

# Building a fortress balance sheet – chase



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erspective P Insights for America's Business Leaders Building A Fortress Balance Sheet: Protect Your Bank's Financial Health While Positioning It For Growth Executive Summary: – The Vauban Model – Current Market Overview – Stress Testing and the Fortress Balance Sheet – Capital-Raising Strategies “ Ultimately, market participants themselves must address the fundamental sources of financial strains – through deleveraging, raising new capital and improving risk management. ” 1 – Ben Bernanke The Vauban Model

Throughout the remainder of the year, banks' capital needs will accelerate as credit losses are expected to continue, despite easing monetary policies and government intervention. To weather the turbulence in an economy that shows no immediate signs of improving, bank management must simultaneously master the:

- Offensive skills to raise capital and seize growth opportunities
- Defensive skills to protect asset quality and fortify their balance sheets

These requisite skills call to mind the exploits of Le Marechal de Vauban, the pre-eminent soldier and military engineer of 17th-century France.

His genius for the offensive (capturing places) and the defensive (fortifying places) earned him a reputation as one of the great captains of his age. This white paper will provide insight into protecting your bank's financial health and positioning it for growth, along with some offensive and defensive strategies for raising capital. The economic recovery is inevitable, so prepare to emerge from it with a roar instead of a whimper. Cracks in the Dike

Many mid-sized banks with little or no sub-prime exposure and well-managed “ capital cushions” were fortunate enough to avoid the burns of the sub-

prime mortgage meltdown. However, many stood by nervously as the larger banks took the majority of the write-down body blows. While bankers and business leaders everywhere hope that the worst has passed, the aftershocks have left many with the premonition that the crisis is not quite over and there is still another shoe to drop.

Already, the effects are starting to encroach on the broader economy as a number of small and mid-cap banks - having tried to grow too fast in the salad days of easy credit - have begun to see erosion in asset quality. Cracks are starting to appear in their "bread and butter" asset classes - from CRE and C&I to Home Equities and Credit Card loan portfolios. This spillover scenario is the new 800-pound gorilla in the conference room that is keeping CEOs and CFOs up at night. 2

Many are asking whether their financial institutions have "the borrow" to raise adequate capital to hedge against any deterioration in asset quality and still:

- Insulate against losses
- Maintain liquidity
- Protect the balance sheet
- Return value to shareholders
- Pursue growth opportunities

While there has been no rash of bank failures, the current landscape for sourcing new capital still appears fairly barren. However, there are signs that the climate could be changing for the better as recent activity in the financial markets indicates.

In its July 21, 2008 issue, Barron's reported that "After a record-setting rally last Wednesday, the brutal sell-off in financial stocks - the worst for any major industry group since the technology bubble burst in 2000 - could be over" 2 and that it's time to consider buying. This may be a good omen for

banks interested in raising common equity, but many traditional, large investors continue to exhibit a reluctance to pump money into the mid-sized banking segment in this sluggish economy.

To compound matters, banks face:

- Increased pressure from regulators to get more deeply involved in raising capital to what is considered to be “above well capitalized”; and
- A paucity of available capital from sovereign wealth funds and private equity investors

In addition, investors are causing waves in the market as they try to get their arms around potential credit losses at banks and predict just where the bottom is. Blend this with high oil prices, inflationary concerns, falling consumer confidence and home price depreciation and you suddenly have the formula for the market volatility we’re experiencing.

And don’t be alarmed if we continue to see more of this as the market tries to find a floor on valuations. Faced with this situation, you and your management team should take steps to raise capital now if there is a projected capital need. After all, there is no guarantee that market conditions are going to improve in the short term, and they could just as easily erode further. 3 “ Our primary concern right now – my primary concern – is the stability of our financial system, the orderliness of the markets, and that’s where our focus is. ” 3 – Henry Paulson, Secretary of the Treasury

**Play Strong Defense** In anticipation of that other shoe dropping and the additional credit stress that could ensue, consider the following strategies and start building an unassailable defensive position. **Stress Test Your Asset**

Classes Stress testing is a pre-emptive risk management process designed to help determine the impact of charge-offs against your current capital levels and the amount of capital you'll need to fill the holes caused by lost earnings. This scenario planning enables you to project peak potential losses by asset type within a specified geography over a defined time horizon.

Typically, analytics are applied against a range of potential situations:

Estimated Peak Losses: Expected 2008 Charge-off Rates (\$MM) Asset Class

1-4 Family mortgages Estimated Peak Charge-offs (%) 3. 0% 0. 4 9. 0 20. 0

9. 0 1. 0 12. 5 15. 0 6. 0 3. 0 3. 0 9. 8 6. 0 4. 0 • Base Case (actual charge-off

experience on loans in current environment). • Stress Case: Potential

charge-offs in a heavily leveraged asset class such as construction loans. •

Worst Case: Peak charge-offs across all asset classes. Stress testing for

plausible scenarios like these, or answering other what if possibilities (" What

if housing prices continue to fall? or " What if we experience a 10% increase

in bad credit card debt? ") has become an operational imperative to defend

against downside risk and to keep your bank out ahead of the " need capital

now" curve. • Blended • Prime • Alt-A • Subprime • Home equity • Multi-

family mortgages C&D • Commercial construction • Residential construction

CRE • Non owner-occupied • Owner occupied • Loans secured by farm The

Fortress Balance Sheet There was a time several years ago when the

concept of the " fortress balance sheet" was considered an aspirational

statement.

Now, with concerns growing over asset quality and the pressure to raise new

capital, the phrase takes on a whole new meaning. C&I • Credit card • Other

consumer loans • Other loans Total Source: Regulatory financials as of March

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31, 2008, Moody's. 5. 2% Capital is the ultimate risk management tool.

Cushioned with ample levels of capital and reserves, the fortress balance sheet can put your bank in a favorable position to withstand whatever challenges the market might throw your way. At the same time, it gives you the ability and agility to exploit market opportunities, including acquisitions, as they arise.

There is very little not to like about the fortress balance sheet. 4 " As of June 20, North American Banks had raised \$158 billion in capital since the third quarter of 2007. " 4 • Regulators like it - the more robust the better - putting you in a more confident position when it comes to meeting regulatory requirements. • Investors and analysts like it because they see it as a strategic asset that protects equity against unforeseen losses while creating opportunities to increase shareholder value. • Bank management and their boards like it...for the reasons outlined above.

Financial institutions should take measures to create fortress balance sheets in anticipation of possible further downside scenarios, which may also include taking a hard look at dividends, selling down risky assets and enhancing loan loss reserves and liquidity. Go On the Offensive Certain markets are selectively open. Now might be a good time to go on the offensive and use this window to raise capital while conditions are more favorable than they were in the recent past. Here are several strategies to consider. Put Up a Shelf

There are times when market conditions are not encouraging enough for banks - or any market sector for that matter - to raise common or preferred

equity through public offerings. However, those conditions can turn favorable unexpectedly, and when they do you'll want the ability to move quickly and take advantage by having a shelf available. Filing a shelf registration with the Securities and Exchange Commission gives you a three-year window of flexibility to implement a new stock offering before doing the actual public offering.

Formally known as SEC Rule 415, a shelf registration provides you with a standing approval to immediately go to market and raise equity without the need to file. Bring Investors Over the Wall Investors are perceptive. Faced with a choice of announcing the need to raise large amounts of capital and then implementing the plan to achieve it, or announcing the need to raise that capital with the solution already in place at the time of the announcement, most bankers would choose the latter. Raising capital using a Wall Crossing strategy protects the privacy of your efforts.

This scenario enables your bank to share non-public information, i. e. , existence of a transaction, with investors ahead of the announcement, giving them additional time to digest the information and make an informed decision. 5 One bank's turmoil is another's opportunity. Combine Common and Convertible Securities For banks with sufficient borrow in their shares, convertible transactions can be structured to fill a Tier 1 or a Tier 2 need with no ratings required to issue in this market.

There are a number of convertible alternatives available for consideration: • Cash Coupon Convertible Debt • Convertible Preferred • Mandatory Convertible Banks without the borrow might consider a combination strategy

that leverages both common equity and the convertible markets by making two separate but simultaneous offerings of common and convertible securities, thereby maximizing the proceeds to the issuer to meet both Tier 1 and Tier 2 capital needs. Benefits of a simultaneous common stock and convertible offering A combination offering offsets the cost of common, making the overall offering more cost-effective.

Common Stock Convertible Leverage Commercial Real Estate Assets Sale-leaseback transactions allow you to tap unrealized appreciation from your fixed assets and turn them into liquid ones. Selling a commercial property and then leasing it back from the buyer provides both seller and buyer with important benefits. As the seller, monetizing your fixed assets can be an effective method of leveraging existing equity and freeing up capital to improve your liquidity position. Optimal Financing Maximize proceeds Greater pricing leverage

Reduce execution risk Greater structural flexibility Flexibility to Right Size each tranche Resize the tranche once full demand Diversify investor base Little or no cannibalization of demand Market-proven strategy for large equity offerings Several markets competing against each other Most notably, you can allocate a substantial sum of the sale proceeds for lending purposes with the loans providing a return. If the return on the loans is greater than your lease payments, you've created positive cash flow. Source: JPMorgan, June 2008.

Conversely, should you find yourself in a strong cash position and see an advantage to adding assets to your balance sheet, being the buyer in a sale-



leaseback agreement can provide a sound investment opportunity and a relatively safe harbor to anchor your funds. Engaging in this side of the equation will enable you to acquire property at a lower-than-market purchase price, receive credit Real Estate Sale-Leaseback Benefits to Seller for depreciation on the property and provide a return on your investment that could

- Converts assets from fixed to liquid onceivably cover all or part of your monthly
- Puts unlocked equity to work payments if you borrowed against the
- Improves your balance sheet by lowering debt purchase.
- Control of the property is retained

Additional Thoughts on Capital

- Defers portion of tax liability through leaseback
- Consider shrinking your balance sheet through the sale of assets to reduce your capital requirements. Include selling loans when sensible, either to the Agencies or to other financial buyers.
- Evaluate your bank's current dividend and determine whether it makes sense in today's environment and relative to your earnings forecast.

### The Road Ahead

While the economy plays through to what is hopefully the finale of the sub-prime crisis, emerging issues like asset quality and accessing capital are drawing more attention. Implementing effective solutions will require sound forward planning, decisive risk management and executive oversight to avert sub-prime II. Fortifying operations with integrated offensive and defensive strategies to build strong balance sheets will enable financial institutions to live to fight another day. Le Marechal de Vauban would be proud. This issue of Perspective is part of a series of publications for executive business leaders, compliments of JPMorgan.

Each in-depth report is designed to present you with relevant news you can use on emerging business issues. For more information, please visit us online at [www.jpmorgan.com/newsyoucanuse](http://www.jpmorgan.com/newsyoucanuse). 7 References 1. Sloan, Steven, Bernanke: Market Needs Industry Help, *American Banker*, May 14, 2008. 2. Barry, Andrew, What to Bank On – Financial Stocks Have Been Trashed, But There Are Signs the Worst is Over and It's Time to Buy, *Barron's*, July 21, 2008. 3. Aversa, Jeannine, Paulson: Government Will Act to Aid Economy, *biz.yahoo.com*; Yahoo Finance, from the Associated Press, March 16, 2008. 4.

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