

Banking Industry Group

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A NEWSLETTER FOR THE BANKING INDUSTRY

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After the Crisis: Getting Back to Basics

Now that we have digested the fact that most banks' loan portfolios are weaker today than they were two years ago, it's a good time to review a few of the basics of commercial lending. To do so, let's first acknowledge the need for community banks to return to the most fundamental of banking models: gathering deposits from within local communities and leveraging them to make loans within those communities.

It's clear now that many of the more non-traditional lending practices that had become commonplace — from subprime and Alt-A loans to more relaxed lending standards — were direct contributors to the financial crisis and credit crunch that have dealt such a crippling blow to the economy, as was the heavy reliance of some banks on non-core funding. Consider these 10 commercial lending fundamentals underscored by the financial crisis:

1. Return to the 5 Cs of credit. There's no better place to start a discussion of back to basics than by returning to what have traditionally been considered the bedrocks of lending: an emphasis on borrowers' character, capacity, collateral, capital, and current market conditions. A close look at the troubled loans in any bank's portfolio will likely reveal exceptions made to underwriting guidelines that started with the lender ignoring one or more of the 5 Cs of credit.

2. Remember the importance of risk-based capital. In March, the federal government undertook an extensive examination of 19 of the country's biggest banks, conducting stress tests to determine the adequacy of their capital levels. This unprecedented measure underscores one of



the many lessons that can be learned from the financial crisis: *Capital matters.*

As a result of the stress tests, the Fed instructed a number of the big banks to bolster their capital levels. Given this, regulators may also require community banks to maintain higher capital levels. This will restrict banks' ability to lend and may crimp returns in the short term, but should ultimately lead to wider margins.

3. Don't downplay the role of confidence and liquidity. At the root of all the problems that have emerged in the credit markets is a lack of liquidity. The liquidity crisis is a direct outgrowth of counterparties no longer trusting each other — and when confidence and liquidity dried up, the market collapsed.

4. Don't ignore risk. Risk can be disguised, but it never disappears. Financial engineers convinced many that

Equity and Contingent Liabilities

In addition to those detailed in our lead article, here are two more hard lessons learned from the financial crisis:

1. Paper equity and borrowed liquidity have a bad habit of disappearing when you need them most.
2. Contingent liabilities tend to become real liabilities at the worst possible time.

In today's continued uncertain credit environment, the fragility of equity and potential exposure to loss posed by contingent liabilities are two areas community banks should pay especially close attention to.

Fragility of Equity

From the commercial lender's perspective, there is a very real purpose to equity: It helps protect against loss in the event that collateral declines in value. Unfortunately, while the value of liabilities rarely shrinks, the current recession has made it crystal clear that the value of assets — real estate, in particular — can evaporate quickly, virtually wiping out equity almost overnight.

Of course, real estate has proven to be a sound investment over the long haul, which is why banks have historically been willing to lend against it. (Hence, the traditional lender's mantra that "If you take dirt, you won't get hurt.") Despite recent declines, there's no question that real estate will rebound when investors return to the market in search of bargains.

But how do we define "the long haul"? When does it begin and end? And how much capital will it take to ride out the current downturn, the length and severity of which no one knows?

During more normal times, equity requirements of 15 to 30 percent were usually adequate protection for lenders. But today, a 30 percent



drop in the value of commercial property held as collateral is not at all uncommon. For example, if a borrower had \$1.5 million in equity in a piece of property that appraised for \$5 million 18 months ago, but the property is now worth only \$3.5 million, the equity has essentially vanished.

This makes it imperative that banks have policies and procedures in place that will facilitate ongoing monitoring of borrowers' financial information, and quickly and thoroughly review and act upon the information once it's received. If any blips or concerns are spotted, these should be reviewed with borrowers immediately. If you don't have confidence in their ability to devise and implement a plan for dealing with problems quickly, it may be time for them to find another bank.

Contingent Liabilities

There has also never been a more important time than now to be concerned with borrowers' and guarantors' contingent liabilities. The domino effect of business failures has turned liabilities that were contingent or indirect — like guaranteed loans, leases and lines of credit — into direct liabilities.

For example, consider a builder/developer who personally guaranteed the debt of his company. Everything was fine as long as he was selling houses, but once sales slowed down, liquidity dried up and his creditors started demanding to be paid, his problems mushroomed as contingent liabilities suddenly became very real. The takeaway for lenders now is to view contingent liabilities as more than just an insignificant footnote on the balance sheet, if they're even disclosed at all. To be safe, assume that they are real liabilities and plug them into your financial and cash flow analyses. Is cash flow still adequate to service both your loan and all or some portion of the guaranteed debt?

Unfortunately, reality can rear its ugly head when we least expect it. Lenders should not fall into the trap many borrowers do in thinking that their business ventures will always be self-sustaining. Dig deep into the numbers to determine whether borrowers have realistically planned for the possibility that they may, indeed, have to cover the debts and liabilities they've pledged to cover. ■

risk could be quantified, but we forgot that the financial models assumed there would always be a market that would substantiate the value of assets. When markets disappeared, asset values crumbled. The lesson: You can slice, dice and sell risk, but that doesn't make it go away.

5. Beware of covariance. Many community banks that weren't directly involved in sub-prime and Alt-A lending learned the hard way that they weren't necessarily shielded from the risks these types of loans posed. For example, some banks active in acquisition and development (A&D) and construction lending lost sight of the fact that their takeout was a subprime, Alt-A or jumbo loan. The collapse of the residential real estate market had a direct and adverse impact on their builder and developer portfolios.

6. Identify your total risk exposure with each borrower. A borrower's exposure to risk may go beyond his or her loans with your bank, especially builders and developers. Therefore, you should be sensitive not only to the risk posed by loans in your own portfolio, but also to borrowers' other projects — or in other words, to your total risk exposure. While your loans may be performing, a borrower's projects and loans with other banks may be faltering, which could eventually impact you.

7. Determine your appetite for risk. The key to doing this is building a model portfolio that defines your risk tolerance. What percentage of the bank's capital should be exposed to what types of loans (as defined by line of business, geographic area, industry, type of property, etc.)? Making exceptions to policy — for example, with respect to debt-to-income, loan-to-value (LTV) and the borrower's credit/FICO scores — is, in effect, the acceptance of higher risk loans. This underscores the importance of carefully measuring risk on an ongoing basis, closely monitoring loans that increase your risk, and regularly reporting your findings to the bank's board of directors.

8. Employ risk-based pricing. The problem wasn't simply that banks took on excessive risk. Rather, it was that they didn't adequately price for it. This encouraged many lenders to take risks they might not ordinarily have considered. For the first time in many years, community banks have pricing power, since most of the non-banks and alternative sources of credit that usurped that power in recent years have disappeared. The keys to pricing adequately for risk are: 1) devising a pricing model that defines exactly what each loan must earn in order to cover costs (including the cost of risk) and meet

profit expectations, and 2) creating pricing agreements that communicate these expectations to borrowers.

9. Remember that cash is king. It's an old cliché, but it's true today more than ever: There is no substitute for cash flow. Using current financial information, lenders should look at both the qualitative and quantitative elements of borrowers' cash flow. What is truly driving cash flow? How stable and dependable is it? What effect will competition have on it? What are the cash flow trends, and how likely is it that they will continue? Not knowing the answers to these questions may set us up to return to an accumulation of excessive risk.

10. Establish expectations with borrowers. Clearly communicate to borrowers your expectations regarding their financial performance, the information that will be required to facilitate monitoring, and penalties that will be assessed for non-performance. Establish benchmarks that give you the ability to adjust pricing or call loans for non-performance, and don't allow borrowers to repay interest with more debt or to increase their lending facilities arbitrarily. ■

To discuss these and other strategies in more detail, contact Tim Johnson, Partner, Wolf & Company LLP at 630-545-4594.

Accountability and Incentives

Perhaps the single biggest lesson learned from the financial crisis and ensuing credit crunch is the importance of holding individuals accountable for their decisions.

This includes borrowers who made little or no down payment, believing that real estate prices would always go up; mortgage

brokers who used subprime loans to put individuals in homes they couldn't afford and bankers who made these loans; entities that packaged the loans and rating agencies that rated them; and investment bankers who sliced and diced the loans. None of these parties took any accountability for the final outcome.

Another fundamental lesson that seems more obvious in hindsight than it did at the time is the impact of incentives, which can have a perverse effect on the perception of risk. Investors stretched for an extra 10 to 15 basis points, lenders chased big bonuses, and banks pursued higher earnings, all without a full appreciation of the increased risk they were assuming.

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BANKING BRIEFS

It's Not Too Early to Start IFRS Planning

There has been plenty of speculation in the past couple of years about the implementation and potential impact of the adoption of International Financial Reporting Standards (IFRS) in the U.S. The SEC clarified some of the uncertainty with the release of its "IFRS roadmap" in late 2008.

The road map identifies seven milestones leading up to the possible mandatory transition to IFRS for all U.S. companies starting in fiscal years ending on or after Dec. 15, 2014. However, certain U.S. issuers could be given the option of using IFRS as soon as this year – specifically, for fiscal years ending on or after Dec. 15, 2009.

The first four milestones involve issues to be addressed before mandatory adoption of IFRS, such as improvements in accounting standards and in the ability to use interactive data for IFRS reporting. The last three address the transition plan for mandatory use of IFRS, including suggested criteria for candidates for limited early use.

Thus far, two broad approaches to the conversion have been suggested: the all-in approach and the tiered approach. All-in encompasses a relatively short time frame, during which all reporting entities within a bank would be converted simultaneously. It would require dedicated bank project teams and significant organizational resources. Conversely, the tiered approach would phase the conversion in more

gradually and spread costs and resources out over a longer period of time.

While 2014 may seem like a long way off, experts suggest it's time to set up your IFRS conversion road map. A successful conversion effort of this magnitude will require a lengthy ramp-up period. In fact, the AICPA states that it considers a one-year timeline to be reasonable for the IFRS transition. With this much notice, there's no reason this conversion has to resemble the panic and chaos that has often accompanied major compliance initiatives such as Sarbanes-Oxley and the Y2K computer conversion.

Set up your conversion plan with our help. Contact our office for more detail.