

CFO

THE BIG FREEZE

**CFOs HOPE GOVERNMENT
INTERVENTION WILL
SOON THAW FROZEN
CREDIT MARKETS.
THAT'S NOT LIKELY.**

EVERY SPRING, the thawing of the Yellow River threatens lives and property across Inner Mongolia. Ice blocks break free and then pile up further downstream, causing floods and dam bursts. The Chinese army often has to shoot cannonballs at the ice to restore the river's normal flow.

In the United States, the federal government has taken a similar approach to freeing up the frozen banking system: blast away at blockages in liquidity so that banks can resume channeling funds to businesses. But it looks to be a long winter, as many lenders simply aren't ready—or willing—to see their capital dislodged. As much as they may profess to care about corporate customers, commercial banks have made their own survival priority number one.

“A couple of years ago, banking was all about leveraging capital and growing [earnings per share],” says Michael Reinhard, CFO of National Penn Bancshares, a community bank with \$9 billion in assets. “Now it's about generating capital and preserving it.”

What do banks have to do before they feel comfortable making loans again? Plenty. For one thing, raising capital is still a struggle, despite the government's bailout largesse. Also, risk management, both credit and otherwise, has to be retooled, especially with federal regulators, shareholders, and lawyers breathing down bankers' necks. Then there is the problem of disclosure: almost everyone is clamoring for banks to come clean about the quality of their balance sheets, which are still riddled with toxic mortgage-related assets.

BY VINCENT RYAN

“IN LESS THAN A MONTH, STERLING NATIONAL BANK USED HALF OF THE \$42 MILLION IT RECEIVED TO ORIGINATE NEW BUSINESS LOANS.”

◆ JOHN MILLMAN *CEO of Sterling National Bank*

But the first order of business for banks is shoring up capital. The federal government’s Troubled Asset Relief Program (TARP), which morphed into the Capital Purchase Program (CPP) for injecting preferred capital into healthy financial institutions, was supposed to ease bankers’ fears and thereby open the lending spigots. Since its inception last October the program had released \$194 billion to 317 financial institutions by late January, a sum surpassing the gross domestic product of Israel.

Treasury and Federal Reserve officials, including Treasury’s interim assistant secretary for financial stability and TARP overseer Neel Kashkari, contended that banks infused with government funds would have no choice but to lend those funds out or use them to absorb loan write-downs and restructurings. That’s because in return for taxpayers’ money the government took preferred shares that pay a 5 percent dividend, which rises to 9 percent after five years. “If a bank doesn’t put the new capital to work earning a profit or reducing a loss, its returns for its shareholders will suffer,” Kashkari said in January.

Has TARP freed up the flow of funds? At some banks, yes. Independent Bank of Michigan, with \$3 billion in assets, wrote \$72.4 million in new lending—equal to the total amount it received from TARP—during the one month it had the funds in its possession, says CFO Robert Shuster. (Media reports that the bank was planning to use the TARP money to buy mortgage-backed securities from Fannie Mae were incorrect, he says.) In less than a month, Sterling National Bank used half of the \$42 million it received to originate new business loans, says CEO John Millman. National Penn Bancshares, which received \$150 million from TARP, has written several loans, including two totaling \$19 million—one to an outpatient medical facility whose lender wanted to exit the relationship and one to a retailer to finance holiday season inventory. “We don’t usually get involved in large business loans, but TARP made it a whole lot easier,” says CFO Reinhard.

GIVE TARP A CHANCE?

OVERALL, HOWEVER, ONLY A FRACTION OF THE money from what is now the Financial Stability Plan has made it from banks’ vaults to companies’ coffers. That despite some banks having had the capital since last October. Commercial and industrial loans on the books of U.S. banks dropped by \$358 billion from November 2008 to mid-January, according to the Federal Reserve. Clearly, some larger banks are hoarding capital, bracing for a worsening economy. In the fourth quarter, for instance, Regions Financial

increased its reserves at the Federal Reserve by \$8 billion. It received \$3.5 billion from TARP. While banks are required to hold a certain percentage of reserves against certain types of deposits, they generally try to minimize them. (In January, the Fed was paying 25 basis points on reserves.)

Bank holding company First Horizon National (\$31 billion in assets), another TARP recipient, also increased its reserve cushion, in part to protect against future losses on bad loans. “We took appropriate steps to ensure that we had as much secure, non-credit-sensitive funding sources as needed,” says First Horizon CFO William “BJ” Losch. “This was a secure way to protect liquidity sources and eliminate counterparty risk.” But Losch admits it was also a lower-return way to invest those balances.

Some bank CFOs who have received TARP funds think the program has been unjustly criticized. “You can’t lend out every dime on day one,” says Shuster. “People have to give TARP some time.” Independent Bank of Michigan could conservatively leverage its \$72 million into more than \$500 million in new loans, he points out.

Aside from stimulating lending, TARP was also intended to slap a seal of approval on healthy banks to attract private capital. But sovereign wealth funds and private equity are shunning the opportunity to buy entire institutions, even after the federal government last year relaxed rules on large bank shareholders. Ridding banks’ books of toxic assets, guaranteeing future losses on such assets, or both could pique the interest of private-equity firms.

Not all banks are finding it impossible to raise private capital. National Penn is raising equity, on a small scale, through a change in its dividend reinvestment plan. Last November it increased the monthly amount of cash that investors could contribute to buy additional shares and introduced a policy to sell the shares at a 10 percent discount to the market price. As a result, the bank raked in \$10 million in three months.

Eventually that money may allow the bank to repay the Treasury Department. Under current policy, a bank can redeem the government’s investment in the first three years using proceeds from a qualifying stock issuance.

“We said from day one that we didn’t view TARP funding as a longer-term strategy,” Reinhard says. “Over time we would look to replace it with newly issued common equity.” TARP capital, which comes in the form of preferred shares, is viewed as inferior to common equity, which will cause some banks to quickly replace it. As hybrid capital, preferred shares earn a dividend, and unpaid dividends accumulate over time. And unlike common equity, if a company is liquidated, preferred shareholders get back a set amount.

NO HAIR, PLEASE

BANKS ARE ALSO TACKLING THEIR ALL-TOO-obvious risk management failures. They have tightened lending standards and are expending lots of energy managing problem credits. Delinquency rates on commercial and industrial loans are mounting. Loans 90 days or more past due constituted 1.61 percent of banks' portfolios in the third quarter of 2008, up from 1.22 percent the year before.

That doesn't include the large increase in worthless loans made to commercial real-estate borrowers. Ron D'Vari, CEO of NewOak Capital, a portfolio risk assessment and valuation firm, is helping banks evaluate construction loans originated for properties in Las Vegas, where real estate values have plummeted. In one case, a company borrowed \$1 billion to build a casino, of which it has drawn down \$200 million. It needs another \$700 million to finish the job, but the property is now worth less than \$500 million. "What is the value of the loan?" asks D'Vari. "It's really negative. Deciding whether or not to put the whole thing on ice and write down the loan is hard for bankers to do."

National Penn recently formed a credit-policy subcommittee to monitor existing commercial real-estate loans. "That's where the biggest cracks in our loan portfolio can occur if we're not careful," says Reinhard. At every weekly meeting the subcommittee reviews the status of the loans, looking for signs of weakness.

Clearly, banks of every size are renewing vigilance on old and new credits. In the second half of 2008, Dime Bank decided it was time to be more selective about lending to small and midsize businesses, despite an improving deposit picture. "We didn't want to shut down the pipeline completely," says Nick Caplanson, Dime's finance chief. "So we said we would look at existing customers or a real superclean A-credit coming off the street. But anything with a little hair to it, we wouldn't write the business."

Indeed, in this climate, privately owned smaller businesses have little chance of obtaining a loan without a personal or government guarantee. Sterling Bank hopes to grow its business between 5 and 10 percent this year by picking up some of the businesses that have been cut off by larger banks, Millman says. Sterling can pursue some deposit growth because all of its borrowers are required to maintain non-interest-bearing deposits at the \$2.1 billion asset bank, reducing funding costs. "Our business customers are concerned about access to credit; they're not interest-rate sensitive," Millman says.

Not all banks are good at handling decomposing loan portfolios and working out problem loans, says Richard Speer,

CEO of Speer & Associates, a banking consultancy. "Half of banks are pretty good at this, but it's a tough experience for the other half," he says. One reason is antiquated information-technology systems. "CFOs are very much at the mercy of what the IT environment is," says Speer. "Some banks are still doing this [credit risk management] with Excel spreadsheets and rudimentary databases."

While making IT investments may seem counterintuitive to banks struggling to minimize large losses, now is a good time to do so, given the snail's pace of originations. At First Horizon

National, management is reviewing the whole application-to-decision-to-close process, with an eye to improving banker productivity and the consistency of credit risk management and decision making. Dime Bank, meanwhile, has adopted a scoring software for small-business loans that will flag risk factors and better document credit positions.

Banks also have to improve stress testing—subjecting assets and liabilities to drastically different assumptions about interest-rate, credit-quality, and operational risk. "What would my balance sheet look like if interest rates suddenly rose two times, four times, six times?" asks Don Ogilvie, chairman of the Deloitte Center for Banking Solutions. "Everybody does stress testing, but the questions [banks should be asking] are, 'Did we stress test properly?' 'Did we anticipate that whole markets would stop?' 'Did we understand the

relationships between market A and market B?'"

Finally, banks need to develop risk-exposure frameworks that span the enterprise and aggregate exposures in a timely manner, say consultants. "Risk concentrations are not attributable to any particular category of risk," comment Allan D. Grody and Peter J. Hughes of ARC Best Practices Ltd. in a recent paper. "Indeed, the unmeasured and unreported risk exposures that contributed to the current financial crisis were a cocktail of all the principal categories of risk."

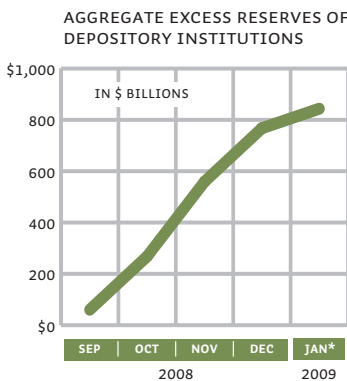
DECENT EXPOSURE

EVEN IF BANKS DO MANAGE TO BOLSTER CAPITAL AND buttress risk management, they will have to shed more light on their balance sheets if they want to regain the confidence of borrowers, investors, and other banks. Openness is not something banks are very good at. As evidenced in the CFO banking survey (see page 52), finance chiefs are still looking for assurances from their banks about financial strength and stability. Yet they often have to pay third-party firms for assessments of the safety and soundness of an individual lender.

In general, banks' financial reports are just too complex, says Sterling National's Millman. "When you talk about

HOLDING PATTERN

Risk-averse banks are building rainy-day funds.



*As of January 14 Source: Federal Reserve

money-center banks with multiple lines of businesses and all kinds of hedging and swap products, I can't pick up the financial statement and understand what's going on," Millman says. "I hope the regulators can."

According to Richard J. Herring, a finance professor at the University of Pennsylvania's Wharton School, regulators have been part of the problem, permitting banking complexity to run amok. The top 16 financial institutions have 2.5 times as many majority-owned subsidiaries as the top 16 nonfinancial corporations have, he notes. Such complexity can have serious systemic ramifications if a financial firm goes under, as demonstrated by Lehman Brothers's 2008 bankruptcy. One solution Herring recommends: require every bank to have a live bankruptcy plan that gets updated quarterly, to ensure an orderly unwinding if a bank fails.

THE RETURN OF BANKING

WHAT, ULTIMATELY, IS GOING TO REVIVE financial institutions, assuming they survive the economic meltdown? New regulations can reduce risk by stemming excesses. Previous programs that purported to manage systemic risk simply didn't work, says Roel Campos, a partner at Cooley Godward Kronish LLP and former commissioner at the Securities and Exchange Commission. "The markets didn't handle this very well by themselves—you need a diligent referee to enforce legitimate, smart rules," he says. "And you need new software, new models, and people who understand them."

But perhaps it would be best if the federal government didn't burrow too deeply into the fabric of banking, suggest some observers who fret over possible governmental control of capital allocation. After all, it took the federal government seven years to extricate itself from an 80 percent takeover of just one bank—Continental Illinois, in 1984.

Consultant Speer says bank CFOs can't rely on the emergence of a silver-bullet product to reignite profits. Instead, smaller improvements in the economic outlook and the mathematics of banking will have to do for now, at least

for "spread lending" institutions that don't dabble in exotic financial instruments.

Kelly King, CEO of BB&T Corp., said in a recent earnings call that the bank is encouraged by the restoration of some pricing discipline in business loans. The bank saw a 100-plus basis-point improvement in loan rates in the fourth quarter. In the last three months of 2008, most banks increased the spread between their cost of funds and the rate they charge commercial and industrial borrowers, according to the Fed. They also charged higher premiums for riskier loans and raised the cost of credit lines, while lowering both the maximum maturity and size of loans and credit lines.

Banks are probably hoping that the combination of a low federal funds rate and the power to increase pricing continues. For that to happen over a long period, credit would have to remain scarce. But lower benchmark interest rates also spur refinancing by other kinds of borrowers, says Dime's Caplanson. "We're going to see accelerated prepayments on loans; that will flood us with cash that we're going to have to put to work," he says.

That raises the problem at the heart of commercial banking: how to keep credit quality high while generating greater loan volume. "Are there going to be enough good credits out there?" Caplanson asks. If not, banks will be happy to stay in a semifrozen state, and the winter of customers' discontent may drag on for many months. **CFO**

VINCENT RYAN (VINCERYAN@CFO.COM) IS A SENIOR EDITOR AT CFO.THING, RAISING CAPITAL IS STILL A STRUGGLE, DESPITE THE GOVERNMENT'S BAILOUT LARGESSE. ALSO, RISK MANAGEMENT, BOTH CREDIT AND OTHERWISE, HAS TO BE RETOOLED, ESPECIALLY WITH FEDERAL REGULATORS, SHAREHOLDERS, AND LAWYERS BREATHING DOWN BANKERS' NECKS. THEN THERE IS THE PROBLEM OF DISCLOSURE: ALMOST EVERYONE IS CLAMORING FOR BANKS TO COME CLEAN ABOUT THE QUALITY OF THEIR BALANCE SHEETS, WHICH ARE STILL RIDDLED WITH TOXIC MORTGAGE-RELATED ASSETS.

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