

How to Manage Assets to Protect and Build Value



By Ken Segal



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Competitive forces challenging community banks are getting more and more intense, particularly as growth slows in various regions throughout the country. Given the ongoing spread compression and aggressive demand for deposits, lending is becoming less profitable, and it is taking more resources to recover from underperforming loans. Some factors may be credit related, but others are tied to unavoidable market events.

And while some community bankers view asset management as the selling of problem assets to periodically clean up their balance sheets, many more are exploring asset sales as a means to address a wider array of objectives.

Non-Performing Loans

As you know all too well, non-performing loans require higher reserve levels, onerous reporting and valuation requirements, unwanted legal expenses and countless employee hours dedicated to loan “rehabilitation.”

To make matters worse, these non-performing assets, conspicuously reported on financial statements, impair key ratios and create general uncertainty as to whether they will generate losses that are consistent with ever-changing, internal estimates.

Consequently, many banks periodically sell non-performing portfolios at their internally marked values. They then redeploy the sale proceeds into higher-quality earning assets that enhance the bank’s financial strength, require lower capital commitment, and allow the bank to focus on growth and more critical strategic objectives.

Your board and regulators will also be pleased that you have demonstrated the ability to liquidate this class of assets.

As the example below demonstrates, there is a huge opportunity cost to hold non-performing assets on balance sheet. Thankfully, there is a similarly positive benefit to liquidating those holdings and investing the proceeds in earning assets over a comparable time horizon.

Table 1

Selling Non-Performing Loans at Their Internally Marked Value (on a five year remaining term)						
	Book Value of Loans	Reserve	Market Value	Coupon Rate	Year 1 Earnings	Earnings over Remaining Term
Sell	\$100,000	\$30,000	\$70,000	7.50%	Non-performing	\$ -
Buy	\$70,000	\$700	\$69,300	7.50%	\$5,250	\$ 13,125

Table II

Selling Fixed-Rate Loans as a Means of Interest Rate Management (on a five year remaining term)					
	Book Value	Market Value	Rate	Year 1 Earnings	Earnings over Remaining Term
Fixed-rate loans	\$100,000	\$90,000	6.00%	\$6,000	\$15,000
Floating-rate loans	\$100,000	\$100,000	8.00%	\$8,000	\$20,000

Interest Rate Hedging

Many community banks do not formally hedge their interest-rate risk. Whether or not a bank intends to do so, however, maintaining a fixed-rate loan portfolio (without hedges) creates exposure tied to changing interest rates.

If a bank believes that rates may be going down, the value of its fixed-rate assets increases. As rates go down, funding costs decrease and net interest margins widen. As appealing as this may sound, the opposite is equally relevant; when rates go up, the value of the bank's fixed-rate loan portfolio will decrease. While these rates trend higher, funding costs increase and net interest margins narrow.

A common, low-tech strategy employed by many banks is to simply sell a portion of fixed-rate assets when there is a belief that rates may be going up. For argument sake, let's assume rates will go up by 200 basis points in the coming year. If rates do rise, as noted in Table II, an investment currently worth \$100,000 will be worth only \$90,000 by year-end. This devaluation is largely due to fixed-rate earnings not being able to increase as rates rise.

Assuming, however, that a bank sells these fixed-rate assets today for its current \$100,000 value and then buys a comparable floating-

rate investment, the market value remains at \$100,000, and the bank enjoys the interest income benefits from the rising rates.

We are not suggesting community banks try to time the market and load or purge fixed-rate holdings based on where they suspect rates are heading. Rather, banks should consider selective sales

Table III

Strategically Selling Loans During the M&A Process							
	Book Value of Loans	Mark-to-Market Value	Coupon Rate	Annual Earnings	Yield	Required Tier 1 Capital	Freed Capital
Sell	\$100,000	\$90,000	6.00%	\$6,000	6.67%	\$5,000	\$ -
Buy	\$90,000	\$90,000	6.67%	\$6,000	6.67%	\$4,500	\$ 500

and acquisitions of fixed-rate holdings as a means to demonstrate liquidity and to manage a portion of interest rate exposure.

Mergers and Acquisitions

Given the current operating environment, many banks are looking at merger and acquisition opportunities as a way to build scale. During that process, interested parties derive combined statements of the merging entities and closely scrutinize the results.

Oftentimes, reviewing the combined income statements

and portions of the balance sheet are relatively intuitive. What may prove more challenging, however, is evaluating the pro-forma loan portfolio.

In some cases, the combined portfolio delivers much-needed diversification. More often than not, though, particularly when regional players merge, the combined entity is composed of a less-than-optimal, geographically concentrated mix of particular assets (such as commercial real estate, home equity loans, credit cards, residential mortgages, equipment leases, non-performers, automobile loans, etc.).

Rather than having these excess concentrations impair the

combined valuation and risk assessment, many banks strategically divest some loan holdings to materially optimize balance sheet composition, free up capital and generate pre-merger gains on sale.

As part of the merger and acquisition process, loan asset values are marked to market prior to acquisition. At times, this process can result in marking certain assets at a value below par while still having to allocate Tier 1 capital for the entire face amount.

Ongoing spread compression and aggressive demand for deposits have led banks to explore asset management to address non-performing loans and focus on growth.

As demonstrated in Table III, selling these assets at their marked value (with no income statement impact) can both generate liquidity and free up capital that can be more efficiently deployed into par-valued investments. Table III also illustrates that a similarly yielding investment valued at par can free up about 10 percent in required capital.

These are only a few of the many reasons why a bank may consider buying or selling assets. A common misperception is that banks only sell assets to rid their balance sheet of problem transactions. There is no question that the sale of non-performers is a powerful balance sheet management tool. However, a bank should

periodically assess its entire loan holdings and determine whether some of the aforementioned tools could enhance its risk profile and clarity of financial performance as well as demonstrate successful access to the loan liquidity markets. **ib**

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