak financial partner.
- Regulatory relationships. Regulators have limited tolerance for significant levels of lingering nonperforming assets, and the consequences of not addressing problem assets to their satisfaction can be severe for the bank, its management and board.
- Shareholder/investor relationships. Investors won't bid up the stock price until they see that asset quality issues have been addressed. Bank investors want to invest in growing institutions, not in the uncertainty of defaulted real estate loans.

Developing and executing a problem-asset resolution plan that satisfies all the constituencies (shareholders, regulators, management, the board of directors and customers) requires making tough decisions that may be unpopular with one group or another. It's important to develop a plan that adequately considers the hard, soft and reputational costs of attempting to resolve problem assets in house. If the calculable expenses approach 30 percent, and the soft costs and reputational costs are indeterminable, the discounted bid might be more attractive.

The Role of Management and the Board of Directors

The first step in the process of evaluating problem assets is for the board of directors and management to objectively evaluate NPAs in the proper context. It is useful to recognize that many current credit problems are the consequence of an overwhelming repricing of asset values.

An open process through which management can quickly and efficiently dispose of problem assets, even if sales result in significant losses, will make the bank stronger in the long term. Management must educate board members with nonfinancial backgrounds about the magnitude of the systemic problem. Boards of directors should consider incentive structures that encourage management to dispose of problems rather than attempting to hide past "mistakes." Management should strongly consider establishing a dedicated work-out group that is given full-time responsibility for either returning assets to performing status or disposing of them in the short term.

It is the responsibility of the board of directors and management to provide the strategic direction necessary to keep their bank on the right side of the competitiveness trade in a rapidly changing market. The community banks that emerge from this credit cycle with strong balance sheets and sound credit profiles will be well positioned to grow and prosper.

About the author

Mindi H. McClure joined The Bear Companies (TBC) in 2006 to expand the firm's capabilities in financial services. She previously spent 15 years at Friedman Billings Ramsey (FBR), where she was most recently a senior managing director of the financial services investment banking practice. During her career, Mindi has completed approximately \$8 billion of capital markets and advisory services transactions for banks and other financial services companies. She was instrumental in developing the Financial Services Investment Banking practice at FBR. She was also responsible for developing and managing many of the firm's most important client relationships and executing innovative transactions on their behalf. These transactions included the best-performing IPO in the United States in 2003 and numerous bank management lift-outs and capitalizations. She is on the Board of Directors of a community bank in Washington, DC.

The Bear Companies is a boutique investment banking firm that focuses on financial institutions and real estate companies. The principals of TBC have completed billions of dollars of capital markets transactions for banks, real estate companies and finance companies for the past 20 years, including asset workouts and bank recapitalization with the FDIC, FSLIC, Freddie Mac and FBR.

For Further Information : www.thebearco.com

[Close Window](#)