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At the Margin

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Managing Capital While Facing a "Restrictor-Plate" Regulatory Mindset

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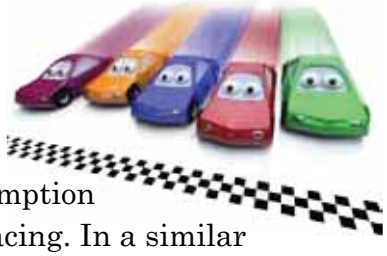
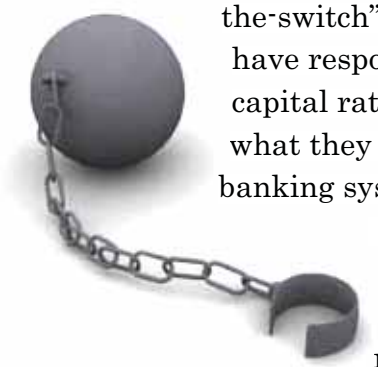
The Doctor Is In!



Those familiar with NASCAR are also familiar with its policy of slowing down race cars by restricting their fuel consumption in order to promote more competitive racing. In a similar fashion, regulators, after facing criticism for being "asleep-at-the-switch" during the onset of our financial crisis, have responded with unprecedented pressure to raise capital ratios in financial institutions… curtailing what they deem to be "excess leveraging of the banking system."



All bankers have heard the non-statutorily based but coercive refrain, "reach and maintain 8% leverage capital and 12% risk-based capital ratios." This is not bad advice for institutions with severe asset quality problems which are undercapitalized and must raise capital and/or shrink. But what of the many institutions with leverage capital ratios of 9% to 12% and higher who react to this regulatory pressure by figuring that when in doubt, just raise capital ratios and everything will be better, especially regulatory attitudes towards their institutions. Believe me, given the financial stakes, Directors are often intimated by even the hint of regulatory impatience.

> Exhibits 3 and 4 graphically show that the opportunity cost of growing slower than ROE is substantial indeed.

With just a little basic banking arithmetic, my fellow Directors,

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Prescriptions for Success!

Ah, as usual, Dr. Tom makes things sound easier than they really are! After all, growing by your ROE net of dividends indicates that you have the assets to grow. So what are they?

You can certainly grow with wholesale investments, but let's face it, the narrower spreads (vs. loans) will require more volume. One of our clients leveraged $50 million in bonds to leverage excess capital (3 years ago when there was a spread) as a temporary step until they could originate loans. Although they did add incremental income, the lower spreads had an impact on their net interest margin relative to their peers.

So, that brings us back to your opportunities to originate loans. Many banks have pulled back from lending (or at least slowed down) due to the economic climate, concern about quality credits, and the

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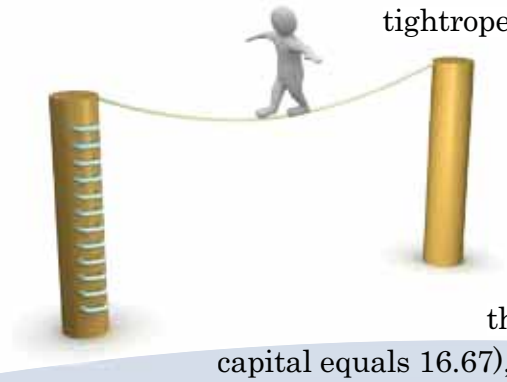
you will see how pushing the entire banking system towards higher leverage capital ratios along with across-the-board higher allowance for loss reserves must lead to less lending at both the macro and micro level. But this same arithmetic will also show you a reasonable target for growth that walks the tightrope between too slow and too fast.



A capital-to-asset ratio of 6% ($6 capital/$100 assets) allows each institution to support $100 of assets with $6 of capital. The inverse of the capital-to-asset ratio is called the leverage ratio ($100 assets/$6 capital equals 16.67), or every $1 of capital supports $16.67 of assets. If you move the accepted minimum of the capital-to-asset ratio from 6% to 8%, you have effectively reduced the leverage ratio from 16.67 to 12.5, a reduction of 25%! Therefore, instead of supporting $16.67 of assets with each $1 of capital, the banking system only supports $12.50 of assets with each dollar of capital.

Note that the re-trenching banking system is not limited to the shrinking loan portfolios of restructuring banks. Even banks who are used to a cushion above the old minimums will seek to reestablish new cushions above 8%.

Regulators reason that if we restrict how fast an institution can grow, then we can restrict how fast they can get into trouble. Unfortunately, these systemic increases in reserves slow the pace of lending. Decreasing the return on all existing equity even raises the profitability requirements of new loans that are made!

So, how are Directors supposed to deal with the regulatory mindset that demands increasing capital ratios, ALLL, and liquidity? Where is the invisible hand that Adam Smith promised?

The answer: ***focus on ROE.***

Return on equity represents the rate of growth of equity (capital) and defines exactly how fast you can grow assets without reducing your capital ratio. Grow assets slower than ROE, and your capital ratio increases; grow faster than ROE, and your capital ratio decreases. If the return on assets that you are adding to the balance sheet is greater than the average return on the assets of your portfolio, then growing by your ROE will improve your ROA, your rate of growth of earnings, your actual dollars of capital, dollars of assets, and most importantly, the average ROE of the bank. This ROE

continued on next page ("The Doctor Is In")

Prescriptions For Success
(continued from page 1)

regulatory "tax" imposed on the first year of the loan (loan loss provisions). But, assuming your credit underwriting is stellar, this is a great time to take advantage of the turmoil in the markets! Several of our clients have been very successful offering "Debt Free Mortgages" to targeted customers and prospects. These mortgages are fast amortizing loans (7 to 10 years) and attractive to borrowers because they are 1) debt-free in a relatively short period of time vs. their current mortgage of 15, 20, or 25 years; and, 2) have an internal rate of return that can beat most investment alternatives. You can read more detail about this mortgage by visiting our Web site http://parlimentconsulting.com/archives.html "Kick It Up a Notch."

We never intend to minimize the challenges posed by retail growth. We get it. It's messy and requires innovation and attention to what the markets need and want in any economic cycle. Dr. Tom and I specialize in retail strategies. Call us! We have no problem getting into the pits and getting grease under our finger nails.

–Janet Frankl-Lockwood

defines the sustainable level of growth of your institution.

In Exhibit 1, we show a $350 million institution that takes a $1.5 million hit to earnings in a loan loss provision in 2010, wipes out earnings, and is sitting at 10% leverage capital-to-asset ratio. Its ROA before the loan loss was about 50 bp and the bank was generating an ROE of about 5%. After this asset quality setback, the Board considered limiting growth to 2% per year and raise its capital-to-asset ratio to 11%.

Exhibit 2 shows the same institution merely substituting an asset growth rate of 5%, equal to the 5% core ROE. By 2014, after growing assets that have a net ROA of 1.5% (after tax), they will be able to have actual dollars of capital that is $2.55 million greater on assets that are $64.5 million greater, an ROA for the entire institution that is 12 bp higher, a doubling of the rate of growth of earnings (10.7% vs. 5.2%), and even a higher ROE on a larger capital base (6.8% vs. 5.0%)!

Exhibits 3 and 4 graphically show that the opportunity cost of growing slower than ROE is substantial indeed.

By the way, I should remind everyone that the ROE that I am referring to is the ROE net of dividends.Of course, many of you know me to be wedded to setting earnings targets of 10% to 12% and then letting the rate of growth of assets be whatever is required to generate the targeted earnings growth. Note that in Exhibit 2, growing by the ROE in this case does in fact generate a rate of earnings growth within my "sweet spot." That's really not an accident, you know!

I realize that when in doubt, the temptation is to put the bank at caution speed, let capital ratios increase and wait for safer lending conditions or easier regulators…. That's likely to be a lot of "caution laps."

There may be reasons why you think that your bank can't sustain growth by your ROE, but if so, let the discussion start there to most effectively manage your capital.

-Tom Parliment

Exhibit 1
Base Case: 2% Asset Growth to Maximize Growth of Capital Ratio

	Ending Assets	Tier 1 Ending Capital	Ending Capital Ratio	Operating Income	Net Income	Retained Earnings	Rate of Asset Growth	Expense Adjustment	Income Growth Rate
2009	350,000	35,000	10.00%	1,750	1,750	1,750			
2010	350,000	35,250	10.07%	1,750	250	250	0.00%	1,500	-85.71%
2011	357,000	37,053	10.38%	1,803	1,803	1,803	2.00%		621.00%
2012	364,000	38,960	10.70%	1,908	1,908	1,908	1.96%		5.83%
2013	371,000	40,973	11.04%	2,013	2,013	2,013	1.92%		5.50%
2014	378,000	43,090	11.40%	2,118	2,118	2,118	1.89%		5.22%

Provision for Loan Loses

Assumptions	2010	2011	2012	2013	2014
Asset Growth	0	7,000	7,000	7,000	7,000
After Tax Spread*		1.50%	1.50%	1.50%	1.50%

*This spread is not only net of taxes, but is intended to adjust for incremental expenses associated with growth. It is understood that growth in loans will be associated with a 1% to 1.25% loan loss provision expense and that this will retard the earnings impact of loan growth during the year of origination.

	ROAE NI/Cap	Equals	ROAA NI/Assets	X	Leverage Assets/Cap
2009	5.00%		0.50%		10.00
2010	0.71%		0.07%		9.93
2011	4.99%		0.51%		9.63
2012	5.02%		0.53%		9.34
2013	5.04%		0.55%		9.05
2014	5.04%		0.57%		8.77

Growing assets by 2%... which is less than the approximate 5% ROE… results in an average 28 bp per year improvement in the capital ratio. The loan loss hit retards the growth in the capital ratio the bank would have realized.

Operating Income for 2010: Previous year's operating income plus half of the asset growth times spread (reflects average assets for the year).

Operating Income for 2011-2014: Previous year's operating income plus half of the asset growth times spread for the current year plus half of the asset growth times spread for the previous year.

Net Income: Operating Income less Expense Adjustment.

Exhibit 2
Strategy 2: 5% Asset Growth (Growing by ROE)

	Ending Assets	Tier 1 Ending Capital	Ending Capital Ratio	Operating Income	Net Income	Retained Earnings	Rate of Asset Growth	Expense Adjustment	Income Growth Rate
2009	350,000	35,000	10.00%	1,750	1,750	1,750			
2010	367,500	35,381	9.63%	1,881	381	381	5.00%	1,500	-78.21%
2011	385,500	37,529	9.74%	2,148	2,148	2,148	4.90%		463.28%
2012	404,000	39,950	9.89%	2,421	2,421	2,421	4.80%		12.75%
2013	423,000	42,653	10.08%	2,703	2,703	2,703	4.70%		11.62%
2014	442,500	45,644	10.31%	2,991	2,991	2,991	4.61%		10.68%

Assumptions	2010	2011	2012	2013	2014
Asset Growth	17,500	18,000	18,500	19,000	19,500
After Tax Spread*	1.50%	1.50%	1.50%	1.50%	1.50%

*This spread is not only net of taxes, but is intended to adjust for incremental expenses associated with growth. It is understood that growth in loans will be associated with a 1% to 1.25% loan loss provision expense and that this will retard the earnings impact of loan growth during the year of origination.

	ROAE NI/Cap	Equals	ROAA NI/Assets	X	Leverage Assets/Cap
2009	5.00%		0.50%		10.00
2010	1.08%		0.11%		10.39
2011	5.89%		0.57%		10.27
2012	6.25%		0.61%		10.11
2013	6.54%		0.65%		9.92
2014	6.78%		0.69%		9.69

While hit with the same income reduction in 2010, growing by ROE gets the institution back on a faster earnings track… while this slows the recovery of the capital/asset ratio, it benefits all other measures of financial performance.

Exhibit 3:
Low Growth Allows a Faster Recovery in the Capital Ratio… But At What Cost?

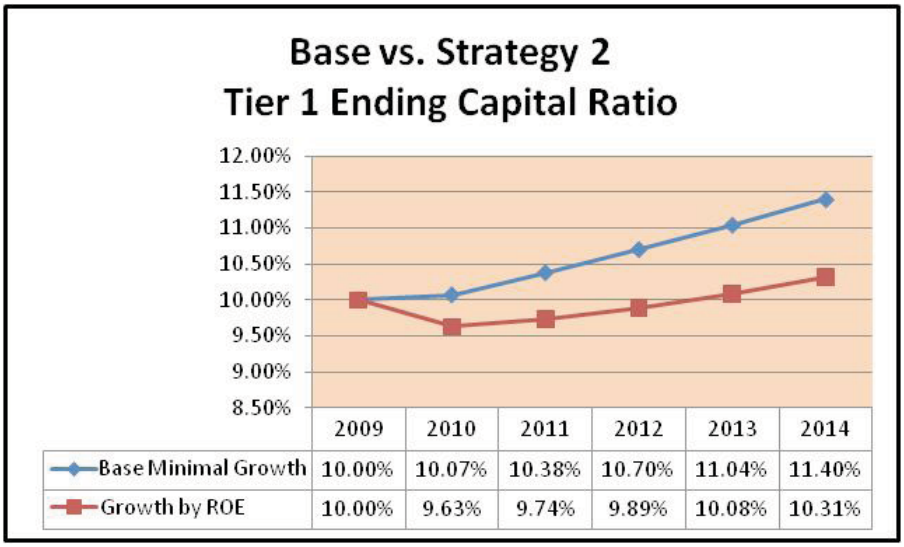
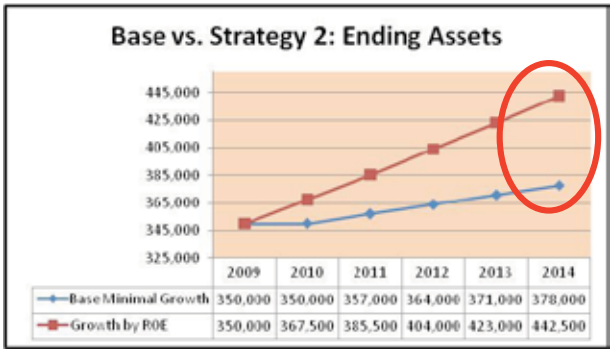
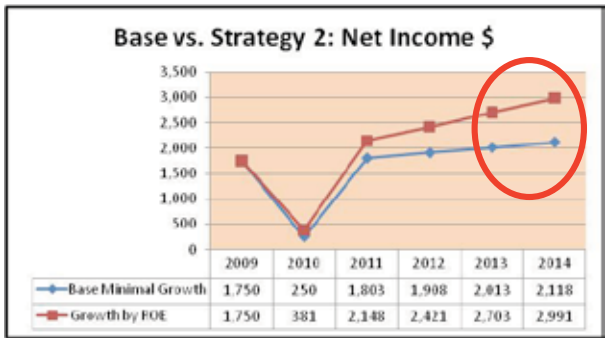


Exhibit 4:
Base vs. Strategy 2: Slow Growth vs. Faster Growth (Grow by ROE)

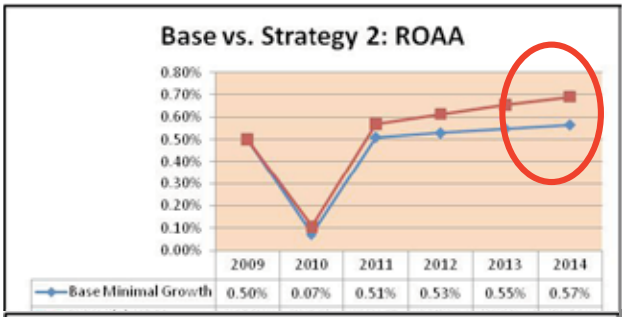


	2009	2010	2011	2012	2013	2014
Base Minimal Growth	350,000	350,000	357,000	364,000	371,000	378,000
Growth by ROE	350,000	367,500	385,500	404,000	423,000	442,500

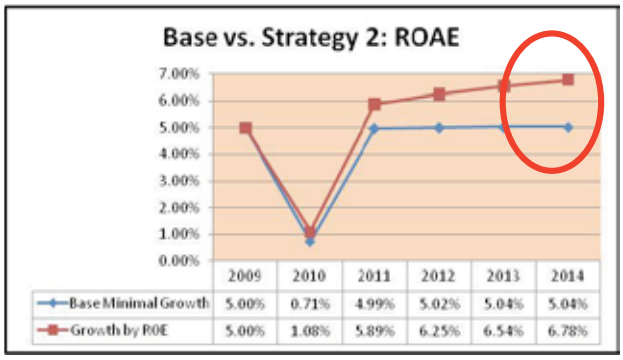
	2009	2010	2011	2012	2013	2014
Base Minimal Growth	35,000	35,250	37,053	38,960	40,973	43,090
Growth by ROE	35,000	35,381	37,529	39,950	42,653	45,644



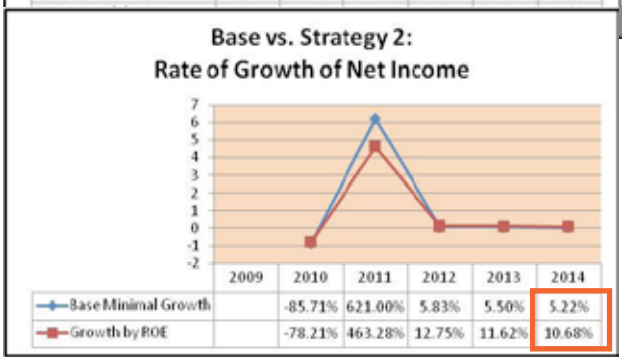
	2009	2010	2011	2012	2013	2014
Base Minimal Growth	1,750	250	1,803	1,908	2,013	2,118
Growth by ROE	1,750	381	2,148	2,421	2,703	2,991



	2009	2010	2011	2012	2013	2014
Base Minimal Growth	0.50%	0.07%	0.51%	0.53%	0.55%	0.57%



	2009	2010	2011	2012	2013	2014
Base Minimal Growth	5.00%	0.71%	4.99%	5.02%	5.04%	5.04%
Growth by ROE	5.00%	1.08%	5.89%	6.25%	6.54%	6.78%



	2009	2010	2011	2012	2013	2014
Base Minimal Growth		-85.71%	621.00%	5.83%	5.50%	5.22%
Growth by ROE		-78.21%	463.28%	12.75%	11.62%	10.68%

In all metrics, Strategy 2 (faster growth) outperforms Base (slower growth).

Parliment Consulting Services focuses on Strategic Financial Planning to help community financial institutions gain and maintain sustainable superior earnings growth. *We specialize in retail loan and deposit strategies.*

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