

Walking a Tightrope

The delicate balance of implementing sound foreclosure strategies

By Scott Frost and Terry Jeffrey

For community bankers, the operating landscape has never been more challenging. As of this writing, 2011 has already seen 14 banks fold under the pressure of bad real estate loans and undercapitalization. At the moment, foreclosures seem to be slowing; however, most observers are predicting a second wave. While the federal government has rolled out multi-faceted programs designed to help community bankers build capital, early reaction indicates that these programs may be creating too many restrictions in addition to administrative and expense burdens. Knowing that banks have to work within the new confines of today's regulations, what can be done to thwart foreclosure crisis part two and reposition community banks for success? The answers can be varied and complicated; however, clear strategies do exist.

A Balancing Act

Community bankers are unique in many ways; high on this list is the commitment, and often the flexibility, they bring to local lenders. In today's highly regulated banking environment, executives are feeling the squeeze between what they want to do with, and for, a troubled borrower and what can be done. A thorough understanding of viable options is paramount, but injecting new and strategic

thinking may be what tips the scales for success. Consider the following example.

A community bank provided a loan for the refurbishment and operations of a locally historic theater. At its inception, the granting of the loan was heralded as a "savior" to the operation and the bank proclaimed it as a beacon in the community; good news all the way around. However, in 2009, in the wake of the credit crisis and subsequent recession, the theater found itself unable to meet its ongoing debt service requirements. To compound matters, the bank found itself frustrated with management for its perceived reporting deficiencies — frustration that grew exponentially as operating revenue dwindled.

Under such circumstances, the bank found itself confronted with two undesirable alternatives: 1) drawing the curtain down on the theater (calling the loan, foreclosing and liquidating); or 2) simply extending the loan and pretending the theater would quickly right itself. Choosing the first option would (in effect) unwind the good will the bank had garnered within the community in the first place, causing reputational damage that can be the life blood of community banks. Choosing option two would, at a minimum, raise the eyebrows of cynical regulators.

After studying its options with counsel, the bank charted a third and ultimately more productive course — it engaged in an amicable "sit down" with management, and studied the business plan and the budgets of the operation. With the borrower's cooperation, the bank hired an on-site management consultant to provide not only

A black and white photograph showing a close-up of a boot's sole as it steps on a thin wire. The sole has a distinct tread pattern. The wire is positioned diagonally across the frame. The background is dark and out of focus.

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competent management but a credible ongoing financial reporting mechanism. With this data, the bank crafted a restructuring plan based on realistic financial benchmarks; benchmarks sufficient to maintain the theater and, just as importantly, sufficient to justify the credit decision to shareholders and regulators.

Weigh the Options

Similar scenarios are playing out in community banks across the United States. Following are some steps an institution may consider as it moves beyond business as usual when it comes to foreclosures.

1. *Take a hard, “real” assessment of the loan and the borrower.* Do not spend too much time on truly unrealistic scenarios, but do think creatively about the situation. Community bankers will need creative thinking skills to survive the next few years.
2. *Consider the use of strategic partners.* Strategic partners are coming in all shapes and sizes. Larger banks may be able to offer some participation loan funding without an acquisition, leaving your bank — in name and in practice — under your control. Individual investors, acquisition and other strategic alliances exist as well.
3. *Realistically determine, by a cost/benefit analysis, if it is time to sell some performing loans.* This may be a daunting scenario as it would likely require the sale of loans at less than 100 percent of their current outstanding principals. However, the loan loss reserve charge and potential foreclosure expense for these loans might ultimately cost the bank more. Bankers waste valuable time and energy challenging the regulator’s rating. Avoid these frustrating endeavors; deal efficiently

with the problems and concentrate energy on more important matters.

4. *Engage the experts.* As the above consideration demonstrates, some options are not for the faint of heart, but can advance the situation. With this, tapping the expertise of outside counselors may be an option worth pursuing. There will be out-of-pocket costs, but expect to work with an individual or team that has a proven track record of helping community banks with the strategic and practical application of real business solutions. And, a command of the ever-changing regulatory environment is mandatory.
5. *Make the decision and move on.* Once a careful review of the options is laid out and lined up against the latest regulations, decide on a course of action and go.

Many community banks and their borrowers have been initially guilty of denial and entered into some form of “extend and pretend” with the false hope that time would make things better. The industry has become wise to the inherent flaws with that thinking and is beginning to take a more proactive position against foreclosures. We have seen a number of our forward-looking banking clients execute a variety of creative strategies with success. We can only hope that others will follow in their footsteps. **BN**

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