



**THE
MANUAL
OF
IDEAS**

TM

Value-oriented Equity Investment Ideas for Sophisticated Investors

A Monthly Publication of BeyondProxy LLC * Subscribe at manualofideas.com

"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

Year III, Volume X
October 29, 2010

When asked how he became so successful, Buffett answered:
"We read hundreds and hundreds of annual reports every year."

Top Five Ideas In This Report

Barclays (London: BARC, NYSE: BCS)	62
Deutsche Bank (XETRA: DBK, NYSE: DB)	66
Mitsubishi UFJ Financial (Tokyo: 8306, NYSE: MTU)	70
Roma Financial (Nasdaq: ROMA)	74
Waterstone Financial (Nasdaq: WSBF)	78

Also Inside

Editor's Commentary	4
Superinvestor Holdings Update	15
Todd Combs' Favorite Banks	16
Banking Crisis Assessment	20
Thrift Conversions	50
Exclusive Interview: Scott Proper ...	41
Exclusive Interview: Mike Godby ...	56
100 Profitable Banks	114

About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors. Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

VALUE OPPORTUNITIES IN BANKS?

- ▶ The crisis: Where we are, where we are headed
- ▶ Five ways of identifying opportunities in banking
- ▶ Thrift conversions: Is anyone paying attention?
- ▶ 100 profitable banks — and other banking screens
- ▶ Top 5 ideas, based on proprietary *MOI* methodology
 - ▶ Plus: Superinvestor holdings update
 - ▶ Plus: Favorite stock screens for value investors
 - ▶ Plus: Exclusive interview with Scott Proper
 - ▶ Plus: Exclusive interview with Michael Godby

Banks mentioned in this issue include Arrow Financial, Bancolombia, BancorpSouth, Bank of America, Bank of Montreal, Bank of Marin, Bar Harbor Bank, Barclays, BB&T, BBVA Frances, BNP Paribas, Boston Private, Brookline Bank, Century Bancorp, CIT Group, Citigroup, Citizens & Northern City National, CNB Financial, Columbia Banking, Commerce Bank, Community Bank System, Community Trust, Credicorp, CVB Financial, Danvers Bancorp, Deutsche Bank, Dime Community, East F.N.B., Fifth Third Bancorp, First Bancorp, First Bank, First Commonwealth, First Commercial Bank, First Interstate, First Merchants, Fulton Financial, German American, Huntington, Iberiabank, JPMorgan Chase, MB Financial, Meridian Bank, National Penn, NBT Bancorp, NY Comm, Gladstone, People's Financial, Roma Financial, Santander Brasil, Southwest Bancorp, Susquehanna, TFS, UMB Financial, Umpqua, Wainwright B & T, Washington Financial, Wells Fargo,

LAST-MINUTE EXTRA:

Favorite Bank Investments of Buffett Pick Todd Combs

p. 16

Inside:

**Exclusive Interview with
Scott Proper,
President,
Proper Investments &
Consulting**

*With compliments of
The Manual of Ideas*

(analyzed con...

Exclusive Interview with Scott Proper

We present an interview with former community banker Scott Proper, who headed the Vail, Colorado operations of Millennium Bank, a Colorado state-based and chartered bank, for five years. In September, Scott left Millennium to start Proper Investments and Consulting, a firm specializing in debt restructuring services and distressed real estate workouts. We find Scott's perspective on the problems plaguing U.S. community banks — and on how to analyze them — invaluable, as he was an active industry participant until very recently. Scott is a Yale graduate and former captain of the Yale Heavyweight Crew Team.

The Manual of Ideas: You experienced the boom and bust in U.S. community banking first-hand. Obviously, it appears banking executives and regulators learned little from the S&L crisis of the 1980s and '90s. Are we as a political and economic system doomed to keep repeating past excessive behavior, or is there a way to get things under control permanently?

Scott Proper: I think these economic cycles will continue. I do not have confidence that there is a way to get things under control permanently. I also do not have confidence that all of a sudden human beings will start paying more attention to the lessons of history than they generally do. Whether that means we are “doomed” or whether it simply means that we ought to anticipate more exaggerated economic peaks and troughs is a matter of perspective. I think that people are eager to forget about the exaggerated peaks and troughs, and get back to “business as usual.” In contrast, I now believe that these exaggerated peaks and troughs are business as usual.

MOI: Analyzing the quality of the loan assets on a bank's balance sheet can be a daunting task, since investors typically don't have access to data on individual loans. What do you focus on when trying to assess the quality of the loan portfolio of a publicly traded bank?

Proper: The most thorough tool for evaluating a U.S. bank's financial circumstances is the Uniform Bank Performance Report (UBPR), available at www.ffiec.gov/ubpr.htm (a user's guide is available at ffiec.gov/ubprguide.htm). To evaluate the quality of a bank's loan portfolio, not only is the information in an individual UBPR important, but so are the trends from UBPRs over time. Sudden increases in the loan loss reserve may indicate that the increase was mandated by a regulator and was not a voluntary decision of management (management tends to try to gradually appropriate a proper loan loss reserve over time). Currently past due loans, which are identified by category in a UBPR, can signal loan losses to come. Furthermore, historically, certain loan categories present more risk and, therefore, likelihood of loss than others.

MOI: Which metrics of loan portfolio quality are particularly prone to management judgment, i.e., can be made to look better than they really are?

“Sudden increases in the loan loss reserve may indicate that the increase was mandated by a regulator and was not a voluntary decision of management (management tends to try to gradually appropriate a proper loan loss reserve over time).”

Proper: GAAP permit substantial interpretation and manipulation of the loan loss reserve. It is theoretically supposed to be calculated based upon historical loan performance. However, the last two years have rendered historical loan performance information basically irrelevant for many banks.

When a loan is booked, a loss reserve expense must be taken on the income statement immediately. That loss reserve for the individual loan is then added to the bank's cumulative loan loss reserve on its balance sheet. As an amortizing loan performs over time, the loan loss reserve expense can be recovered as the loan's principal is paid down. For a revolving loan, the loan loss reserve taken can be recovered when the loan matures and is closed out (not renewed). Keep in mind that the loss reserve means that booking a new loan normally leads to a loss on the income statement that is offset over time by interest revenue.

The loan loss reserve that must be set aside on the financial statements is based upon how lenders have graded their loans, and what management perceives appropriate reserves to be for each grade. For example, a CD-secured loan won't require any loan loss reserve at all. However, a used car loan may require a 3% reserve. Lenders have a conflict of interest in grading loans, because they are evaluated heavily based upon their loan origination skills. This is supposed to be offset by lenders' superiors, but they are often incentivized the same way. That leaves the policing up to the compliance and audit departments. If those departments do not oversee loan grading and reserve amounts correctly, the last defense is regulators, who can mandate that a bank increase its reserves. I have never heard of a regulator requiring that a bank decrease its reserves.

When the loan loss reserve is being manipulated drastically from month to month or quarter to quarter or even year to year, it's probably inaccurate. Substantial fluctuations in the loan loss reserve — in percent, not absolute dollars, because loan loss reserves fluctuate as aggregate outstanding loan balances change — mean that management really didn't understand the risks of the loans the lenders were originating, which is why it needed to modify the loan loss reserve down the road. Several big increases can mean that loans are weakening but management is just hoping and hoping that something would get figured out. Finally, a sudden, very large increase in the loan loss reserve reflects management exhaustion for a deal that is basically uncollectible. I would interpret any of these things as a major red flag in my evaluation of overall bank health: if management did not understand the loan risks adequately earlier, it probably does not understand them now, either.

“The loan loss reserve that must be set aside on the financial statements is based upon how lenders have graded their loans, and what management perceives appropriate reserves to be for each grade. [...] I have never heard of a regulator requiring that a bank decrease its reserves.”

A number of banks have doubled or tripled their loan loss reserves over the past two years; this is ultimately totally arbitrary and most likely done to appease regulators. It makes getting an honest sense of the strength of a bank's loan portfolio very challenging. I have seen banks with 15% equity that are ultimately worthless when one evaluates their loan portfolio and adjusts their loan loss reserve fairly. This is because overconfidence about the bank's loan portfolio — or outright dishonesty, in some instances — had led management to avoid taking losses by avoiding setting aside appropriate loan loss reserves. In result, the balance sheet is more an interpretive dance than it is communicative of anything meaningful. In contrast, I have seen banks with 6% book equity that are run by very conservative bankers who arguably overstate their loan loss reserves because they are very critical in their loan grading as well as in their reserve percentages for loans by grade.

MOI: How does information on the loan-to-value (LTV) of mortgage loans help investors gauge the solidity of a loan portfolio? Let's assume a bank is sitting on loans that were made at the peak of the real estate bubble in Arizona, where prices in some areas have been cut in half. If the original LTV of the loans was 75%, would it be fair to assume that the bank would be looking at a 25% hit to bring the loans in line with market? Is there a rule of thumb on how much a bank must spend to market and sell a foreclosed property?

Proper: In your example, you are correct, except that the bank has to pay sales commissions and other transaction costs. It is also not in a strong position as seller; I think an appropriate estimate is that the bank will receive 85% to 90% of the property's market value in actual cash proceeds. I am reluctant to put out this ballpark figure, though, because the appropriate loss to forecast depends most heavily on the location, location, location of the property. When the bank is the owner of record, the property is often not kept up well. There have been many instances where borrowers who have been foreclosed upon intentionally trash the property out of spite to pass a less valuable property on to the bank. A bank worth its salt is monitoring the values of its collateral actively. This includes ordering new appraisals when significant shifts in real estate values have occurred, and adjusting loan loss reserves accordingly. It's appropriate, especially when you consider that a bank monitors the value of the collateral for a revolving line of credit secured by accounts receivable at least monthly. How could it be prudent to monitor the value of real estate as collateral only once at origination? When a bank forecloses on a property, it is then responsible for ongoing maintenance, property taxes, insurance, owners' association dues, etc. These carrying costs can be substantial.

MOI: Explain for us the difference between loan loss provisions and charge-offs... At what point is a bank required to charge off a problem loan? Are banks resisting charge-offs simply because they want to keep their reserves looking strong in order to appease regulators, or are there other reasons?

Proper: A parallel can be drawn between a bank's loan loss provision and a manufacturing company's reserve for accounts receivable losses (bad debt). The bank sets aside a provision as individual loan performance as well as market conditions suggest. As previously mentioned, this provision is malleable and is constantly being interpreted by management. A charge-off occurs when management decides that the deal, or a portion of it, is a goner.

Suppose a bank has a \$500,000 loan to a client and it had previously taken \$150,000 in provision on the loan because the value of the collateral had deteriorated. At that point, the bank has a \$500,000 loan asset on its balance, offset by the \$150,000 provision. If management decides that there is no way that the \$150,000 provision is recoverable and opts to take a \$150,000 loss on the loan, the asset's value on the balance sheet decreases to \$350,000, and the \$150,000 provision goes away. There is no loss on the income statement, because the \$150,000 expense was already taken when the \$150,000 provision was established to begin with. This illustrates the importance of the provision as a predicting tool.

If a bank realizes it must take a loss on a loan but has not set aside adequate provision, it will use up the provision and then some when it takes the loss.

“When the bank is the owner of record, the property is often not kept up well. There have been many instances where borrowers who have been foreclosed upon intentionally trash the property out of spite to pass a less valuable property on to the bank.”

Sometimes, a bank sets aside excessive provision. It can recover this provision, so it is not permanently punished for overestimating its provision. In the current economic climate, recoveries on the loan loss provision are basically nonexistent. The excess provision is retained by management so that further increases to provisions down the road are less likely.

MOI: It seems that some banks have adopted an “extend and pretend” strategy of restructuring loans, particularly commercial real estate loans, in order to keep them classified as performing. In July, the Wall Street Journal pointed to Winston-Salem, NC-based BB&T Corp.: “Its total of one type of restructured commercial loan hit \$969 million in recent months, the bank reported in April. That was a huge jump from six months earlier, when the figure was just \$68 million.” The Journal added that, “BB&T’s report showed a significant number of cases where it was extending loan maturities and allowing interest rates not widely available in the market for loans of similar risk.” Do you view these types of loan restructurings as an “extend and pretend” strategy, and how prevalent is this behavior?

Proper: To me, “pretend and extend” is the imprudent modification of an existing loan to avoid an increase in the loan loss reserve or to avoid a write-off of principal. I have seen all types of this behavior, whether it’s modifying a loan from amortizing to interest-only, drastically lowering a loan’s interest rate so the rate does not appropriately reflect risk, allowing the release of collateral so the borrower can generate cash proceeds to keep his head above water and cover another six months’ of payments, etc.

“... ‘pretend and extend’ is the imprudent modification of an existing loan to avoid an increase in the loan loss reserve or to avoid a write-off of principal. I have seen all types of this behavior, whether it’s modifying a loan from amortizing to interest-only, drastically lowering a loan’s interest rate so the rate does not appropriately reflect risk, allowing the release of collateral so the borrower can generate cash proceeds to keep his head above water and cover another six months’ of payments, etc.”

The most egregious case I observed was a bank that had a \$900,000 nonperforming mortgage on a single family home worth about \$750,000. The bank offered to have a third-party client set up an LLC to buy the property for \$900,000. That \$900,000 would be financed 100%, and the loan had no personal recourse. The client moved into the house and had to pay 2% interest monthly on the \$900,000 loan. After five years, the client could sell the house. Any proceeds left after the \$900,000 loan was paid off were the LLC’s to keep. Any shortfall in proceeds would be written off by the bank. This is a straw man transaction and is a prime example of surreptitiously structuring a deal to delay the inevitable. The counter-argument is that it buys the bank time. But that’s the thing in business: Time is always of the essence. It was shocking to me when I learned the bank had modified loans this way many times, and with regulatory approval!

Basically, if a loan is not performing and is in the proverbial emergency room, a “pretend and extend” renewal puts it on permanent life support. The hope is that there will be a miraculous medical invention that will get the patient off life support. This avoids write-offs of principal or appropriate loan downgrades and overstates the strength of a bank’s loan portfolio. Ultimately, the bank needs a reality check and needs to pull the proverbial plug on the loan that’s in the emergency room. “Pretend and extend” is what leads to zombie banks. Such banks have tons of basically nonperforming loans and assets, but thanks to a mixture of regulatory encouragement and liberal interpretation of GAAP, they continue to limp along. Banks that are hopping on the “pretend and extend” bandwagon, and regulators who are turning their heads the other way or even endorsing it, are all praying every night that inflation will rear its head soon.

MOI: It's clear that inflation would be a boon for banks' loan portfolios in terms of helping to stabilize and ultimately increase the market prices of the real estate collateralizing the loans. However, if inflation does take off in earnest, long-term interest rates would likely rise substantially as well. This could be great for home owners who owe money on 30-year fixed mortgages, but those holding such mortgages as assets could see the mark-to-market value of the assets impaired substantially. Help us understand who would take the hit in the case of much higher long-term interest rates — would it be the banks themselves, Fannie and Freddie, or someone else?

Proper: Since late 2008, the primary purchaser of long-term fixed-rate residential mortgages has been the Federal Reserve. It has been accepting a yield 1% to 2.5% less than the next highest bidder at pooled debenture auctions. The Fed has not yet been able to extricate itself from this predicament, in a manner somewhat similar to the corner China has backed itself into with its purchases of U.S. government debt. If the market value of these pooled mortgage bonds gets blown out of the water by increasing long-term interest rates, the Fed would have to deal with the mark-to-market problem. However, because these bonds are presently illiquid, there's no real way of valuing them currently and, unlike any other entity on the planet, the Fed can always just print more dollars to cover its losses. The same asset value write downs would apply for Fannie and Freddie and any holder of such mortgage-backed bonds.

MOI: The behavior of regulators seems to be one of the biggest wild cards in the banking industry today. Not only does Washington seem to have an incentive to keep “zombie” banks alive in order to avoid further foreclosures, layoffs, etc., but institutions like the FDIC may not be physically able to deal with all the problem institutions out there. The FDIC's employee count has gone from 4,476 at the end of 2006 to 7,393 as of June 30th of this year, while the number of problem institutions has gone from 50 to 829 in the same period. This implies a ratio of fewer than nine FDIC employees per problem bank, the lowest level since data has been available (1990). What is your view of the approach regulators have taken and are likely to take in the future?

Proper: Regulators have been absolutely overwhelmed by the problems in the banking industry. The implosion has reflected very poorly on regulators. To me personally, this cannot be overstated and has left me with a permanent sense that very few, if any, regulators and bankers have a comprehensive understanding of what they are doing. They are just along for the ride, tossed about by the waves of market forces, with inadequate tools to redirect the waves.

If regulators insisted tomorrow to put an end to the extend-and-pretend, ostrich-head-in-the-sand approach, and seized all the banks that ought to be seized, the losses would be so substantial that the FDIC would deplete its reserves and be insolvent. If the FDIC were insolvent, perhaps the U.S. government would come to the rescue to provide emergency reserves, but who can say? The mere exercise would have substantial and destabilizing economic and political repercussions. This is why regulators have enabled banks that ought to fail to stay alive: the problems are so prevalent and significant that regulators have been forced to rewrite the rules and their own economic standards in order to prevent a collapse of the FDIC.

“If regulators insisted tomorrow to put an end to the extend-and-pretend, ostrich-head-in-the-sand approach, and seized all the banks that ought to be seized, the losses would be so substantial that the FDIC would deplete its reserves and be insolvent.”

MOI: For the reasons you mention, there seems to be little doubt the FDIC would ever be allowed to fail. The government and the Fed have made it clear – with actions, not just with words – that they will keep supporting the economy and large failing institutions virtually without regard for the cost. Investors like David Tepper of Appaloosa have made no secret of the fact that their investments have depended on and benefited from the “Bernanke put” etc. Yet, many small publicly traded community banks now sell at valuations that imply a high likelihood of failure. Does this create asymmetric risk-rewards in some situations, and if so, how would you go about identifying the most attractive opportunities?

Proper: What you outline is critical. The current capitulation within the banking industry is the kind that yields profoundly attractive mispriced assets. A basic approach is to screen banks based upon their market capitalization relative to their tangible equity — first, goodwill on a bank’s balance sheet is utterly worthless and second, there are banks with market caps of only 5% of book equity.

Some very rudimentary review of the bank’s UBPR to evaluate its loan loss provision and the adequacy of the provision relative to its peers (all of this is communicated within a UBPR), along with a review of what types of loans make up a bank’s loan portfolio can give the investor a good sense of whether a bank’s stock is worth buying. It’s always important to read the bank’s annual report and to review news headlines related to the company. These days, the CEO and CFO will take a call from any investor, and I consider it worthwhile talking to them, even if just to discuss the economy in general, to see what they say and how they say it. Some bankers are so paranoid about potential shareholder lawsuits that they’ll speak very openly about their bank and its problems.

I think that significant concentration within a particular community bank is risky, but that a significant concentration within a basket of community banks is attractive. I am surprised we have not yet seen a community bank ETF for banks with tangible equity of less than \$1 billion. They are the most significantly mispriced class of banks, in my view. I personally invested a fixed dollar amount equally in about 250 community banks. I think that worst case, 20% of them will fail, but that these worst-case losses will be more than offset by appreciation in the others. As always, only time can tell. Most of these community banks are currently trading at ten-year, if not historic, lows.

MOI: Scott, thank you very much.

“I am surprised we have not yet seen a community bank ETF for banks with tangible equity of less than \$1 billion. They are the most significantly mispriced class of banks, in my view. I personally invested a fixed dollar amount equally in about 250 community banks. I think that worst case, 20% of them will fail, but that these worst-case losses will be more than offset by appreciation in the others.”