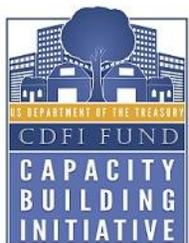


Training Module: Improving Financial Health Part 1: Addressing Asset Quality



This training contains general information only and Deloitte is not, by means of this training session, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This training is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

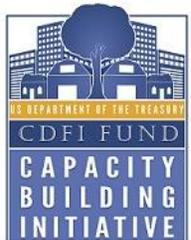
Deloitte shall not be responsible for any loss sustained by any person who relies on this training session.

Provided by: **Deloitte.**

Why Address Asset Quality?

A lack of proactive management of asset quality can lead to:

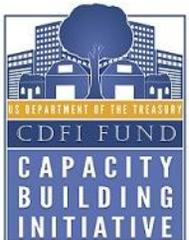
- Problems with Regulators
 - As of June 21, 2013, 45 percent of the CDFI MDIs are under enforcement action. Asset quality and credit risk management are among the most common reasons cited
 - Can have a negative affect on CAMELS ratings
- Challenges in Capital Adequacy
 - If risk exposure is not identified early, it can lead to capital problems as regulators may require the movement of capital into loan loss reserves quickly upon examination
- Issues Raising Tier One Capital
 - Only 31%* expect to meet all future regulatory capital requirements



*all respondents to the capacity assessment tool for New York and Atlanta

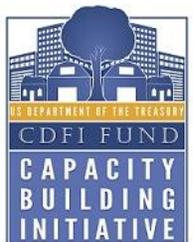
Structure of the Module

- I. Identifying and Re-Underwriting Problem Assets
- II. Leading Practices for Managing Asset Quality
- III. Options for Dealing with Problem Assets



Goals of the Module

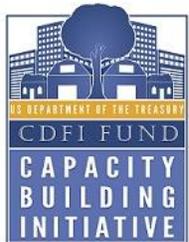
- Understand the importance of managing asset quality at the asset/loan level
- Learn how to re-underwrite problem assets in order to better understand how investors are evaluating your sub-performing and non-performing assets
- Improve ability to assess and manage the risk of sub-performing and non-performing assets
- Make better decisions on how to restructure sub-performing and non-performing assets and determine potential sell candidates



Asset Quality among CDFI MDIs

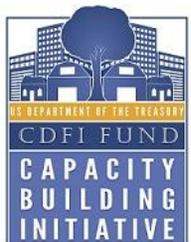
- High Texas Ratios: As of June 2013, 7 out of 40 CDFI MDIs had Texas Ratios above 100 percent - a sign of heightened risk among CDFI MDIs in being able to manage the risk of their non-performing loans

Average Financial Performance for Participating Institutions	9/30/2013	9/30/2012
Portfolio		
Total Assets	\$253,318	\$255,360
Total Loans	\$141,494	\$140,981
Total Deposits	\$204,502	\$208,286
Asset Quality		
% Non-Performing Assets	3.5%	4.2%
Texas ratio	33.1%	37.3%
% Charge offs	1.2%	1.0%
Long-Term Assets as a Percentage of Total Assets	29.5%	29.2%
Earning Assets to Total Assets	90.4%	90.4%



CDFI MDI Asset Quality Management: Results from the Capacity Assessment Tool*

- At a majority of banks in attendance, senior management is responsible for creating, monitoring, and keeping policies and procedures current for loan origination and portfolio monitoring
- 86% of banks have written workout and collection procedures in place that are reviewed at least annually
- Asset Concentration: 57% of banks have between 25-50% of portfolio in one asset class or industry
- Borrower Concentration: 21% of banks have at least one borrower that comprises 5% or more of portfolio
- Risk management:
 - Staff dedicated to risk management and a culture of risk management: 43%
 - Individual dedicated to risk management on full-time basis: 7%
 - Individual dedicated to risk management on part-time basis: 29%



*based on those in attendance that submitted a completed capacity assessment tool

Identifying and Re-Underwriting Problem Assets

Steps for Evaluating Problem Assets at the Loan Level

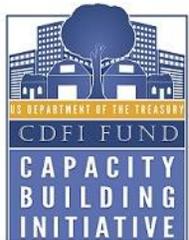
Step One: Understand portfolio composition by segmenting loans and REO by size, asset class, geographic location, age, and overall market performance of similar loans

Step Two: Assess portfolio quality by performing, sub-performing, and non-performing assets

Step Three: Conduct a detailed review of disposition/restructuring candidates: sub-performing and non-performing loans and real estate owned (REO)

Step Four: Re-underwrite problem assets

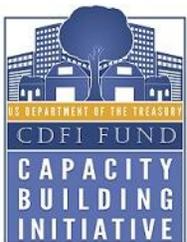
Step Five: Evaluate options for improving balance sheet



Why is Step 4 (Re-Underwrite your Problem Assets) Important?

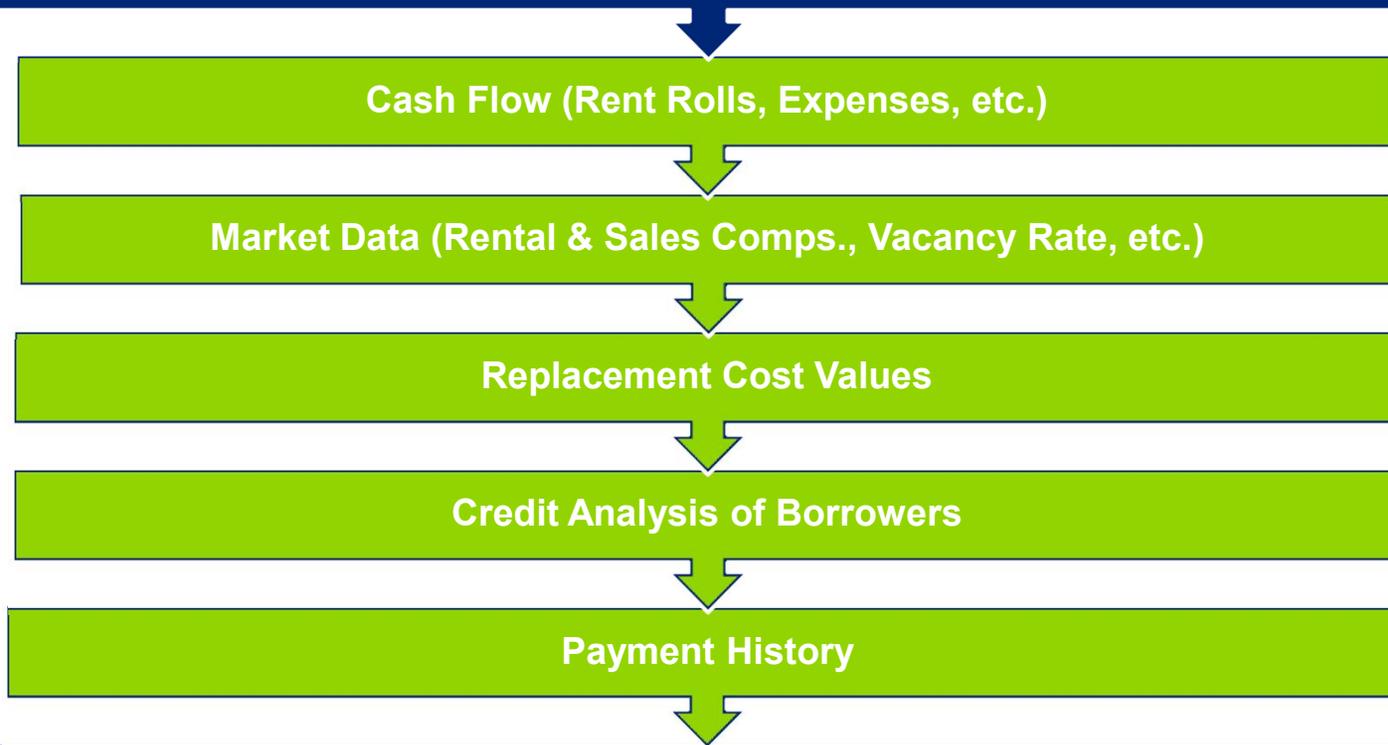
- If you don't re-underwrite your problem loans and assets based on current market valuation:
 - Regulators can downgrade your CAMELs rating and may require you to increase your loan loss reserves
 - Regulators may not endorse the restructuring strategies you propose for your bank
 - Investors will discount your assets severely—maybe even more than needed
 - Investors will not consider your bank favorably for new capital investments

Tip: Data integrity, i.e., current valuations, is the most critical factor for the successful sale of your distressed assets; it mitigates having assets re-traded or kicked-out

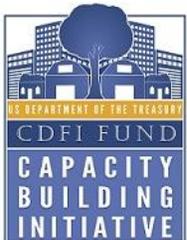


Process for Re-Underwriting On-Book Loan/Asset Values

Underwriting Process Should be Conducted Independently* and Utilize Current:



Results: Updated Current Loan/Asset Values, Sales Price Range, LTV, and Reserve Level



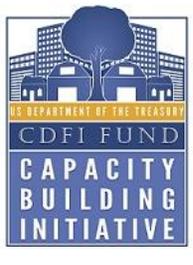
*Could be someone in the bank or external

Leading Practices for Managing Asset Quality

Who is Involved?

Risk Management – *This department should be independent of all business operations at the bank and report directly to the CEO.*

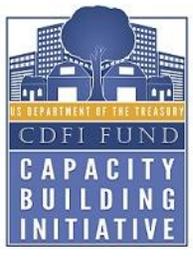
- **Chief Risk Officer or Chief Credit Officer (CCO) typically leads team and is accountable for:**
 - Monitoring all of the bank’s assets and ranking them by size, type, performance, and risk class
 - Determining the assets that pose risk to the CDFI MDI’s sustainability
 - Evaluating and recommending risk mitigation options for management and board consideration



Who is Involved?

Risk Management – *This department should be independent of all business operations at the bank and report directly to the CEO.*

- **Internal or External Workout Specialist or Team tasked with addressing sub-performing and non-performing loans:**
 - Re-values and re-underwrites the sub-performing and non-performing assets based on current market criteria
 - Individual(s) is/are separate and not associated with CDFI MDI's loan officers that originate and underwrite the bank's loans



Risk Management: Enhanced Monitoring for Sub-Performing and Non-Performing Loans

How often should you monitor loans?

- Quarterly monitoring for sub-performing/restructured assets
- Monthly monitoring of non-performing assets

Who is responsible for enhanced loan monitoring?

- Workout Specialists are responsible for the day-to-day monitoring of individual assets and the accurate rating of loans
- The Chief Credit Officer (CCO) is responsible for portfolio monitoring of assets

What type of enhanced monitoring and tracking should you do?

- Working with the workout specialists, the CCO is responsible for identifying and tracking loan/assets that present undue risk to the bank. By putting these assets into special asset groups for alternative and more intense monitoring, the CCO is able to focus on strategies to mitigate loan ratings from dropping further

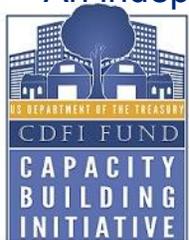
How and when do you involve an external reviewer?

- Make sure you have a reputable firm doing at least an annual loan review
- An independent appraiser conducting an annual REO valuation review

Attributes of Reputable External Reviewer

- Expert in bank loan purchases and sales, and/or asset purchases and sales
- Employs best practices in loan underwriting, credit analysis, loan valuations and/or property valuations
- MAI* designation for real estate appraisal and valuation services
- SEC licensed, if required, to sell loans
- Brokers license, if required, to sell REO

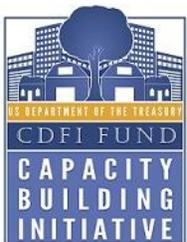
*Member of the Appraisal Institute, a global organization for real estate appraisers



Credit Risk Management for Sub-Performing and Non-Performing Assets

- Follow ALLL and set your own standards for risk rating that reflect local environment
- Be able to provide clear rating justifications to investors and regulators reflecting good analysis
- Adequately fund the loan loss reserves to reflect your risk exposure
- Benefit from identifying and addressing problems early – mitigate risk of running into capital adequacy problems
- Consider automating various credit and risk management functions

Tip: It is key to show your regulators and potential investors that you not only know how to handle existing sub and non-performing assets but also performing assets that are 30 or 60 days past due



Sample Tools to Enhance Risk Management

Enterprise Risk Management Tools

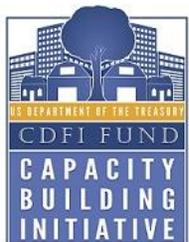
- MetricStream
 - Wolters Kluwer
 - IBM
 - Oracle
 - SAS
- Most commonly used by banks with less than \$500 million in assets*

Credit Risk Analytics

- SunGard (Ambit credit portfolio)
- FICO
- Experian
- LexisNexis Risk Solutions
- Moody's Analytics

Cloud Based Risk Management Solutions

- Emerging low cost solutions mentioned by community banks and credit unions

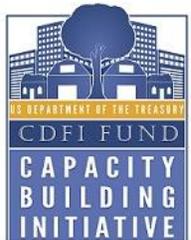


Options for Dealing with Problem Assets

Be Proactive When Dealing with Distressed Assets

Senior management, led by the Chief Risk Officer or Chief Credit Officer, should communicate with the board regarding:

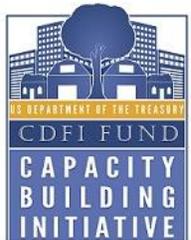
- **Your loan/asset watch list, which should include:**
 - Ranking of assets by severity
 - An outline of risk mitigation action steps
 - Recommendations for time and performance metrics required for their approval
- **The effects and timing of fair-market value of investments vs. book value of investments on capital ratios**
- **Restructuring and disposition opportunities including:**
 - If selling distressed assets is an option for your CDFI MDI
 - Sales price ranges for distressed assets and the resulting affect on capital/capital ratios
 - Deal terms and conditions for sales
 - i.e., sell the asset and keep the servicing, etc.



Options to be Discussed for Dealing with Asset Quality

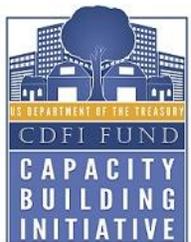
- Selling off sub-performing and/or non-performing assets – what buyers are looking for
- Creating a subsidiary to hold distressed assets
- Capitalizing on an investor CD depositor to buy distressed assets
- Exploring mergers and acquisitions
- Placing a stock offering

The following examples are illustrative of approaches used by financial institutions to address asset quality concerns. Please discuss these and other approaches with your legal and financial advisors to determine the best approach for your organization.



Recapitalization Scenario: Asset Sales

- Determine the size of the asset sale (i.e. single, pool, or bulk)
- Determine the asset price ranges for “sell candidates”
- Decide on deal parameters
 - For example: sell the loan and keep the servicing
- Determine sales parameters for distressed assets and effects on capital ratios
- Need adequate capital to make this work
- Improves your balance sheet



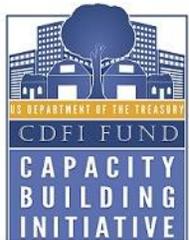
Identify Potential Local Buyers for Assets up to \$10 Million

Individual Loans/Asset Sales:

- Local developers
- Local/regional real estate companies
- Brokers
- Local and regional banks

Strategies for Identifying Buyers for Asset Sales:

- Use networks and referrals in your backyard
 - Board members (of your bank and on boards you serve)
 - Current shareholders
 - Your customers
 - Local businesses
 - Investment clubs/charitable organizations/alumni groups
 - Civic organizations/industry associations/professional associations
- Hire an investment bank or consultant with bank expertise
- Utilize online investment-investor platforms
 - ImpactBase
 - National Community Stabilization Trust



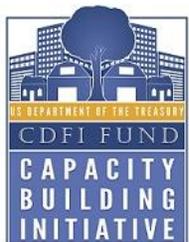
Tip: In recent years new online platforms have emerged to address the challenge of matching buyers and sellers

Buyer's Return Parameters are Sensitive to the Market Environment

- Internal Rate of Return (IRR's) expectations depend on the buyers cost of funds*
- Buyers/Investors typically require the following returns for **sub-performing** and **non-performing loans/assets**:
 - Private equity investors/hedge funds: 10-13 percent
(lower cost of funds)
 - Private investors: 15-20 percent
(higher cost of funds)

* The avg. IRR is approximately 15 percent

Note: As the overall market gets better the expected IRR drops and can be lower with local investors.

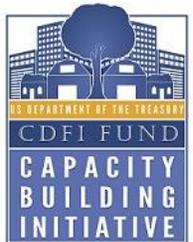


Your Goals of Asset Sale

LITTLE-TO-NO RETRADING

- Run a tight process where important documents are given out to potential buyers and approved by the buyers at the beginning of the process
- No GAPS: If there are gaps in the due diligence documentation, CDFI MDIs should provide supplementation for the gaps and be able to explain the gaps prior to starting the sales process

GAPS=RISK=PRICING REDUCTION

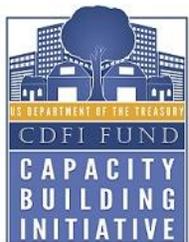


Recapitalization Scenario: Restructuring Example

Example of Restructuring Distressed Assets:

- Regional bank in the Midwest
 - Created a subsidiary for distressed assets
 - Contributed distressed assets to the new subsidiary*
 - Reclassified the distressed assets on the new subsidiary's balance sheet
 - Loaned money to the new subsidiary, (do if possible)

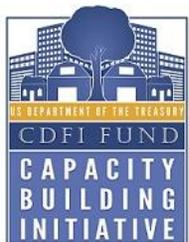
*The financial institution's new subsidiary formed a joint venture partnership with a reputable developer and contributed REO properties that were under construction that needed to be completed in order to be sold to create additional value. In addition, a large parcel of land, once subdivided will yield more value as smaller parcels than as one large parcel.



Key Considerations and Challenges

- Your CDFI MDI must have:
 - Sufficient capital to withstand the write downs
 - The ability to make a loan to the new subsidiary, if required
- Your restructuring plan may be subject to regulatory review and approval
- In the example, the bank talked with their regulators about their strategy to implement this restructuring option and obtained their suggestions and feedback to minimize the regulatory risks
 - The bank that implemented this strategy conducted write downs over a two year period
 - When the developer was identified, the regulators were informed
 - The experience and credit of the developer and the terms of the joint venture deal were disclosed to regulators prior to closing

Tip: Communicate with your regulators throughout the process to make sure they are onboard and to minimize unexpected obstacles during the process



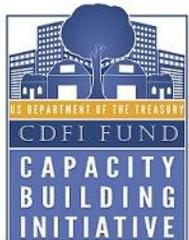
Recapitalization Scenario: Certificate of Deposit Example

Example from a CDFI MDI

During the hold period, the distressed assets' on-book values were written-down to reflect the net realizable value (six months of taxes, insurance, condo fees, legal fees, commissions, etc.)/market value

- The distressed assets' on-book values were approved by the regulators
- Investors included: corporations, affiliates, large banking clients, etc.
- The CDFI MDI bundled its distressed assets (\$15-\$20 million) and sold them to an investor for the on-book value
 - The CDFI MDI sold assets with tax credits to reduce losses associated with the sale of its distressed assets

Results for the CDFI MDI: Clean balance sheet, future write-downs eliminated, loan loss reserves removed or reduced, capital ratios improved, able to make new loans, and generated additional profits

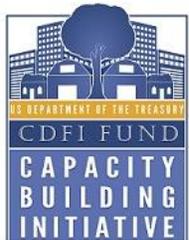


Recapitalization Scenario: CD Depositor Example (cont'd)

The Investor/New Investment Entity:

- The investor held a CD (ex. \$20 million) in another banking institution
- The investor used the CD as collateral to secure a loan for \$15-\$20 million
- The investor capitalized a new investment entity (ex. LLC) with the loan proceeds (\$15-\$20 million) and purchased the CDFI MDI's distressed assets

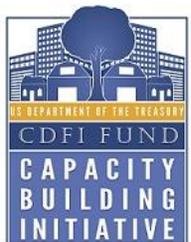
Results for the Investor: Purchased assets at today's market value, given time (5-10 years) to work-out assets, non-regulated management discretion to foreclose, restructure, joint venture, etc., able to generate fees (management, leasing and sales commissions, debt restructuring, etc.), and able to sell assets for a profit



Key Considerations and Challenges

Your CDFI MDI must:

- Have sufficient capital to withstand the write downs
- Identify a potential investor
 - Local business
 - Government entity
 - Current shareholder
- Go through regulatory review
 - In this example the CDFI MDI:
 - Reviewed and discussed their loan write downs with regulators over a 1-2 year period
 - Sold the distressed loans to the investment entity at the written down levels reviewed by their regulator



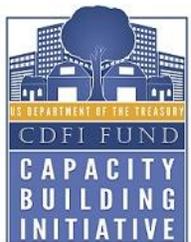
Recapitalization Scenarios: External Banking Solutions

Mergers and Acquisitions:

- Consider merging/joint venturing with another compatible and financially stronger institution
- Consider acquiring an institution that will increase your market-share

Stock Dilution-Stock Offering:

- Notify existing shareholders of stock offering(s)
- Most shareholders will want to understand how the dilution of their stock and the infusion of new capital will generate future profits



Recapitalization Scenarios: Stock Offerings

Types of Stock Offerings:

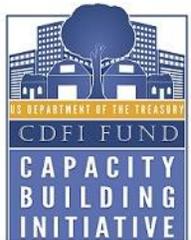
- **Rights Offerings***: to be extended to existing stockholders
- **Private Placement Offering***: for accredited investors only (unregistered)
- **Public Offering****: for public investors (registered)

Offer customers/depositors, board of directors, employees, etc. the ability to purchase stock.

Check Regulatory Limits: No investor should own more than 9.9 percent of outstanding shares.

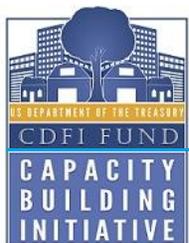
*Most commonly used by CDFI MDIs

** Typically not used by smaller banks



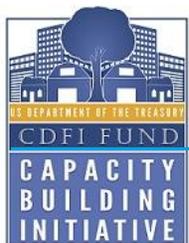
Benefits and Risk of Recapitalization Options

	Benefits	Risks
CD Depositor	<ul style="list-style-type: none"> • Clean balance sheet • Future write-downs eliminated • Loan loss reserves removed or reduced • Improved capital ratios • Able to resume new loan origination 	<ul style="list-style-type: none"> • Having sufficient capital to withstand write-downs • Identifying a potential investor • Not obtaining regulator approval • Length of process
Restructuring	<ul style="list-style-type: none"> • Diversification of revenue streams 	<ul style="list-style-type: none"> • Having sufficient capital to withstand write-down and make a loan to the new subsidiary • Finding a potential joint venture partner • Length of regulatory review and getting approval
Mergers and Acquisition	<ul style="list-style-type: none"> • Diversification of revenue streams • Increased market share potential • Ability to resume new loan origination • Lower operational costs for individual banks 	<ul style="list-style-type: none"> • Cultural compatibility of banks including mission and potentially different target markets • Losing either or both CDFI MDI status



Benefits and Risk of Recapitalization Options: Stock Offering

	Benefits	Risks
Rights Offering	<ul style="list-style-type: none"> • No stock dilution for existing shareholders • New capital to stabilize the bank 	<ul style="list-style-type: none"> • Might not obtain desired return on investment (ROI) • Might not be able to complete offering
Private Placement Offering	<ul style="list-style-type: none"> • Unregistered offering with accredited investors only • New capital to stabilize the bank 	<ul style="list-style-type: none"> • Might not obtain desired ROI • Dilution of stock for existing shareholders • Loss of MDI status • Might not be able to complete offering • Limitations of accredited investors
Public Offering	<ul style="list-style-type: none"> • New capital to stabilize the bank 	<ul style="list-style-type: none"> • Needs to be a registered offering with the SEC • High cost, especially for transaction of under \$25 million • Dilution of stock for existing shareholders

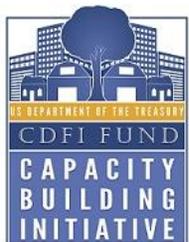


Wrap-Up

Key Takeaways

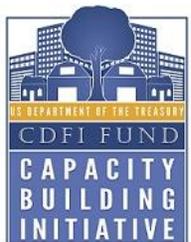
The strategies and steps proposed herein for restructuring portfolio holdings are to assist you in your efforts to:

- Improve your CAMEL Ratings
 - Enhanced asset quality processes and procedures
 - Enhanced credit and risk management methodologies
- Improve your bank's balance sheet
- Generate more interest from investors
- Negotiate higher asset sales values for distressed assets, and
- Make better choices when evaluating recapitalization options

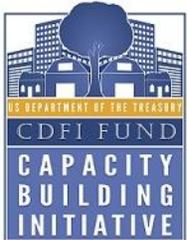


Examples of Potential Technical Assistance

- Review of policies and procedures for loan portfolio monitoring
- Perform valuation of assets
- Provide information on recapitalization options based on your bank's specific situation
- Support with identification of potential investors



Questions?





About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

