Zachary Scott
INVESTMENT BANKERS

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The Bank Capital Shortage

Financial distress among lenders has left middle-market companies with fewer options.

by Michael T. Newsome and William S. Hanneman

Credit is the lifeblood of the economy. Access to debt capital allows businesses to invest in growth initiatives and refinance existing indebtedness. Thanks to the fallout from a period of aggressive lending and the subsequent financial distress among lenders, the middle market has gone from feasting on financing options to a starvation diet almost overnight. While credit market conditions have improved markedly in recent months, as compared to the dark days of 2009, we are not yet out of the woods. Bank capital shortages will continue to define how, at what price, and which businesses will have access to the credit markets in 2010.

2010 – THE YEAR OF BANK DELEVERAGING

A shortage of bank capital will persist in 2010, which has implications for business credit. To understand the linkage, a bit of background is required on how banks fund their lending activities. Funding comes principally from three broad categories:

1. Capital – common and preferred equity, together with retained earnings;
2. Debt – short- and long-term notes; and
3. Deposits – purchased funds, and interest- and non-interest-bearing accounts.

Credit losses have depleted bank capital. As a result, both regulators and investors have pressured banks to shift funding away from debt and brokered, or "hot money," deposits in favor of a combination of government-provided TARP preferred and common equity raised in the public capital markets and stable deposits. In fact, the federal government sought to bolster availability of stable low-cost deposits by according unlimited FDIC insurance coverage to all non-interest-bearing deposits.

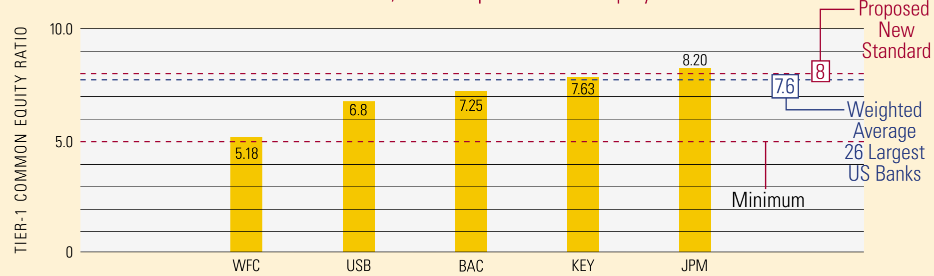
From a regulatory perspective, the definition of "capital" seems to have been bifurcated, with the smaller regional/community

[1]TC is generally defined as the sum of common equity + non-cumulative preferred equity + retained earnings + deferred tax assets – goodwill and intangible assets.

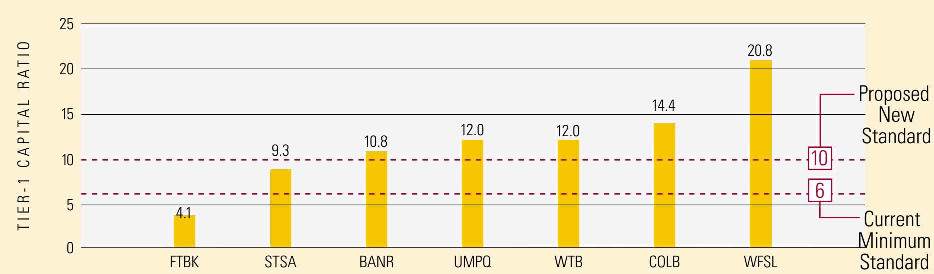
[2]TCE is generally defined as the sum of common equity + retained earnings + deferred tax assets.

[3]Total risk-weighted assets are calculated based upon a complex formula that weighs different classes of balance sheet assets and off-balance sheet contracts and commitments.

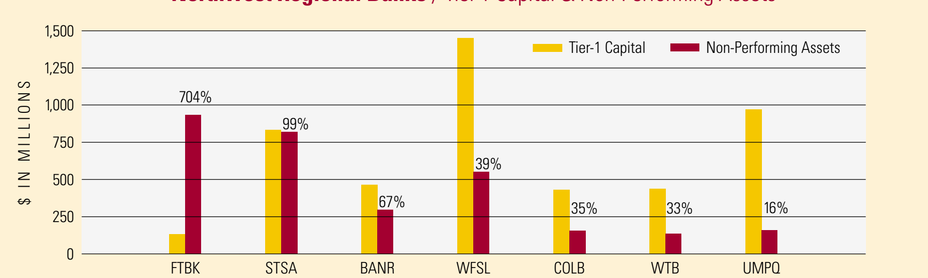
National Banks / Tier-1 Capital Common Equity Ratio



Northwest Regional Banks / Tier-1 Capital Ratio



Northwest Regional Banks / Tier-1 Capital & Non-Performing Assets



NATIONAL BANKS

WFC / Wells Fargo
BAC / Bank of America
USB / US Bank
KEY / KeyBank
JPM / JPMorgan Chase

NORTHWEST REGIONAL BANKS

FTBK / Frontier
STSA / Sterling
BANR / Banner
UMPQ / Umpqua
COLB / Columbia
WTB / Washington Trust
WFSL / Washington Federal

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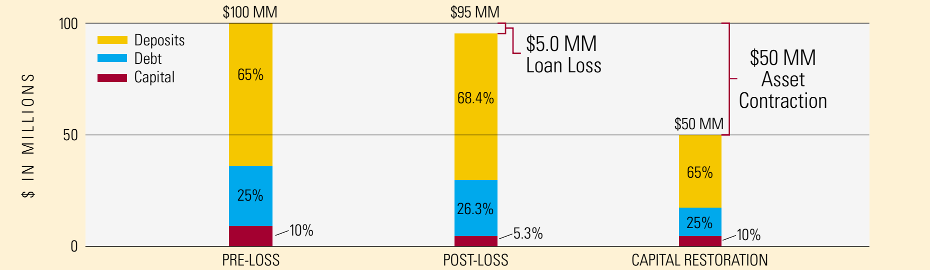
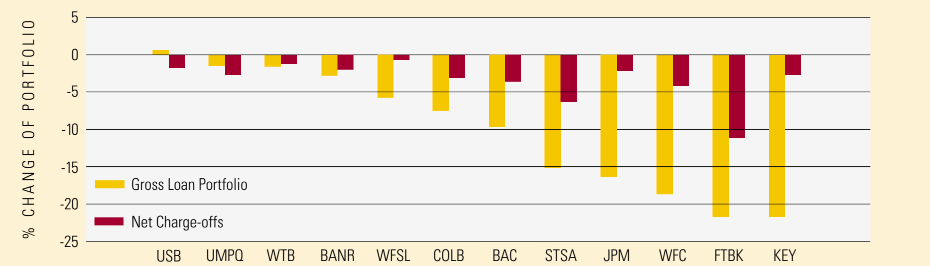


Bank Capital Arithmetic



Loan Growth & Charge-Offs*

*Last four quarters ending 9/30/09.

banks being measured using Tier-1 Capital (TC), while large national or super-regional banks are viewed relative to a more stringent Tier-1 Common Equity (TCE) standard. The adequacy of TC or TCE is assessed based on its ratio to total risk-weighted assets.

There continues to be considerable uncertainty with regard to minimum capital standards that Congress and regulators will impose on banks. Current thinking seems to be that a Tier-1 TCE ratio in the 5% to 8% range is appropriate for large banks. Unfortunately, as of the end of Q3-09, only one of the major banks active in the Northwest (JPMorgan) exceeds the 8.0% standard.

A regional or community bank is expected to maintain a TC ratio of at least 6% in order to be considered "well-capitalized" (the regulatory euphemism for minimum capitalization). There is much talk among bank regulators and Congress about increasing the capital requirement, perhaps to as high as 10%. Even when measured against these higher standards, Northwest regional banks (except for Frontier) don't look too bad.

But, in reality, regional bank capital positions are weak when viewed in the context of their non-performing asset loads. Both Frontier and Sterling are buried in problem credit, which leaves little doubt as to why they are under the gun to raise capital. The other regional banks have significant credit challenges, relative to any historical norm. Even under these conditions, most were able to raise additional equity in 2009 to supplement the TARP funding they received. What's not reflected in the adjacent charts are the 20-plus Washington community banks, with nearly $14 billion in assets, that are operating under regulatory cease-and-desist orders or similar corrective agreements. Most of these banks are burdened by non-performing real estate portfolios and capital deficiencies.

Of course, new capital is costly in terms of shareholder dilution. For even modestly troubled regional/community banks, it may be nearly impossible to go back to the well for additional capital. There is no easy answer to this problem. The path of least resistance for many banks has been, and continues to be, to shrink by eliminating higher-cost deposits and by shedding assets in an effort to improve capital ratios.

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IMPACT ON CREDIT CREATION

A crucial consequence of deleveraging has been a reduced ability of the entire financial system to lend money. According to the Federal Reserve, lending to businesses has plummeted from a peak of $1.65 trillion in October 2008 to around $1.35 trillion at the end of 2009. This is the most significant business-credit contraction since the government began tracking the statistic. Since September 2008, the loan portfolios of the major banks shrank by $264 billion (11.2%), after factoring out the impact of major acquisitions. During the same time frame, Northwest regional bank-loan portfolios declined by $2.83 billion (7.3%). To be sure, this is not just erosion of commercial and industrial loans. Banks have rolled back consumer credit and real estate lending, and many borrowers are not using available credit lines to the same degree as previously. Only US Bank and Umpqua appear to have originated more credit than they charged off over the past year.

The struggle to deleverage is hampering a more vigorous economic rebound and portends a vexing dilemma for lenders. At the same time that politicians are castigating banks for failing to bolster credit availability for small businesses, and Congress is threatening to impose punitive taxes that will diminish bank earnings retained as capital and increase the cost of credit to borrowers, the regulatory screws turn tighter on bankers to lend evermore prudently and carry larger capital cushions against future losses. These conflicting demands are not easily reconciled and may, in fact, grow worse. The FDIC recently finalized new accounting standards that mandate inclusion of securitized assets on bank balance sheets, rather than as disclosures in the footnotes. These new standards usher in more pressure on banks to build capital and

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(continued p.3)

limit lending.

COMPETITION FOR CAPITAL ACCESS

The implications of insufficient bank capital are potentially daunting for corporate borrowers – tighter money and higher borrowing costs. As we described in some detail in the Fall 2009 edition of IN$IGHT, a wave of credit maturities looms. Much of this credit was originated in the five-year run up to the financial crisis and funded by securitizations. These assets cannot be rolled over at maturity and, by necessity, will compete vigorously for scarce bank capital. As essentially the only game in town, banks will be in a position to be highly selective in the risks they underwrite and can charge dearly for doing so. Businesses will need to compete for access to credit. Although higher-priced credit may not be roundly appreciated by the businesses dependent upon it, the capital retained as a result of higher margins, over time, will restore bank balance sheet health and improve prospective borrowers' access to funding. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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