

# How to Plan Strategically in Today's New World of Banking

Presented to  
CBAO 35<sup>th</sup> Annual Convention

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# Planning in the Good Old Days (2007 and earlier)

- Focus on growth -- assets, loans & deposits
  - Five year time horizon
  - Asset growth meant earnings growth
  - Earnings growth meant share price growth
- 
- Shareholders were happy!
  - Management was happy!
  - Employees were happy!
  - Regulators were happy!

# 2009 Reality

- Focus on *survival*
  - Time horizon – 12 to 18 months
  - Capital is king
  - Growth is not
  - Asset quality is critical to survival
  - Earnings are important to support capital – not share price
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- Shareholders are not happy!
  - Directors are nervous
  - Management & employees are not happy!
  - Regulators are definitely not happy!

# Examine the Environment

- External – the economy
- Internal – current operating issues
- Regulatory attitudes

# External Market Environment

- Economic growth does not exist
- Unemployment level
- Consumer spending
- Business activity

# Internal Operating Environment

- NPAs increasing
- Growth is difficult/non-existent
- Margins are compressed – but improving
- Provision expense is increasing
- Noninterest expenses increasing
  - FDIC premiums & assessments
  - Collection expense
  - ORE expense
- Earnings are weak
- Must preserve capital

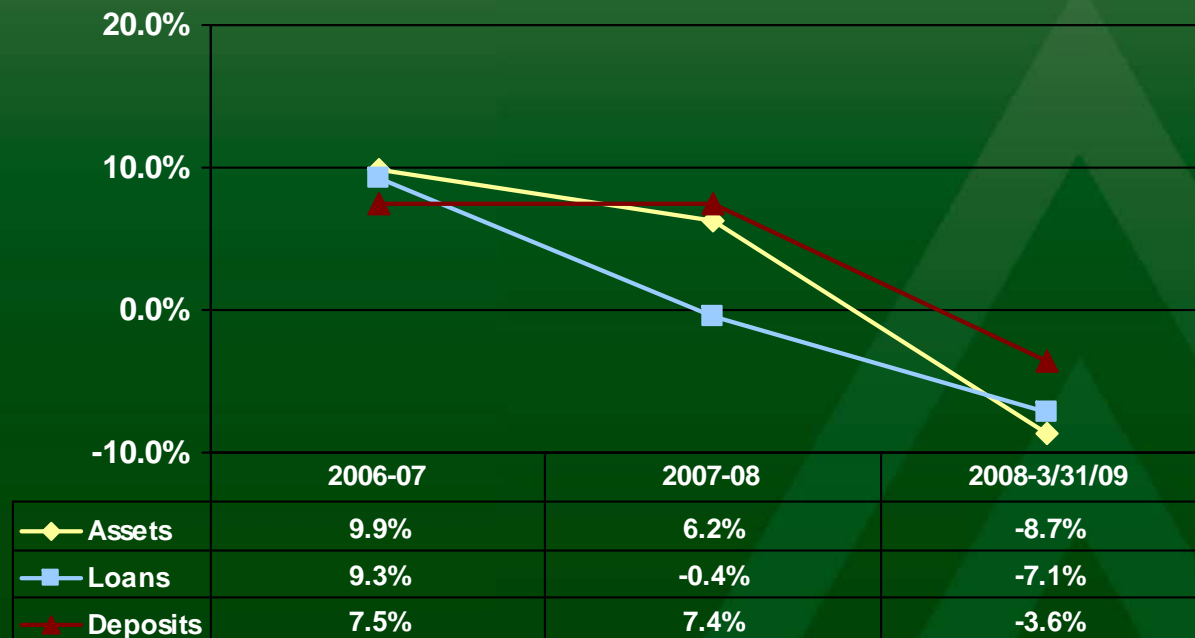
# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## NPA/Assets (%)



# All FDIC-Insured Institutions

## Growth Rates



# Aggregate U.S. Commercial Bank Data - ALL

## Net Interest Margin - FTE (%)



# Aggregate U.S. Commercial Bank Data - ALL

## Provision Expense (\$mil)



# Aggregate U.S. Commercial Bank Data - ALL

## Noninterest Expense/AA (%)



# Aggregate U.S. Commercial Bank Data - ALL

## FDIC Deposit Insurance Assessments (\$mil)



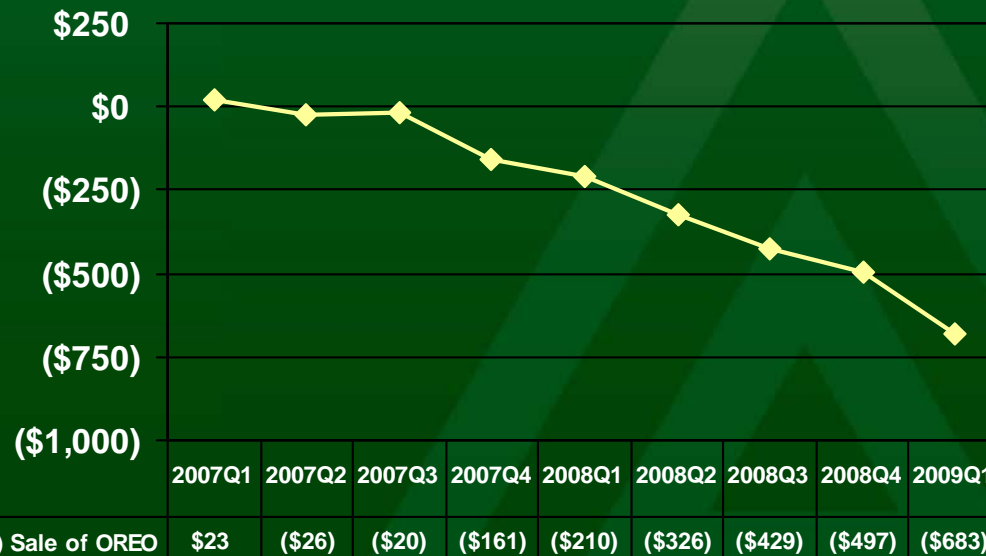
# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## Efficiency Ratio (FTE) (%)



# Aggregate U.S. Commercial Bank Data - ALL

## Net Gain/(Loss) on Sale of OREO (\$mil)



# Aggregate U.S. Commercial Bank Data - ALL

## Return on Average Assets (%)



# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## Return on Average Assets (%)



# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## Leverage Ratio (%)



# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## Tier 1 Risk-Based Capital Ratio (%)



# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## Total Risk-Based Capital Ratio (%)



# Regulatory Attitudes

- Increasing level of scrutiny
- More outside political pressure
- Increasing regulatory actions
  - MOUs
  - Written Agreements
  - Cease & Desist Orders
  - Individual Minimum Capital Ratio letters (IMCR)
  - Failures
  - Increasing required capital levels

# Estimated CAMEL Scores of 3-5 (Based on All Reporting Institutions for Each Quarter)

*\*Includes Commercial Banks,  
Savings Banks, and Savings  
Institutions*

**Estimated CAMEL 3-5 Rated Banks  
(As % of Total Banks)**



	2007Q1	2007Q2	2007Q3	2007Q4	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
# CAMEL 3-5	829	833	870	929	952	1,036	1,163	1,324	1,281
Total Institutions	8,648	8,615	8,561	8,535	8,496	8,452	8,385	8,307	8,248
▲ % of Total	10%	10%	10%	11%	11%	12%	14%	16%	16%

Note: CAMEL 3-5 scores represent moderate to severe degrees of supervisory concern. Estimated based on Veribanc safety ratings.

Source: SNL Financial

# Bank Failures 2008 - 2009

2008 Failures: 25

2009 Failures: 57 (through 7/20/09)

*FDIC Chairman Sheila Bair estimates up to 500 more banks could fail.*

## Ohio and Selected States (# of Failures)

**Ohio: 0**

Michigan: 2 (1 in 2008 and 1 in 2009)

Indiana: 0

Illinois: 13 (1 in 2008 and 12 in 2009)

Kentucky: 0

West Virginia: 1 (1 in 2009)

Pennsylvania: 0

# FDIC Problem Banks

FDIC Problem Banks



# Cease & Desist Orders (FDIC, OCC & OTS)\*

*\*Based on most recent data provided by each regulatory agency*

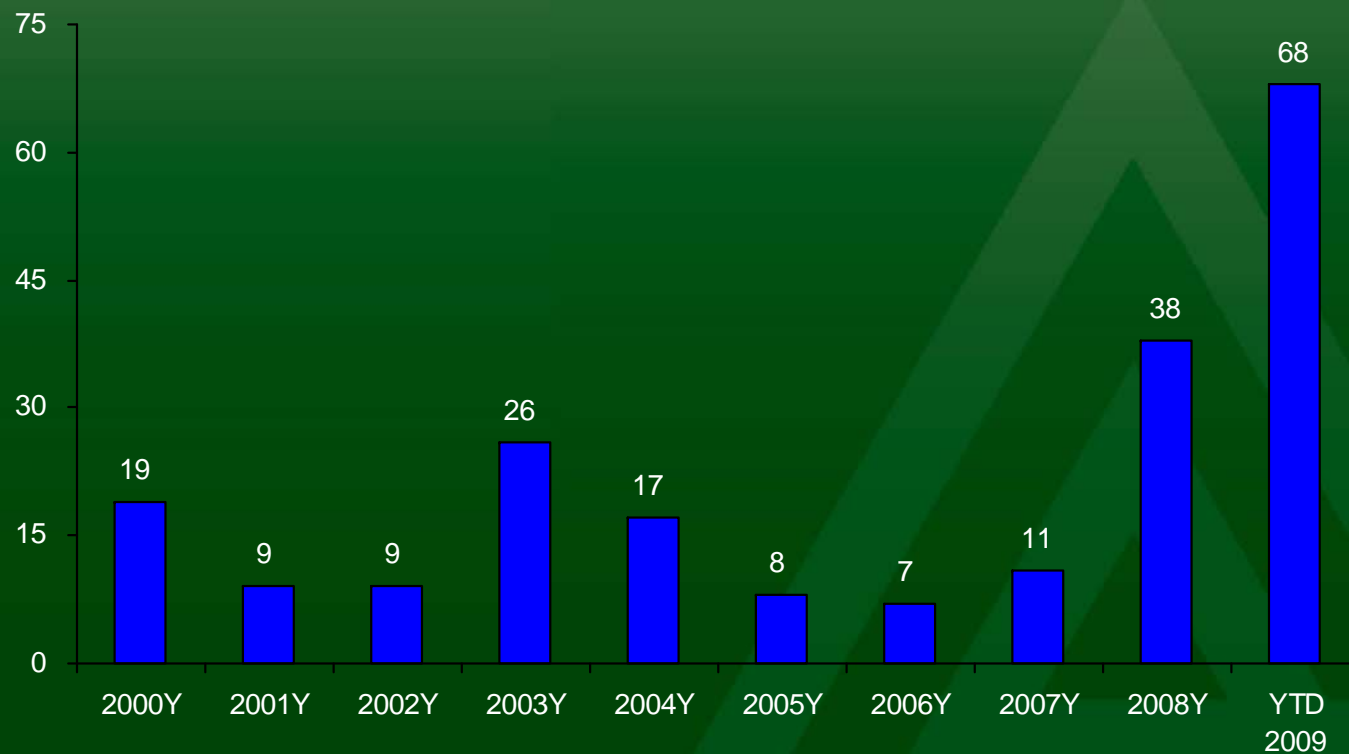
## Cease & Desist Orders



# Written Agreements (Federal Reserve)\*

\* Excludes Written Agreements  
with Individuals

## Written Agreements



# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

Texas Ratio (%) <sup>(1)</sup>



# Aggregate U.S. Commercial Bank Data (< \$1.0 Billion in Assets @ March 31, 2009)

## # of Banks with Texas Ratio > 100% <sup>(1)</sup>



# What Does this Mean from a Strategic Planning View?

Survival is the strategic plan

Survive to take advantage of the economic recovery

When will the recovery begin?

# The New Role of a Director - Examine your Bank

YOU – examine your bank; if you wait for the regulators,  
it's too late!

Follow the CAMELS rating system

Capital

Assets

Management

Earnings

Liquidity

Sensitivity

# CAMELS Rating System

## Capital

- Know your capital levels (3)
- Look at historic trends
- Estimate future levels based on earnings levels & dividends
- Use worst case earnings levels
- Do you need to prepare a Capital Plan?
- *New capital does not exist*

# Regulatory Capital Ratios

	Well-Capitalized	Adequately-Capitalized	Under-Capitalized	Significantly Under-Capitalized	Critically Under-Capitalized
Tier 1 Leverage Ratio	5%	4%	< 4%	< 3%	< 2%
Tier 1 RB Capital Ratio	6%	4%	< 4%	< 3%	
Total RB Capital Ratio	10%	8%	< 8%	< 6%	

# Regulatory Capital Guidelines

## Banks operate with 3 key regulatory capital ratios:

Tier 1 Leverage Ratio: Tier 1 Capital/Average Tangible Assets

Tier 1 Risk-Based Capital Ratio: Tier 1 Capital/Risk-Weighted Assets

Total Risk-Based Capital Ratio: Tier 1 & Tier 2 Capital/Risk-Weighted Assets

Tier 1 Capital Components: Total equity minus nonqualifying intangibles/goodwill

Average Tangible Assets: Average total assets minus nonqualifying intangibles/goodwill

Tier 2 Capital Components: Loan loss reserve plus qualifying sub debt and term preferred stock

Risk-Weighted Assets: The sum of assets multiplied by appropriate risk-weights

## Bank-Level Capital Limitations:

Tier 2 Capital: Loan loss reserve cannot exceed 1.25 percent of risk-weighted assets

Tier 2 Capital: Sub debt and term preferred stock limited to 50% of Tier 1 capital

Tier 2 Capital: Total of Tier 2 capital is limited to amount of Tier 1 capital

# CAMELS Rating System

## A Asset Quality

- Complete & thorough initial analysis
- Do annual internal credit review
- Is risk weighting accurate?
- Have independent loan review
- Effective problem loan management
- Reserve adequacy
- Trends – delinquency, NPA
- Migration analysis

# CAMELS Rating System

## Management

- Executive Officers – CEO, CLO, CFO, CCO
- Directors – can you objectively evaluate performance
- Every regulatory order requires an independent management study
- Typical C&D Management Plan
  - Identify type & number of officer positions
  - Identify & establish necessary board committees
  - Evaluate all bank officers
  - Prepare a plan to reorganize, train, recruit & hire
- If low CAMELS component rating, there is a management problem
- In this environment, bank can't afford a weak link in chain of command

# CAMELS Rating System

## Earnings

- The bar has been lowered
- Above zero is good!
- Is bank proactively managing overhead?

# CAMELS Rating System

## Liquidity

- Competition for core deposits has diminished
- Banks are more liquid
- Be careful of your non-core funding dependence

# CAMELS Rating System

## Sensitivity

- Forecast the impact of market rate changes
- Are you asset-sensitive or liability-sensitive, and what happens to margin and earnings?

# Risk Management

	Inherent Risk	Adequacy of Risk Management	Composite Risk	Trend
CREDIT	High	Strong	Moderate	Increasing
MARKET	Moderate	Acceptable	Moderate	Stable
LIQUIDITY	Moderate	Weak	Moderate	Decreasing
OPERATIONAL	Low	Acceptable	Low	Stable
LEGAL	Low	Acceptable	Low	Stable
REPUTATION	Low	Acceptable	Low	Stable

# Risk Management

## Regulatory Expectations

- Risk management program
- Developed by senior management
- Strong, involved oversight by Board
- Evolves toward “enterprise-wide program”
- Prioritize by greatest risk

# Risk Management

## Five Vital Action Items

- Inventory and quantify key risks
- Inventory and assess mitigating controls
- Develop plan on “under-mitigated” risks
- Challenge assumptions
- Include and inform Board

# Risk Management

## Stress Testing

- Individual large/weak loans
- Loan portfolio segments
- ALLL
- Capital ratios
- Liquidity/funding sources

# Recent Summary

## FDIC Assisted Transactions

- 57 banks and thrifts failed from January 1 – July 20, 2009
- Median asset size for failed institutions at \$278 million in 2009
- 40% of M&A transactions in 2009 are FDIC-assisted transactions
- Willingness for FDIC to share in loss has enhanced activity
- Pricing discounts on assets has created buyer interest

# FDIC Assisted Transactions

## Buyer Profile

- CAMELS – 1 or 2
- Well-capitalized
- No regulatory enforcement actions
- Larger in size compared to failing bank
- Favorable asset quality

# FDIC Assisted Transactions

## Current Transaction Structure

- Most common transaction type - whole bank with loss share
- Loss share transaction requires separate bid on assets and deposits
- Typically, asset bid is negative with minimal deposit premium
- Must consider loss share thresholds established by FDIC
- First loss share threshold with 80% of losses covered by FDIC; after threshold limit is exceeded, 95% of loss covered by FDIC
- Loan due diligence is key in determining asset bid discount
- Quick process – close bank on Friday and Buyer takes over on the next business day

# FDIC Assisted Transactions

## Other Types

- Whole bank without loss share
  - One bid on assets and deposits
  - Typically substantial negative bid
- Deposit only transaction
- Winning bid based on least cost alternative to FDIC

# M&A Environment

## Current Trends

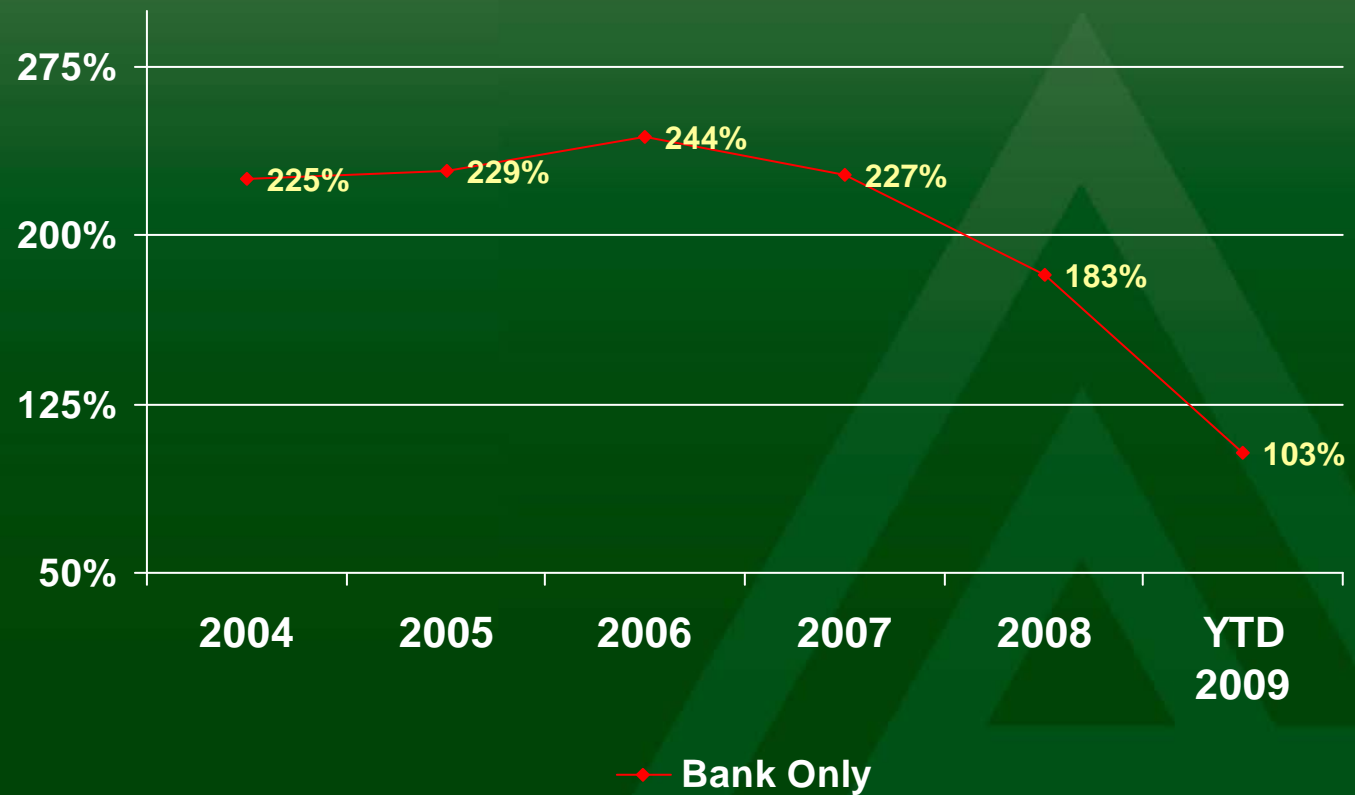
- Depressed stock prices
- Limited access to capital
- Increased asset quality concerns
- Increased regulatory involvement

The above points are just a few of the reasons for the significant decline in number of M&A transactions and pricing levels

# M&A Deals Traditional Whole Transactions



# M&A – Price/Tangible Book Multiple Traditional Whole Transactions



# Trends in M&A Space

- “MOE” concept – no premium transactions
- Focus on contribution analysis
- Book-for-book concept
- Cultural issues typically slow or stop the process

## Recent Engagements

- Two *de novo* banks combine as stage 1, with capital infusion as stage 2
- Start-up bank with excess capital coupled with larger bank with asset quality issues

# Equity Investment Trends Financial Institutions

- Private equity – increasing activity
- Private equity on side lines for much of 2008
- “SCAP” analysis required common stock issuance in 10 of 19 large financial institutions
- Private equity typically very selective with 20% to 30% annual returns
- Wells Fargo & Co. and Morgan Stanley first two large financial institutions to issue common equity, opening the door for others

# Ideas for Strategic Planning Checklist

- Form strategic survival planning committee (include directors)
- Examine your market – describe findings
- Examine internal environment – recent financial performance & trends
- Examine your regulatory relationships – assume the worst
- Prepare a CAMELS assessment/SWOT analysis – written report

# Ideas for Strategic Planning Checklist

- Detailed financial forecast
  - Look at historical trends
  - Best case/worst case
  - Shorten forecast time horizon
  - Emphasize provision expense and capital levels
  - Written assumptions
- Prepare risk management plan
- Present strategic survival plan to Board for discussion and approval
- Review at least quarterly
- Update annually

# A Strategic Survival Plan

- Prepare as much written documentation as possible – suitable for regulatory consumption
- A pro-active, pre-emptive strike
- Prove to the regulators that you really care and you are doing something about it