TRY THIS AT HOME

by Steve Brown

Did you know that Leonardo da Vinci could write with one hand and draw with the other at the same time? Given such a creative mind, maybe that is why he is credited with inventing scissors, the parachute, helicopters, the tank and a whole lot more. We do not know a banker yet who can do any of that, but if you hear of one, let us know.

In the meantime, we thought we would take a look at capitalization among community banks and what creative solutions might exist to solve a specific dilemma. While our data is as of March, we will be closely watching June and updating you as it comes out. At this point, more banks are reporting difficulties, so we expect deterioration for the next few quarters, until things get better.

We start our discussion by providing some data as a backdrop to current conditions. As of the end of the 1Q, industry average Total Risk-Based Capital was running at 12.83%, Tier 1 Risk-Based was 10.10%, Equity to Assets was 10.18% and Core Capital (leverage) was 7.87%. More specifically on the Core Capital front, community banks with assets less than $100mm were at 13.5%, those $100mm to $1B were at 9.90% and those $1B to $10B were at 9.39%. Our projections are that these percentages will likely drop 2% to 10% on average in the 2Q.

Next, we focus in on the exploding cost of capital. If you haven't been out in the market in awhile to raise capital, know that things have become downright ugly. Trust preferred pools are deader than a doornail and institutional money is virtually nonexistent. While some one-off trust preferred placements are occasionally getting done, we have recently seen pricing surge as high as 9% to 14% fixed with up to 5 points in upfront fees.

Community banks aren't alone in this problem, as large banks are having trouble too. In short, raising capital in the current environment is hitting every financial institution hard. Consider for instance that even large national banks have been issuing new capital at a cost of 8% to 10%. That isn't the half of it, however, since investors who put up that new capital have seen the price of the bank stock plunge around 45% from issuance date. When institutional investors put money into a bank and the price drops that sharply, you can be sure the next time it is going to cost much more. For now, this expensive capital raising problem looks like it will persist through 2009 or until housing finds a bottom and banks stop reporting ongoing credit issues.

Industry pressures on capital also continue to occur. As of 1Q, there were 10 financial institutions deemed "Undercapitalized," 5 were "Significantly Undercapitalized" and 3 were "Critically Undercapitalized." All told, this group held $16.9B in assets, which isn't that big in the grand scheme of banking, but it certainly sounds large to depositors should any of them fail. As long as the newspapers plaster lines of people standing outside banks like IndyMac trying to get their money, pressure will continue to mount on bankers to raise capital, shore up reserves and reduce expenses.

In creative ways that should make Leonardo proud, bankers are working hard to boost capital ratios. While no bankers we know have yet been able to invent free-capital-made-of-water, innovation and creativity are nonetheless flowing. Some of the best ideas we have heard include eliminating unprofitable (or lower profit) business lines, consolidating branches, increasing remote deposit capture rollouts so branches can be closed in 2009 and 2010, closing loan production offices, reducing dividends, suspending director fees, suspending stock repurchase programs, shrinking investment and loan portfolios, rolling off expensive deposits or FHLB Advances, tightening lending standards to slow production, increasing fees charged for loans / deposits and consolidating open staffing positions.

Community bankers are inventive and many are taking immediate action to conserve capital in this tumultuous time. Things will eventually get better in the industry, but until then, take a page from Leonardo and stay creative, flexible and driven to succeed to tilt things in your favor as much as possible.

BANK NEWS

Wachovia

The 4th largest bank reported a record quarterly loss of $8.9B, slashed its dividend by 87% and announced plans to fire 6,350 employees. The company said it will sell non-core assets and focus on protecting, preserving and generating capital.

Bank of America

The bank reported net income fell 42%, but results were well above expectations for 2Q. Merger and restructuring costs offset a 3.5% revenue rise and a 26% increase in net interest income, while the loan loss provision was increased by $3.45B.

Regions

The bank slashed its dividend by 74%, after reporting 2Q profit fell more than expected. The bank reported nonperforming assets climbed to $1.6B, mostly as a result of deterioration in loans to home builders and condos.

GSE Pressure

As Paulson works to increase the amount of money the Treasury can lend to FNMA and FHLMC, the OFHEO has just announced it expects FN/FH may need to take more writedowns related to purchases of subprime and Alt-A mortgages.

Brutal Biz

More businesses filed for bankruptcy in the most recent monthly report than at any time since changes to bankruptcy laws took effect in 2005. Overall, 235 commercial bankruptcies were filed each day on average during the month, nearly a 50% jump over the same period last year.