

Community Banks' Achilles' Heel: Strategies for Raising Capital in a Capital Poor Environment

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In the current anemic economic environment, many community banks face extreme pressure to raise capital, to avert a bona fide threat of receivership, terminate a long lasting enforcement action, pay down or pay off TARP, reposition the bank to compete effectively again or achieve a combination of these goals. As the balance sheets of community banks weaken under continuing credit stress, regulators routinely impose higher capital requirements at the very time when capital levels drift lower. Additionally, the regulator-imposed timeframes for meeting those higher capital requirements are short, and the regulators' directives establish legally enforceable mandates that can provide the groundwork for further enforcement actions.

The Regulatory Risk of Declining Capital

Specifically, failure to comply with a capital directive may result in a bank's steady slide down the prompt corrective action staircase to the start of the 90-day clock to receivership, when tangible equity drops below two percent and a bank is deemed to be critically undercapitalized. Because capital is the typical receivership trigger, and a bank's high, medium or low ranking on the regulators' long list of troubled banks is tied to its capital standing, managing the bank's capital ratios is essential to stabilizing the institution with the regulators and averting any threat of receivership.

Capital Scarcity

New sources of capital remain scarce in the current environment, while further downward pressure on real estate values continues to impair the capital remaining on bank balance sheets. Capital is scarce because strategic buyers remain on the sidelines for "open bank" acquisitions and the natural "roll-up" acquirers are either tending to their own balance sheets and regulatory challenges or pursuing acquisitions out of FDIC receivership. Financial buyers are searching for returns on investment in the mid-20-percent range, and finding bank investment opportunities that can realistically produce returns like this is challenging, particularly given continuing uncertainty about further credit deterioration.

Dealing with Reality and Searching for Capital

Notwithstanding this trying reality, there are things community banks can do to improve their chances for raising capital now or when capital becomes more abundant. A bank under a regulatory directive to raise capital has an obligation to continue to try to raise capital despite difficult market conditions. A bank that is not under a formal directive may have an independent interest in pursuing a capital raise to put itself in a safer regulatory condition or improve its competitive position. In either case, there are ten fundamental strategies that form the backbone of a successful capital-raising strategy.

1. Increase Credit Transparency. Many banking professionals instinctively avoid third-party credit reviews for fear of what the review could reveal about the quality of the bank's portfolio and the related capital "hole." Third-party credit reviews used as a basis to support a capital-raising initiative are different in scope and methodology than traditional loan reviews that assess accuracy of risk ratings, which many banks perform using an independent review firm at least annually. Third-party credit reviews for capital-raising purposes focus on non-GAAP measurements of credit quality, such as migration risk, non-performing asset disposition values, cumulative loss analysis and other analytical valuation tools to assess future embedded losses in the portfolio that can affect the value of the enterprise to an investor. Institutional investors will not commit capital to a bank that cannot provide an objective and substantiated view of its credit quality. Without an objective view on credit quality, management and the board of directors cannot properly evaluate the capital need and the optimal method for sourcing the needed capital. While third-party credit reviews are important in these ways in the capital-raising effort, a bank should not rush into it. Both timing and methodology of the review deserve serious thought and consideration. For instance, depending on an institution's unique circumstances, commissioning a review may be more appropriate after a regulatory exam rather than immediately before, and there are numerous review methodologies that need to be evaluated for the bank's particular circumstances.

While third-party credit reviews have many advantages, a review is not always a prerequisite to raising capital. For example, public companies raising capital, whether from their existing stockholder base or new investors or both, often can avoid a third-party credit review and take the position that investors will rely on their U.S. GAAP consolidated financial statements as filed with the Securities and Exchange Commission. Likewise, privately held banks that intend to raise capital from retail, as opposed to institutional, investors may, like their public company counterparts, do so without conducting a third-party credit review. This is not to say, however, that a review, even when unnecessary to raise the capital, does not give the board of directors extra protection in issuing securities. This is an important consideration and one that needs to be evaluated. Whether public or private, no company wants to issue securities only to announce, shortly thereafter, severe credit surprises that drive down the value of those securities.

Overall, regardless whether a third-party credit review is an essential aspect of an institution's capital-raising strategy, management should give serious consideration to whether it could be beneficial to the institution. Along these lines, careful attention needs to be paid to the quality of the firm conducting the third-party review, the scope of the review and its timing. In thinking through issues involving the use of a third-party credit review, remember the Hippocratic Oath: "First, do no harm."

2. Stabilize the Current Balance Sheet and Operations. Given the pressure to raise capital quickly and the consequences of not acting with a sense of urgency, it is understandable that many community banks have a tendency to move quickly toward a capital-raising transaction even before the bank's current balance sheet and operations have been stabilized. This can be a mistake. When a bank is distressed, there are many elements of its balance sheet and operations that have to be stabilized before a capital raise can move forward with a high probability of success. For instance, liquidity is a key performance metric for measuring stability. Excessive liquidity risk or just plain

choppiness in its liquidity position can induce the regulators to intervene more quickly and dramatically than expected, and liquidity instability will deter savvy investors because, after all, a financial institution's core business is about satisfying cash demands from customers and commercial counterparties. Likewise, regulatory stability is also important. Investors will want to understand the bank's status with its regulators and the likelihood of future examiner-induced credit impairment charges and exam downgrades. While much of this information is confidential, the bank seeking capital needs to be as sure as it can that its status with the regulators is essentially stable for the foreseeable future or will be after the capital is raised.

Another area that raises stability concerns is human capital. When asking investors to contribute capital to a distressed bank, the bank has to persuade investors that the capital can be effectively deployed. The loss of key employees, especially lenders, will jeopardize this goal. Thus, strategies for employee retention and growth of the business need to be defined and realistic before approaching investors. And, management can only effectively handle so much at one time. Trying to stabilize the institution while also engaging multiple investors in a capital-raising initiative can be overwhelming and one of the two priorities is likely to suffer.

3. **Generate Realistic Financial Projections.** Investors want to know how capital will be deployed and what returns can be expected on that capital. Presenting potential investors with realistic financial projections includes undertaking an honest analysis of future credit costs and revenue growth opportunities. Superficial projections of future good fortune will not satisfy investors. Prepare detailed financial projections that demonstrate thorough and rigorous analysis using reliable methods for forecasting and detailed assumptions. Include an analysis of how new capital will be deployed—whether capital proceeds will be used to offset past credit losses or pay down TARP or holding company debt, promote organic growth, or support strategic acquisitions. Specific parameters, strategies and projections are especially important when capital will be used toward acquisitions. Of course, any financial projection has to begin with a realistic assessment of current credit quality to determine the depth of the capital “hole” based on estimates of future credit costs. When necessary, management should employ outside resources for financial modeling. The model is fundamental to setting a baseline for attracting investors and ultimately will be the core document presented to the regulators as part of a regulatory application supporting the capital injection and change-in-control filings.

4. **Strategically Source Capital.** Carefully targeting potential sources of capital given the particular situation of the bank, and developing a strategy for that sourcing, needs to be done early. An accumulation of small amounts of capital from a variety of sources may not serve a bank as well as the same amount of investment from one key investor. Starting with a base investor who commits a large amount of capital may attract more small investors—and ultimately more capital—than starting with several small investors. Consider possibilities for a large “anchor” investor—perhaps a member of the board or a community member with whom the bank has good relations. Using the anchor investor, the company may want to consider a rights offering to current stockholders, and the success of that broader capital raise will likely be enhanced by wrapping it around one or more large investors. Banks should also assess the legal and regulatory requirements necessary to raise capital from each potential investor. The preparation of equity purchase agreements, detailed disclosure documents, regulatory applications and related items can require substantial time and cost to prepare and complete. For holding companies that are not already mature public companies, for example, the cost and time necessary to complete a registered public offering generally rule out that course of action. The time and cost should be assessed in connection with the overall goals and timeline of the capital raise. To this last point, when a bank is distressed it becomes desperate for capital and can run down many blind alleys, which will prove to be an expensive (and often unproductive) strategy.

Starting work on a capital-raising strategy before the bank's options narrow and its regulatory runway shortens puts it in the best position to cogently choose the optimal path for capital-raising success.

5. Develop a Realistic Stance on Stockholder Dilution. Stockholder dilution is a likely, if not inevitable, aspect of capital-raising for a troubled bank in the current environment. Major shareholders need to be educated that restoring the bank to a safe and sound position, and complying with capital directives imposed by the regulators, may require the raising of a large amount of capital at a steep discount to book value, thus creating a dilution event for existing stockholders. If the capital contingency is not promptly satisfied, the entire equity interest of every stockholder is at risk, making the significant dilution possibility more palatable when put in the proper risk context. Stockholders who are also directors should understand that the board faces a real risk of personal liability, to the FDIC or otherwise, should the bank fail. Getting the realistic prospects for dilution on the table early will break down barriers that may otherwise cause a board to reject investment proposals that in hindsight should have been rigorously pursued.

6. Ensure Capital Plans Raise Enough Capital to Put the Bank in Safe Harbor. Ensure that your capital plan will raise enough capital for the bank to continue as a going concern for the foreseeable future. Investors do not want to invest in a bank that, after their money is invested, may fail or end up in a long downward spiral. There are examples where investors injected a meaningful amount of fresh equity only to have that equity wiped out by credit impairment charges resulting from later exams. Be realistic about the amount of capital truly needed and the timeframe in which it must be raised. Consider the composition of the bank's credit portfolio, its history of growth, management of credit problems, liquidity, timing of the next exam and any other factor that could affect future foreseeable capital needs. Again, the depth of the bank's credit "hole" and any third-party credit review are of paramount importance in making this assessment.

7. Get the Board of Directors Involved. It is important that the board understand the risks facing the bank as well as its strategic alternatives for raising capital. Sometimes, the full gravity of the situation is not understood by board members until the regulators impose a formal enforcement action. The board may struggle to apprise itself of the bank's financial standing and future prospects, all the while needing to move rapidly to meet the directives and deadlines imposed by the recent enforcement action. The board should be made well aware of the bank's situation long before regulatory action is taken to correct any financial performance issues. Processes must be in place at the management level to ensure that the board is informed about capital standing and provided with clear reports that demonstrate that risk is being appropriately managed and recorded. If one does not already exist, the board should consider forming a capital management committee to thoroughly monitor and oversee capital management. A focused, small group of directors may be the most effective way for the board to assimilate the complex information that needs to be accumulated and processed to make informed business decisions about capital.

8. Educate Management on Capital Market Developments. Management needs to stay abreast of capital failures and successes in the industry. Internal reviews and understanding of the bank's position are important, but so is an understanding of how other banks have or have not raised capital. Management should follow industry developments and keep itself informed about where other banks are finding capital, how they are utilizing it and their strengths and weaknesses in managing that new capital. Lessons can be learned from both failed banks and banks that have successfully boosted capital and nursed themselves back to health. There may not be a one-size-fits-all solution, but understanding the successes and failures of others may lead to development of a unique strategy that could work for a particular bank. Analyze the industry, identify trends and apply them toward creating your own solutions. The complex and unique current operating environment requires that

management continually educate itself on market developments and be vigilant for capital-raising opportunities. Along these lines, there are many balance sheet tactical moves that can be made to prolong a bank's life and put it in a position to ultimately succeed in a capital range. Those moves need to be understood and assessed.

Management should also keep itself informed of trends in institutional investing. Take the time to meet with institutional investors—such as family offices, foundations, mutual funds and private equity firms—in order to develop relationships and acquire an understanding of how institutional investors approach investing in the current economic environment and their priority strategic considerations. These relationships can and should be developed well in advance of any potential investment transactions. Regardless of whether these institutional investors ultimately invest in the institution, these relationships can provide valuable insight that can be utilized when creating and implementing a capital-raising strategy. What better way to understand how the market looks at your bank than talk to the “market”?

9. Take Informed Risks. Community banks have been under siege for several years based on credit impairments, capital constraints, harsh regulatory exams and enforcement actions. The environmental trendlines, including the bank failure rate, create fear, and fear can understandably paralyze management and boards, resulting in a stance that is so conservative they will not take the risks necessary to turn the bank around and avoid receivership. Inaction is a decision, and inaction can doom a bank to failure. The key is to take balanced, measured and reasoned risks. Employ creative strategies. Do not act recklessly, but do act courageously.

10. Move with a Sense of Urgency. Every day that the bank fails to take action, an opportunity is lost and a door to capital closes. Action must occur. Acting with urgency does not mean acting hastily or unwisely—it means acting thoughtfully as though the bank's health depends on it. Create a timeline based on a realistic assessment of how much time the bank has to raise capital, and stick to the timeline. Do not put off decisions about internal or third-party evaluations for another day. Do not wait to get the board involved in assessing every aspect of every possible solution or action. Develop plans now and take action in accordance with those plans. Saving banks is about project management – critical path thinking, milestones and ruthless attention to timelines.

Developing an effective capital-raising strategy can be daunting, but our experience shows that responsible preparation and planning, and disciplined, rigorous project management toward capital raising are the keys to success.

Members of Schiff Hardin's Financial Institutions Group who work on bank restructurings and recapitalizations are available to discuss your capital situation. We are here to help. We have helped numerous clients assess their capital needs and we have a deep understanding of the current capital market and sources of potential capital. We look forward to working with you.

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