

The Role of Asset Level Management in Capital Planning

By Andy Sigl, Partner

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Capital planning has long been a survive-and-thrive strategy, but the practice has recently taken on new considerations. Regulatory initiatives for the past 24 months have moved capital requirements higher for many financial institutions.

In fact, requirements of 8% and 12% for tier 1 and risk-based capital are not uncommon. In many cases, the increased requirements arise from an above-average level of classified assets to found in an examination.

One of the key strategies for increasing capital levels is managing asset levels to fit within the confines of an institution's capital. When doing so, an institution should consider these four critical issues: the impact of reducing total assets, the capital requirements of off-balance sheet commitments, correct risk-based asset classification, and loan concentrations.

Reducing total assets: tread wisely

Before pursuing this strategy, an institution must recognize that the strategy requires an evaluation of both the short- and long-term implications with regard to liquidity and net interest income. That's because a reduction in assets is accompanied by a change to interest margin and net income.

Consider this example of a financial institution reducing assets by reducing outstanding loans:

Proposed reduction in earning assets	\$10 m
Risk rating	100%
Assumed interest rate earned	5.75%
Assumed cost of funding	2.00%
Proposed risk based capital ratio required	12.00%

Here the institution would forego an interest margin of \$397,000. The required risk-based capital is \$1.2 million. The margin as a percent of required equity is 33%. Assuming adequate credit quality, this hardly seems like a winning proposition since there is probably not a material reduction in the net overhead as a result of the proposed reduction in assets.

Certainly \$1.2 million of capital is a tempting way to move institution closer to its goal of an increased capital ratio; however, the longer-term implications of lost revenue must be strongly considered.

Capital requirements of off-balance-sheet commitments

The amount of risk-based assets an institution reports is computed on schedule RC-R of the quarterly call report. The increase in risk-based assets arises from three off-balance-sheet components: letters of credit, credit equivalents, and commitments greater than one year. This area deserves special attention since these commitments often require capital.

RC-R includes three line items for letters of credit. When examining the schedule, it appears many institutions have these. If an institution had \$1 million of risk-based assets computed as a result of the outstanding letters of credit and it has a 10% risk-based capital requirement, the institution needs to allocate \$100,000 of risk-based capital to the letter of credit commitment. Assuming the institution's goal is a 15% return on equity before tax, customers should be charged \$15,000 per year for the institution's outstanding commitment. This amounts to a commitment fee of 1.5% per year for the unused commitment.

Line 50 of the RC-R includes "recourse for direct credit substitutes subject to low-level exposure and residual interests subject to a dollar-for-dollar capital requirement." A common example of this type of off-balance-sheet component is the FHLB "Mortgage Partner Finance" program. If the credit exposure commitment was \$1 million, the risk-based assets would be \$12.5 million and the required risk-based capital requirement based on the \$12.5 million. It is very possible to have more capital committed to a program than the actual loss exposure.

Another common RC-R line item is unused commitments with an original maturity greater than one year. Most unused commitments do have capital requirements. The key here is to ensure that lenders understand them and other implications when structuring loan commitments.

Assume an institution's commitments total \$2 million and the risk-based asset equivalent is \$1 million. Assuming a 10% risk-based capital requirement and a 15% return on equity before tax, the institution would have needed \$15,000 fee income per year to achieve ROE objectives, or a .75% loan commitment fee for the unused commitment.

Given ROE objectives, an institution shouldn't neglect the opportunity to recover the cost of required capital for unfunded commitments.

Correct risk-based classification

The call report contains various risk weightings as of the report date. Accordingly, call report preparers should be careful to report assets and commitments in correct classifications. In addition, management should prepare potential strategies to minimize the amount of risk-based assets as of call report dates.

Loan concentrations

Loans for commercial real estate and land development (CRE) have become significant concerns for regulators since the 2006 issuance of interagency guidance on the subject.

Essentially, it states that higher capital ratios and enhanced credit risk management are required for a financial institution with significant CRE concentrations. Such an institution is described as reporting loans for construction, land development, and other land

representing 100% or more of total capital or an institution reporting total CRE loans representing 300% or more of total capital where the outstanding balance of CRE has increased by 50% or more during the prior 36 months.

Before expanding any loan category, a financial institution needs to consider the implications of concentration and the potential for increased levels of capital.

About the Author

Andy Sigl devotes 100 percent of his time to consulting with clients on issues related to profit improvement, asset/liability management, strategic planning, and acquisitions of branches and charters. He provides clients with a different perspective on their business issues and is well known for his ability to evaluate financial performance in a unique and communicative manner. To learn more, please contact Andy at asigl@wipfli.com.

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