

The New York Bankers Association

2009 Senior Management Conference

***Raising and Managing Capital in
Challenging Times***

June 12, 2009

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Market Update

Market Update

Current crisis is unprecedented.....

- ❑ Collapse or crippling of some of the largest financial institutions in the world
 - Bear Stearns, AIG, FreddieMac, FannieMae, Lehman Brothers, Wachovia, WaMu
- ❑ Weakness/losses in loan portfolios have resulted in substantial increases in loan loss provisions and charge-offs
- ❑ Losses and writedowns on securities (e.g., Fannie Mae, Freddie Mac, corporates, mutual funds, CMOs, CDOs) have been widespread in the industry
- ❑ FDIC seizure of 25 community banking institutions in 2008; 37 YTD in 2009
- ❑ Unprecedented government intervention in an attempt to provide stability
 - EESA, TARP, TLGP, TALF, CAP, PPIF, PPIP
- ❑ Financial institutions continue to wrestle with their accountants over mark-to-market and OTTI issues
- ❑ How severe/prolonged will the recession be and what will recovery look like?
- ❑ **Conclusion is inescapable: capital is king, and will be for the foreseeable future**
 - Expect a tightening of regulatory capital rules and oversight
 - Threshold question for regulatory permission to do anything will be "what is your capital position?"

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Market Update

Recent Market Performance

One-Year Comparative Price Performance



Note: Market data from June 9, 2008 to June 9, 2009 (data is market cap weighted)
Source: SNL Financial

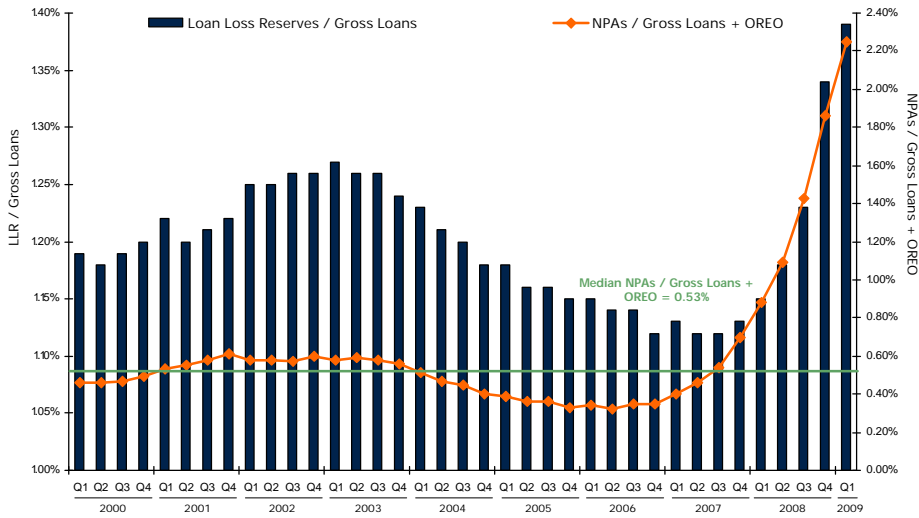
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Market Update

Nationwide Credit Quality Trends

Coverage Ratio versus NPA Levels: 2000 – Q1 2009



Note: Includes all publicly traded banks and thrifts nationwide
Source: SNL Financial

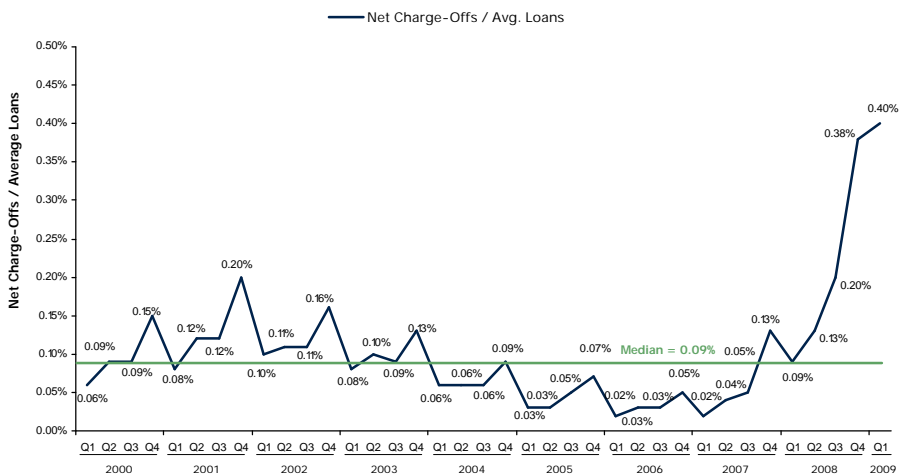
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Market Update

Nationwide Credit Quality Trends

Net Charge-Offs / Average Loans: 2000 – Q1 2009



Note: Includes all publicly traded banks and thrifts nationwide
Source: SNL Financial

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Market Update

Some signs that things are improving, but not out of the woods yet.....

- ❑ Large banks are beginning to stabilize
 - Stress tests complete, capital levels appear manageable
 - Companies are returning to the private markets to issue both debt and equity
- ❑ Clarification of mark-to-market accounting requirements has eased capital pressure
- ❑ Concerns continue to exist about asset quality
 - Non-performing assets are expected to continue to rise
 - Some securities still at risk of further OTTI charges
- ❑ Investors are starting to look for opportunities
- ❑ Regulatory reform efforts later this year merit a watchful eye

Capital Planning

Capital Planning

Presented to



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June 12, 2009

Agenda

- ◆ **Capital Standards Being Redefined?**
- ◆ **Capital Plan - Requisite Components**
- ◆ **Capital Plan - Optional Components**
- ◆ **Line of Business Profitability Analysis**
- ◆ **Internal Capital Strategies**
- ◆ **Contingency Planning**
- ◆ **Ideas For Small Banks**

Capital Standards Redefined?

◆ Is 8% the new 6%?

- Regulatory – Unlikely: Territorial Inertia
- Investors – Probably Not: Don't want lower return/ Do want less volatility
- Management – Depends: "Pillow" factor

◆ If so (8%), what are the implications?

1. Reduces ROE: Will lower stock prices unless investors give full benefit to risk vs. return tradeoff.
2. Increased Costs to Customers: Provided product pricing reflects cost of equity, cost will be passed to consumers.

Bank Capital Plan

◆ *Requisite Components*

◆ Declarations

- Capital Levels – *Minimum levels & steps to get there if fall below*
- Dividend Policy – *Dollar amount, % of earnings, flexible*
- Capital Structure Goals – *Common, preferred, TRUPS*
- ROE Requirements – *Flat, % over treasury, risk adjusted*

◆ 5 Year Projections

- Balance Sheet
- Income Statement & Dividends
- Regulatory Capital
- Sensitivity to Key Assumptions

Bank Capital Plan

◆ *Requisite Components*

◆ **Asset Liability Management**

- Changing mix, or holding constant

◆ **Capital Raising Alternatives**

◆ **Contingency Plans**

- Interest rate shocks
- Credit problems
- Investment portfolio hits

Bank Capital Plan

◆ *Optional Components*

◆ **Acquisition Planning**

- Targeted
- Opportunistic

◆ **Extraordinary Organic Growth**

- Expansion (Rare today. Go contrarian?)
- Opportunities to pick up what large banks are ignoring?

Line of Business Profitability Analysis

◆ Goals

- Optimize allocation of capital
- Balance growth vs. return
- Client & product selection
- Acquisition & divestiture decisions

Line of Business Profitability Analysis

◆ Components

- Capital requirement of each line (risk based capital)
- Income from line
- Direct costs – actual & marginal
- Indirect costs – actual & marginal
- Transfer pricing

Line of Business Profitability Analysis

◆ Output - Risk adjusted ROE (historic & projected) of each line

- Higher than required rate: Allocate more capital, grow the line, consider lowering prices (rate vs. volume analysis), consider adding scale through acquisition, keep investing in new technologies to keep competition out
- Lower than required rate: Can it get to required rate in short term? Long term? If yes, allocate more capital. If no, divest, fold, wind down

Line of Business Profitability Analysis

High
Growth

Meal Tickets

Allocate as much capital to reach the point that marginal returns = required rate. Make strategic investment if necessary to keep competitors out, even if it means sacrificing short term returns.

Unknowns

Can this turn profitable in the short term/ long term? What are the odds? Should capital be allocated? These are the decisions Senior Management is paid to make.

Low
Growth

Cash Cows/ Money Trees

Allocate only enough capital to keep competitors out. Take profits, invest elsewhere or pay as dividends

Fix or Fold

If possible, take measures to make profitable without allocating capital (throwing good money after bad). If not, divest/fold/wind down

High ROE

Low ROE

Line of Business Profitability Analysis

◆ All lines are earning > required rate

- Raise more capital / decrease dividend to keep growing the bank
 - *Many community banks hesitant to do so*
 - *But, doing shareholders injustice if limiting highly profitable growth to what can be supported by retained earnings*

◆ No lines are earning the required rate

- Cut growth, consider culling least profitable products/customers
- Reduce overhead
- Still not projecting required returns? Consider Sale

Internal Capital Strategies

◆ Unwind Wholesale Leverage

- Poor historic risk adjusted ROE (Today 5-8 ROE%)
 - *Generally, credit & interest rate risk not fully factored in*
 - *Competing (on MBS) with tax advantaged REITS, who bid yields down*

◆ Cut or Eliminate Cash Dividend

- Examples – Northway, Trustco, Citigroup...

◆ Limit Growth To Most Profitable

- Cherry pick loans
- Lower deposit pricing to bottom quartile

Contingency Planning

- ◆ **OTTI** (\$2 - 5 million hit on average)
- ◆ **TARP Repayment** (3% of weighted assets)
- ◆ **Extraordinary Loan Losses** (Stress test)
- ◆ **Rising Rate Squeeze On Net Interest Income** (-10 to -20% impact?)

Banks @ 8% possibly handle internally & recover

Banks @ 6% probably going to need outside capital

Ideas For Small Banks

- ◆ **Still Need External Capital? Try:**
 - Rights offerings
 - TRUPS placements to local investors/ friends & family
 - TARP still open & 5% is cheap
- ◆ **Kate To Discuss Additional Strategies**

Capital Alternatives

Capital Alternatives

Capital Raising Spectrum / Senior Debt



Benefits

- ❑ Issued by HC with proceeds down-streamed to Bank
- ❑ Maturity must be minimum of 5 years, typically 10-15 years
- ❑ Will count as Tier 1 capital at Bank level, no capital treatment at holding company level
- ❑ Interest payments are tax-deductible
- ❑ No change to ownership structure

Considerations

- ❑ Can you raise enough?
- ❑ Not permanent capital, must have ability to repay or refinance
- ❑ Must be able to dividend funds from bank to service debt
- ❑ Will not solve a capital issue at the holding company level
- ❑ Earnings dilutive unless leveraged to break-even or better
- ❑ Limited market for small companies; usually obtained as a loan from another financial institution

Capital Alternatives

Capital Raising Spectrum / Subordinated Debt



Benefits

- May be issued by HC or Bank
- Maturity must be minimum of 5 years, typically 10-15 years
- If issued by HC, is considered Tier 2 capital at holding company capital, can be contributed to Bank as Tier 1 capital. If issued by Bank, is considered Tier 2 capital
- Interest payments are tax-deductible
- No change to ownership structure

Considerations

- Can you raise enough?
- Not permanent capital, must have ability to repay or refinance
- If Tier 2 capital, sub debt limit equals 50% of Tier 1 capital; capital qualification is reduced 20% annually during last 5 years to maturity
- Impact on earnings of interest cost; must be able to service debt at issuer level
- Limited market for small companies; usually privately placed with another community financial institution or a private investor

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Capital Alternatives

Capital Raising Spectrum / Trust Preferred



Benefits

- Issued by trust subsidiary of HC
- Maturity is typically 30 years
- Counts as Tier 1 capital
- Interest payments are tax-deductible
- Capital limit is 25% of Tier 1, net of goodwill
- Callable at par after 5 years

Considerations

- Can you raise enough?
- Not permanent capital, although longer-term than subordinated debt
- Capital qualification is reduced 20% annually during last 5 years to maturity
- Reflected on the balance sheet as long-term debt (Fin 46)
- Window for issuance currently remains closed for pooled securities

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Capital Alternatives

Benefits and Considerations / Troubled Asset Relief Program ("TARP")



Benefits

- ❑ With recent term sheets for MHCs and mutuals, now available to all types of community banks
- ❑ Application window has been reopened for banks < \$500 million in assets and amounts increased from 3% to 5% of risk-weighted assets
- ❑ May be the least expensive, or only, capital available to some institutions in the short-term
- ❑ Redeemable at par after 3 years; earlier with proceeds from a qualified capital offering

Considerations

- ❑ "I'm from the government and here to help"
- ❑ Market perception: now universally perceived as a sign of weakness/concern
- ❑ Limited to 3% (5%) of risk-weighted assets; can you raise enough?
- ❑ Not permanent capital; 30-yr term but incentive to redeem by 5th anniversary
- ❑ Comes with conditions and operating constraints; rules could change after signing up (remember supervisory goodwill?)
- ❑ Transferability of securities by Treasury to private holders

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Capital Alternatives

Capital Raising Spectrum / Preferred Stock



Benefits

- ❑ Increases tangible equity without increasing common shares
- ❑ Non-cumulative perpetual preferred counts as Tier 1 capital
- ❑ May be convertible into common stock, either mandatorily or at the option of the holder

Considerations

- ❑ Higher current cash cost relative to issuance of common stock
- ❑ Coupon is paid in after-tax dollars
- ❑ Informal guidance from the Fed suggests that trust preferred and non-cumulative perpetual preferred securities should not exceed 40% of the pro forma Tier 1 capital
- ❑ Limited market for smaller companies

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Capital Alternatives

Capital Raising Spectrum / Common Stock: Follow-on Offering



Benefits

- ❑ Provides Tier 1 capital in form most favored by regulators
- ❑ Represents permanent capital
- ❑ Can be issued using a variety of structures:
 - Private placements
 - “Overnight” public issuances (utilizing a shelf registration)
 - At-the-market transactions (ATMs)
 - Standard public offerings (not utilizing a shelf registration)
 - Rights offerings

Considerations

- ❑ Concerns about dilution to existing shareholders
- ❑ Current stock prices at or near multi-year lows for most public companies
- ❑ Potential concern over ability to effectively deploy “excess” capital
- ❑ Market conditions

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Capital Alternatives

Capital Raising Spectrum / Common Stock: Conversion



Benefits

- ❑ Provides Tier 1 capital in form most favored by regulators
- ❑ Valuations are low, which means greater upside potential for investors and limited concern of overcapitalization for Bank
- ❑ Ability to raise permanent capital in a cost effective manner through a single transaction
- ❑ Opportunity to maximize stock-based contribution to charitable foundation
- ❑ Provides an equity incentive for potential hires, management, directors, depositors, and the broader community
- ❑ Clarifies ownership

Considerations

- ❑ New constituency (shareholders)
- ❑ Exposure to public scrutiny of performance
- ❑ Potential concern over ability to effectively deploy capital
- ❑ Additional costs and reporting requirements for public corporations
- ❑ Increased compensation costs related to stock benefit plans
- ❑ Not immune to challenges to independence, both from within and outside of organization
- ❑ Market conditions

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Capital Alternatives

Recent Capital Markets Activity

- ❑ **The debt capital markets for community banks currently remain closed**
 - Debt service pressures and questions
 - Distressed trading market for currently outstanding securities

- ❑ **Equity and equity-linked transactions are the primary focus for community bank investors**
 - Market began to thaw in mid-April and release of stress test results in early May resulted in sharp increase in pace and size of offerings
 - To date, majority of issuers have been large banks
 - Many transactions have an element of TARP payback stated as partial use of proceeds
 - Small and micro-cap issuers still struggling to gain market recognition

- ❑ **Trends in the near future will likely include:**
 - Additional shelf registrations filed by banks with market caps > \$150 million
 - Smaller companies focusing on alternative structures to public offerings (e.g., private placements, rights offerings, etc.) until public markets more receptive
 - Cutting of cash dividends paid to shareholders prior to raising outside capital
 - Banks increasing capital through the sale of assets, branches, business lines, etc.
 - Bank failures continuing to pressure pricing for bank capital offerings while at the same time providing opportunities for banks to immediately leverage new capital