Bulk Sales v. Systematic Disposition: Considering <u>All</u> Costs and Benefits

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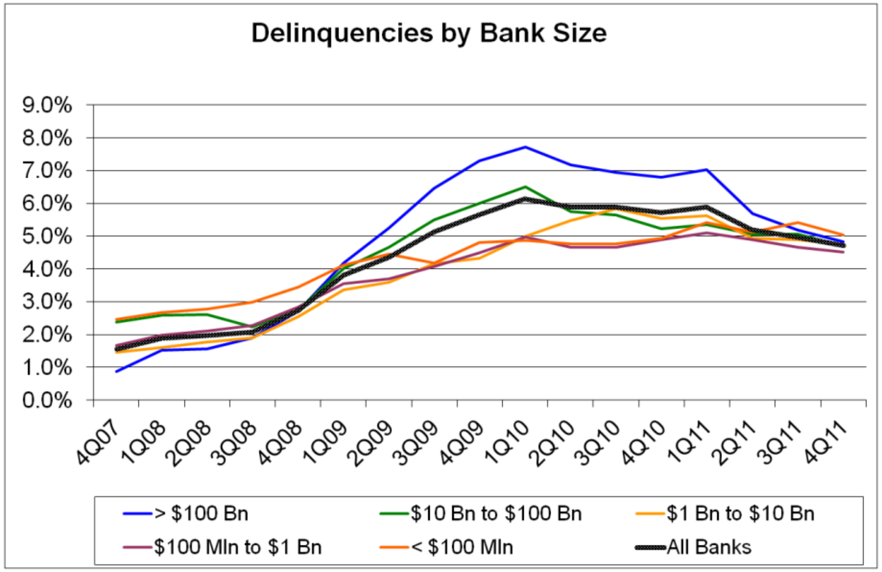
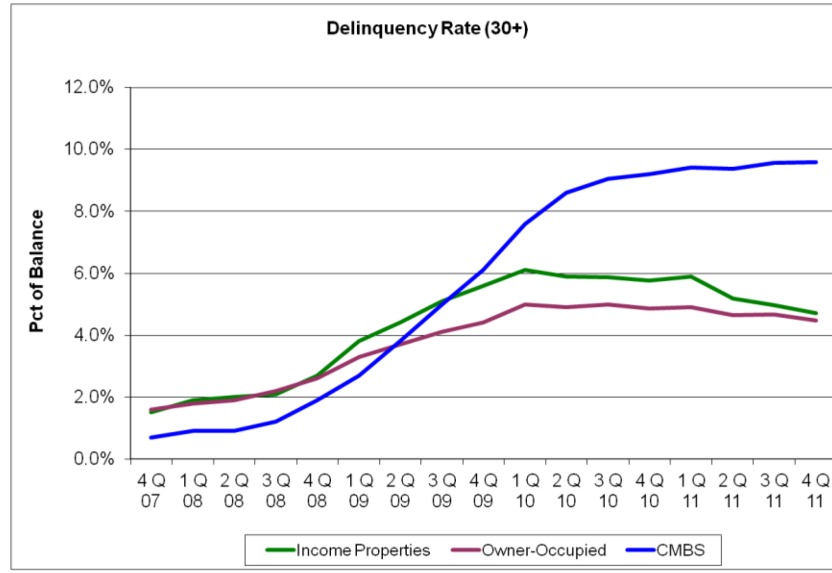
How does 2011 compare vs. 2006?

Source: FDIC Quarterly Banking Profile	2011	2006	% Change
Total assets	13,883,363	11,860,229	17.06%
Return on assets	0.88%	1.28%	-31.25%
Return on equity	7.86%	12.30%	-36.10%
Net interest margin	3.60%	3.31%	8.76%
Core capital (leverage) ratio	9.09%	8.22%	10.58%
Efficiency ratio	61.37%	56.79%	8.06%
Total loans and leases	7,465,728	7,233,323	3.21%
Total noninterest expense	411,632	332,292	23.88%
Noninterest expenses as % of loans	5.51%	4.59%	20.02%
Non current assets plus other real estate owned	354,026	62,859	463.20%
Non current assets plus other real estate owned to assets	2.55%	0.53%	381.13%
Loss allowance to noncurrent loans and leases	62.52%	136.84%	-54.31%
Net charge-offs to loans and leases	1.55%	0.39%	297.44%

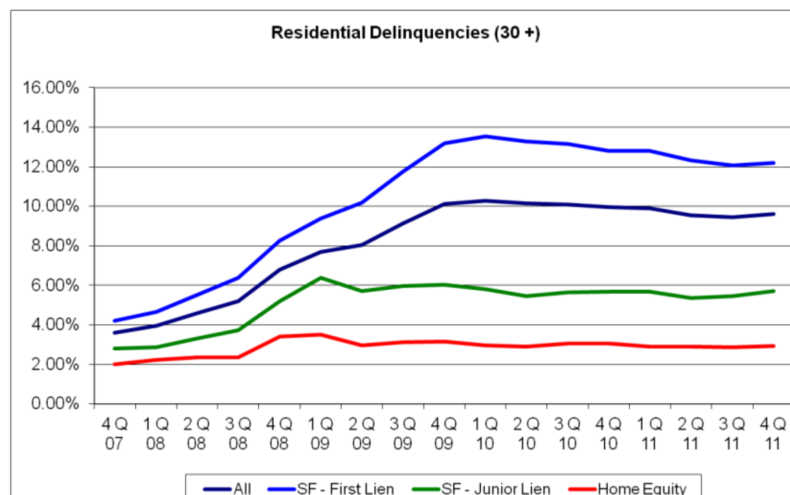
- Industry recovering, but profitability impacted by elevated NPAs
- Noninterest expenses grew by 20% as a percentage of loans
- Half of the profits in Q4 ’11 based on reduced provisions
- Loan balances rose in Q4 ‘11 by 1.8% - the largest quarterly increase since 2007

Good News: Asset quality improving

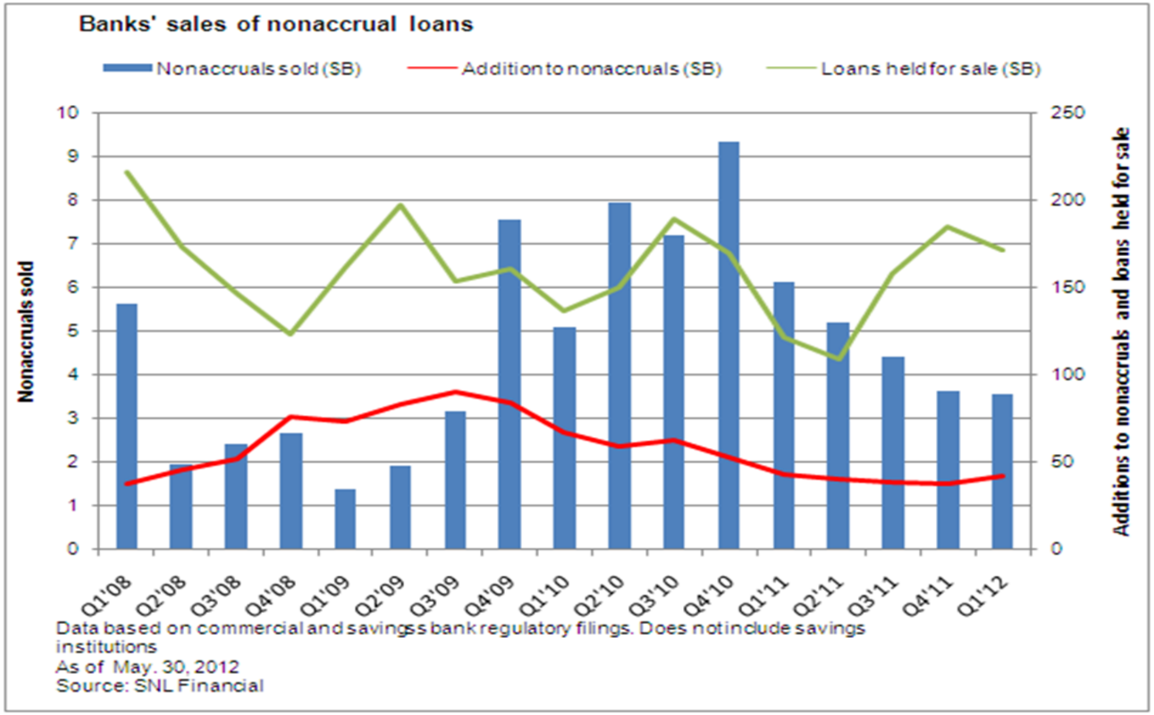




- Larger banks have made the biggest dent in reducing delinquencies
- Banks performing better on real estate loans than CMBS lenders, excluding C & D loans (13.44% delinquency)
- No movement on residential delinquencies
- Source: Trepp, FDIC



Tic, Toc: Problem assets pile up



- Non-accrual asset sales actually declined in 2011! After sales of $31 billion in 2010, sales in 2011 fell to $20 billion
- This is clearly unsustainable
- If banks were carrying their nonperforming assets at their true market value, they wouldn't have any!

Tic, Toc: While sales are slow

Company	Nonaccrual assets sold (2011)	Additions to nonaccrual assets (2011)	Total nonaccrual assets (12/31/11)	Nonaccrual assets sold (2010)	Additions to nonaccrual assets (2010)
Citigroup Inc.	4,929,000	18,063,000	12,332,000	8,998,000	28,796,000
Ally Financial Inc.	1,441,000	5,614,000	3,949,000	1,374,000	7,350,000
JPMorgan Chase & Co.	1,405,000	21,254,000	22,317,000	2,521,000	29,802,000
Bank of America Corporation	1,273,852	21,980,680	29,027,352	935,105	29,147,772
Wells Fargo & Company	1,222,000	20,387,000	21,433,000	1,474,000	30,948,000
BB&T Corporation	1,091,891	3,215,932	1,872,096	850,950	5,058,696
U.S. Bancorp	918,000	2,963,000	3,084,000	994,000	4,959,000
Regions Financial Corporation	816,545	3,162,191	2,699,846	1,542,605	4,729,511
Zions Bancorporation	407,215	1,058,805	1,035,742	380,748	2,072,366
Popular, Inc.	335,000	1,725,000	2,084,000	33,000	1,960,000
Synovus Financial Corp.	304,915	948,801	913,177	738,511	1,592,102
BBVA Compass Bancshares, Inc.	279,264	1,400,895	1,441,223	937,389	2,567,684
CIT Group Inc.	277,810	603,248	702,041	507,216	1,784,829
Capital One Financial Corporation	273,593	1,194,553	1,060,343	596,840	2,014,688
KeyCorp	219,250	1,276,077	763,496	700,707	2,746,695
First Horizon National Corporation	212,789	317,386	452,276	24,569	736,499
First BanCorp.	191,630	758,011	1,143,126	102,995	1,029,890
SunTrust Banks, Inc.	188,009	3,537,044	2,903,000	543,188	5,170,551
PrivateBancorp, Inc.	166,020	363,540	279,747	30,312	526,018
MB Financial, Inc.	156,338	238,136	129,309	0	481,043
Totals	16,109,121	110,061,299	109,621,774	23,285,135	163,473,344

- According to SNL, of the top 20 sellers in 2011, not one sold more in non-accruals than additions

Discussion Question

How do the carrying values on your bank's NPAs (Unpaid Principal Balance – (FAS 114 + Charge-offs) compare to market values?

1. About the same or less than a 10% divergence
2. Carrying values exceed market values (i.e., selling will involve a further loss) by 10% or greater
3. Market values exceed carrying values (i.e., selling will involve a gain) by 10% or greater
4. Don't know

Discussion Question

- What is your average recovery rate (net proceeds as a % of original unpaid principal balance) on resolved non-performing CRE loans?

- 81% or greater
- 61 – 80%
- 41 – 60%
- 40% or less
- Don't know

We find most banks believe they average 70%. But are they calculating the length of time as a non-accruing asset before resolution and all relevant costs. Is 70% really a 55% recovery if all factors are considered?

Results from Prior Webinar Survey

Question:	What is your average recovery rate (net proceeds as a % of original unpaid principal balance) on resolved non-performing CRE loans?	
Choice	Number of Votes per Option	% of Total Votes cast
81% or greater	17	10%
61 - 80%	51	31%
41 - 60%	16	9%
40% or less	12	7%
Don't know	66	40%

Question:	How do the carrying values on your bank's NPAs (Unpaid Principal Balance (FAS 114 + Charge-offs) compare to market values?	
Choice	Number of Votes per Option	% of Total Votes cast
About the same or less than a 10% divergence	84	56%
Carrying values exceed market values (i.e., selling will involve a further loss) by 10% or greater	16	10%
Market values exceed carrying values (i.e., selling will involve a gain) by 10% or greater	9	6%
Don't know	39	26%

Expected losses on CRE loans

Loss Severity is more severe than first glance

Date	Loss Severity - All Loans
2010 Average	45.20
2011 Q1	30.81
2011 Q2	43.57
2011 Q3	44.72
2011 Q4	50.73
2011 Average	42.80
12-Jan	39.54
Total	**43.50**

Date	Loss Severity - Stripping Out Losses < 2% of Balance*
2010 Average	59.64
2011 Q1	47.60
2011 Q2	50.78
2011 Q3	54.53
2011 Q4	55.77
2011 Average	52.54
12-Jan	53.23
Total	**55.07**

**Notes relating to adjusted loss severity*

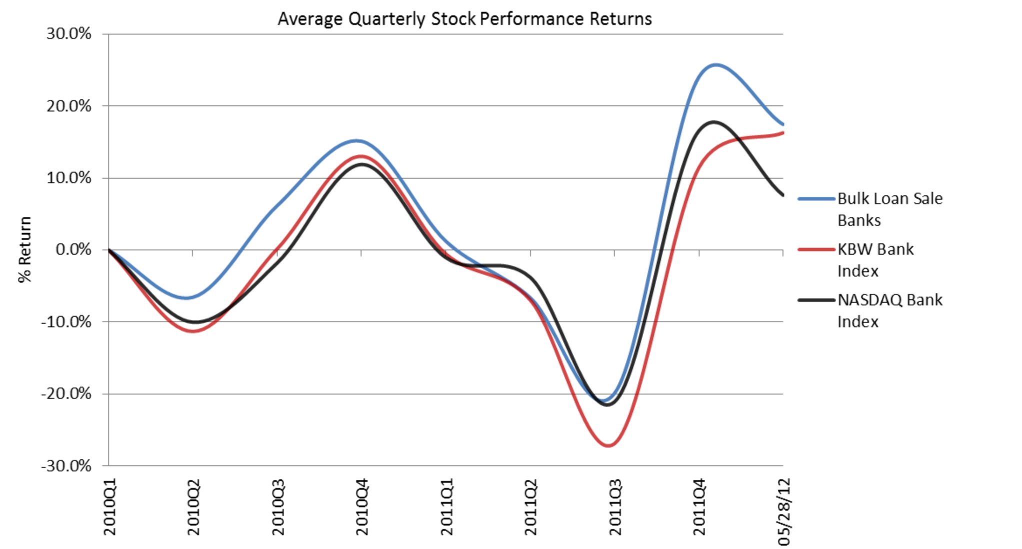
- Over the course of the year, a number of large loans paid off, but the special servicer fees led to small losses
- Stripping out these loans shows both a jump in the average loss severity and a more consistent monthly observation

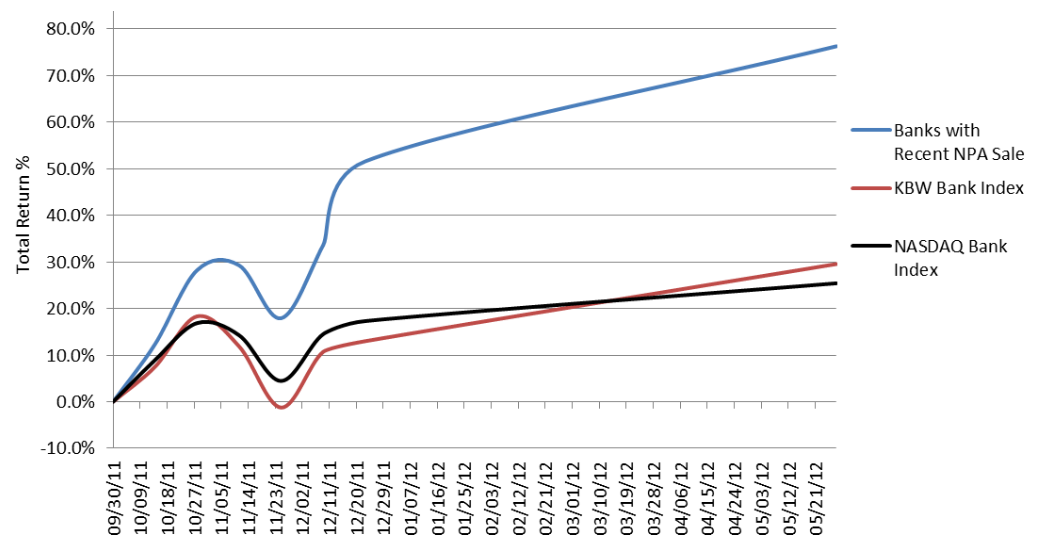
- When CMBS loans are resolved, losses are 43.5% of the outstanding balance; 55% excluding par recoveries
- Banks do not track recovery rates universally; but they are a better predictor of actual losses than appraised values
- Source: Trepp, LLC

Bank investors rewarding bulk NPL sellers

- 16 healthy public banks between $1 and $30 billion of assets sold 15% or more of their NPLs in any quarter between 2010 Q1 through 2011 Q4
- The 16 bulk sellers have outperformed the KBW and NASDAQ bank indices by 5.7% and 4.9% on average, per quarter, respectively.

- **Recent bulk sellers outperforming to a greater degree**
- Q3-Q4 2011 bulk NPL sellers (by ticker symbol): FFCH, FHN, FRBK, OKSB, CSFL





Considering long-term NPL portfolio management expenses

- Does your bank monitor all costs associated with managing NPLs? Expenses are much more than FAS 5 and FAS 114.
- For a well-capitalized bank, is the strategy of attempting to recover every last possible dollar from an NPL the correct one?
- What was your total non-interest expense related to managing non-accrual assets in 2006 vs. 2011?
- What % of time does your chief credit officer spend managing problem credits versus new originations?
- **Consider all expenses carefully. It is impossible to make the correct decision to rapidly dispose of NPAs or systematically over time if you don't collect and monitor expenses.**
  - Cost of capital and funding the portfolio
  - Increased workout staff
  - Appraisal, more frequent outside loan review, legal, property taxes, receiver costs, etc.
  - Regulatory costs
  - Opportunity costs
  - Employee morale

Long-term NPA portfolio expense survey

We requested the below data from 179 publicly traded banks with at least $20MM of NPAs on the balance sheet for a minimum of two years. Received 22 responses and only two banks provided answers to all of the below questions. Most CFO responses directed us to their bank 10K's. None of the banks publicly disclosed answers to all of the questions in their 10K.

1. Could you provide your bank's 2011 total interest expense to fund your NPL portfolio?
2. Could you provide us with an estimated cost of capital to carry your NPL portfolio in 2011?
3. Could you provide us the cost of staffing your internal workout group or any other personnel expenses you deem attributable to managing the banks NPLs in 2006 and 2011? (2006 only if available)

   How many bank staff members spend 75% or more of their time managing NPAs? How long will they be in those roles?

1. Could you provide us with your 2011 cost of appraisals for your NPA portfolio?
2. What were your total legal costs in 2011 attributed to your NPLs and OREO, including demand letters, foreclosure litigation, document review, receivers, etc.?

   Banks need to separate NPA legal vs. other legal expenditures to monitor

1. What did you pay in property taxes on your REO and NPL portfolios in 2011?
2. What did you pay in property management expenses for your REO portfolio in 2011?
3. What were your costs for outside loan review and workout consultants (if applicable) in 2011?
4. What was your total FAS 114 reserve and charge off expense for 2011?

Disposition strategies

- Bulk disposition vs. systematic disposition
- Bulk disposition allows a bank to quickly move past legacy problems and focus on growth and opportunities – institutional investors appear to prefer this strategy
- Systematic disposition is helpful to more capital-sensitive banks, but likely to depress earnings over a long period vs. an expeditious resolution
- Larger NPL portfolio sales attract institutional buyer interest and are fairly quick to execute
- Smaller banks can join in multi-bank loan sales organized by Clark Street and other providers; assets organized by geography, collateral and performance

Final Thoughts: Investors Want Action

"Bank analysts like to see decisive action and strategies that enable companies to focus on growth and profitability – the future and not the past. I expect that we'll see additional bulk asset sales as long as values remain somewhat stable"
– Nancy Bush, renowned Bank Analyst and SNL Financial columnist

"Bank executives need to decide whether it is better to spend the next 3-5 years trying to recover every last dollar from a bad loan already made, or repositioning the bank to grow and prosper once again. "
– Josh Siegel, Managing Principal at StoneCastle Partners