

Capital considerations

Bankers must have a plan for raising money, advisers say

By Becky Nelson

“There is always plenty of capital for those who can create practical plans for using it,” author **Napoleon Hill** once wrote.

Whether that is true in banking today is debatable. These days, capital is hard to come by – although it is more accessible for those institutions that have a good plan in place.

Compared with other states, Wisconsin banks are generally well-capitalized. Out of the 238 banks in the state, 16 of them – or 6.7 percent – had Tier 1 capital ratios under 8 percent as of June 30, 2011, according to **Mike Mach**, banking administrator at the state Department of Financial Institutions.

But as recent events have proven, changes can occur quickly and banks need to be prepared.

“The events over the last few years are a reminder that ‘well capitalized’ banks do not really have that much capital in terms of hard dollars and capital can disappear very quickly in tough economic times,” the Conference of State Bank Supervisors wrote in an October 2010 white paper.

Difficult process

Industry consultants say that community banks tend to be reactive, rather than proactive, in raising capital, as it is a difficult, time-consuming process. Most banks don’t undertake the process unless they find themselves under a regulatory agreement (defensive capital) or with an immediate opportunity to make an acquisition (offensive capital).

“As everybody in the industry knows, the regulators have pretty high expectations of banks regarding capital. That is a constant drum beat coming from them,” said **John Knight**, partner at Boardman Law Firm and WBA general counsel.

As banks or regulators begin to re-classify problem loans, regulatory agencies have the authority to require capital levels that exceed the regulatory guidelines, which then puts banks in the position of needing to raise money – fast.

Bank managers and directors must plan ahead. “Capital is a here today, gone tomorrow item,” said **Jon Bruss**, CEO and managing principal at Fortress Capital Partners. “There are three choices: either you fail, or you just get by, or you really make it big. In each instance, capital is critical to the outcome.”

Yet “banks notoriously fail to integrate the capital plan with the strategic plan,” Bruss said. He points out that nearly every regulatory order requires a bank to develop a capital plan because they don’t have one.

Moral of the story: don’t wait.

“I think there’s a perception, a part of every banker that likes to think that his or her situation is different from the others. In fact, at the end of the day, that’s not the way the regulators perceive it, and it’s certainly not the way the accountants perceive it,” Bruss said.

“If you think you might need capital down the road, for any reason, do it now,” Knight said. “It’s best to act now while you still have a good story to tell to investors.”

The capital plan should include triggers that will set the wheels in motion, said **Mark Koehl**, a partner in Wipfli’s Financial Institutions Group. “Sometimes banks delay the process, thinking things are going to turn around. The cost of the capital becomes even higher at that point.”

Bank managers and directors “should be communicating with their shareholder group on an annual basis on what their plans are,” Koehl said. “If they feel they may need to come to the shareholders for additional capital, then they have at least ‘taken the pulse’ of shareholders for doing that in the future.”

Factors to consider

“There are people out there with money to invest, but we all have to remember that they have a lot of choices today,” Knight said. “Whatever a bank’s story is, it needs to be a good one to get the attention of investors.”

That means, if loans have been the issue, the story includes the message, “We’ve addressed them; we’ve got them under control; we don’t expect any more surprises. Our board is intact; we’ve got a good management plan; we’ve got a good market; we’ve got a good plan for growth in our market,” Knight said.

An inaccurate portrayal of a bank’s loan portfolio can strike fear into the heart of a prospective investor – which is why a third-party loan review may be needed to help bank managers and directors view their loan portfolio from an outside perspective.

“One of the challenges that we have today, and we continue to have, is that bankers are not coming to grips with the extent of the credit issues they’re dealing with,” Bruss said. “The kinds of individuals or institutions that are making investments in banks today really understand what’s going on.”

Investors' tolerance of credit risk varies from a low level of 1 percent non-performing loans "all the way to maybe 10 percent," Bruss said. "There's very, very few, if any at that top end. If investors had their druthers, they would be in the 1, 2, 3 percent area."

Banks with non-performing loans in the high single or low double digits need to consider how to lift those loans out of the bank, he said.

Another consideration for raising capital is to consider how ownership will be distributed and what changes will be required. If there is a large shareholder or investor involved, changes to bank management may be a condition of the deal. "In order to raise that capital, bankers and the board of directors may have to swallow hard and say, in order to survive, this is what we have to do," Bruss said.

Banks also need to consider the form of capital, particularly since debt instruments aren't often used now; look at dividend issues; and think about liquidity.

A possible change in federal law will help some banks raise capital by increasing the bank shareholder threshold for SEC registration from 500 to 2,000 – changing a limit that has been in place since 1964. The House just passed the legislation (H.R. 1965), which now goes to the Senate.

At the same time, as a precaution, banks may want to explore other options while they're trying to raise capital, such as merging with another smaller institution.

Throughout the process, the board needs to be actively engaged – and ideally, willing to invest themselves. Passing the hat around the board room table is a critical demonstration of confidence to investors, industry advisers say.

As those who already are involved in the process know, raising capital is almost never quick and easy. "It's like anything – when you really need it, it's the hardest to get," Koehl said.

Nelson is a freelance writer for the Wisconsin Bankers Association.

Sidebar:

Capital Under Stress

Stress tests show how capital could erode. One company, Invictus Group, runs a stress test on the balance sheets of all FDIC-insured banks in the nation each quarter. Results are a weighted-average based on the risk-weighted assets of each bank. Under this model, in the second

Wisconsin Banker
December 2011

quarter 66 Wisconsin banks (24.2 percent) were considered undercapitalized, defined as having Tier 1 capital of 8 percent or less.

“By taking slices of the call report data, we are able to derive some very valuable information,” Invictus Group CEO **Kamal Mustafa** told *Wisconsin Banker*.

The company shares its quarterly reports with regulators, presenting them with a different picture than what they may have concluded.

“Given [regulators’] limited resources, whether their assumptions are right or wrong, they apply them consistently to all the banks,” Mustafa said.

A stress test can, for example, uncover trends in loan deterioration without the normal delay caused by the loan reclassification process, he said.

Stress testing has now become part of the “fabric of bank supervision,” with the Dodd-Frank Act requiring the nation’s largest banks to undergo annual review, the Conference of State Bank Supervisors notes.

“The entire financial services industry should be prepared for increased expectations as financial regulators become accustomed to seeing stress testing as part of the risk management framework and an important part of the supervisory process,” CSBS wrote.