

# AMERICAN BANKER

On Focus and In Depth

## California IOUs: Tough Calls Run Gamut

American Banker | Monday, July 13, 2009

By American Banker Staff

Presented with a difficult choice between two risks — angering depositors or effectively extending a loan to crisis-stricken California — banks have varied widely in their willingness to accept IOUs the state has issued to their customers.

Several institutions, including large national ones like Wells Fargo & Co. and JPMorgan Chase & Co., held firm that they would not accept California's so-called registered warrants after Friday. But some, notably Citigroup Inc., said Friday that they were considering an extension.

Some banks have not accepted the IOUs at all; others will cash them only for their customers; still others are only doing so on a case-by-case basis. The holds that banks have placed on the warrants have ranged from one to seven days. And some banks said Friday they were still figuring out what their policies should be.

Many bankers have long memories of 1992, when a previous state budget crunch had them accepting IOUs for a month or more. Doing so only prolongs the problem, they argue.

"We don't want to be the bartender serving the drunk," said Brian K. Garrett, the chief executive of \$71.9 million-asset Community Bank of the Bay in Oakland. "There's been so much frivolous spending by government that all we'd be doing is enabling politicians in Sacramento to continue what they're doing and not pass a budget."

But he said his institution and most other community banks are honoring the warrants on a case-by-case basis because they do not want customers to suffer.

California began paying IOUs to thousands of businesses and individuals on July 2.

The IOUs, which resemble checks, are promissory notes for everything from tax refunds to services provided to the state. California agreed to pay banks an interest rate of 3.75% since they would not be reimbursed until at least Oct. 2.

The state controller's office has estimated that it will issue roughly \$3.2 billion in registered warrants this month.

"There is a great deal of uncertainty about the proper approach" for banks to take, said Tim O'Brien, an analyst with Sandler O'Neill & Partners LP. "It has created a plethora of risk, and these banks have to figure out how to properly manage through the process, because it is a here-and-now issue. They have to make these tough decisions now."

The risks, O'Brien said, extend beyond the worry of repayment to the potential for fraud, the proper treatment on the balance sheet and the loss of business should a bank decide not to participate.

"This is far greater a nuisance than it is an opportunity," O'Brien said. "California banks are not interested in incurring more losses just to help the state, but they want to do everything they can to support their customer base."

Paul Bate, the compliance manager at the \$900 million-asset River City Bank, said it would continue to accept the warrants as a matter of customer service.

"The main reason is, we don't feel a lot of our business customers have the capacity to hold on to them until October," he said. River City has accepted seven IOUs, mostly around the \$200 range, but one was for \$300,000.

Bate said River City feared that with other banks deciding to stop accepting the warrants, customers needing to cash them would flood the bank.

So to avoid that situation, the bank will only accept the warrants from those who were customers as of July 2.

The process for ensuring the vouchers are legitimate usually means the bank holds the funds for about a day, he said.

"If we get copies to the state by 8 a.m., they tell us by noon if they are legitimate," Bate said. "We haven't had to put a hold on the funds for more than a day."

Wes Schaefer, the vice chairman of American Business Bank in Los Angeles, said it is still figuring out its stance on the warrants, mostly because it has yet to honor one.

Three of its customers have received them — the first one was for \$18 — but given their minor amounts, Schaefer said the bank advised the customers to hold them for now.

However, Schaefer said that will likely change as the amounts get bigger and the payments become crucial for customers' businesses.

"It will have to be an occasion where our customers say we really need this," Schaefer said. "We would not, however, use this as a way to drum up new accounts ... and we are not going to do anything that puts the bank at risk."

Since the IOUs would be an investment — the Securities and Exchange Commission has deemed them to be securities — regulations would let American Business Bank accept only about \$15 million given its \$840 million in assets.

Schaefer said that should the bank need to accommodate customers further, it could use the warrants as collateral on a loan.

He said he is confident that the state will honor its commitments, but is apprehensive as to when it will.

"It is supposed to be October, but will it be October? Or will it be Dec. 31 or will it keep moving?" Schaefer asked. "A pushback could cause capacity problems or liquidity issues for banks and for the entire state for that matter."

And if California's debt were to be downgraded by the rating agencies, it might increase the regulatory risk-weighting of these assets and force banks to take impairment charges.

"Everything we've ever invested in has been at the top end of the scale, so I just don't know what the effects would be," Schaefer said.

Julia Tunis Bernard, a spokeswoman for Wells, said Friday it was sticking to the July 10 deadline because the state, "just like any household or business, must be responsible for living within its means. Banks cannot be the solution to California's budget problems."

San Diego National Bank never accepted the warrants, but spokeswoman Kristy Gregg would not say why.

Rick Smith, the president and chief executive officer of TriCounties Bank in Chico, Calif., said it set a July 10 deadline for the IOUs, but will reconsider that decision over the weekend.

"Part of that consideration is if the state is moving forward," he said. "We can't accept the warrants indefinitely."

Smith said his bank, a subsidiary of TriCo Bankshares Inc., had several concerns about continuing to accept the warrants. One is the risk of cashing a forged IOU. But even with the genuine warrant, repayment is not guaranteed.

"On Oct. 2, we are told we can redeem them back to the state of California for payment, but we also know the state could pay us with a new warrant," he said.

"The state is doing this because they don't care about banks, and they know they are putting us in a bad position to where we have to accept these."

Citi spokesman Rob Julavits said early Friday that the company was still evaluating whether to continue accepting IOUs this week.

Some banks changed their minds on Friday.

James Abbott, spokesman for Zions Bancorp. in Salt Lake City, said early in the day that its California Bank and Trust unit would stick with the July 10 deadline.

"It's all about risk mitigation," Abbott said. "We don't want to be accepting these warrants two years from now. We'd like to get back to the business of cash payments. There's a certain element of risk as to when the California budget would be balanced."

But later in the day, a spokeswoman for California Bank and Trust sent an email saying that the unit "will not be changing our policy on accepting the warrants (IOUs) today."

She reiterated what the bank had said when it first announced it would accept the warrants: "We value the relationship and financial role we have with our customers and hope that by honoring these IOUs, we are able to help our customers."

However, California Bank and Trust said it "reserves the right to terminate or limit acceptance of these IOUs at any time," and that as long as it is accepting them, "some restrictions may apply."

Beth Mills, a spokeswoman for the California Bankers Association, said banks "have been through this before," when they accepted IOUs from the state in 1992.

"They accepted IOUs then for about 30 to 45 days and it prolonged the budget problem," Mills said. "It is incumbent on state officials to get a budget in place."

On July 2, Colleen Haggerty, a spokeswoman for Bank of America Corp., said it would not accept the warrants after the 10th because of the lessons learned from 1992.

"The longer the registered warrants were accepted by banks, the longer it took the Legislature to resolve the matter," she said then. B of A did not return calls by press time Friday.

JPMorgan Chase spokesman Tom Kelly said Friday that his company was sticking with the July 10 deadline. He would not give a reason.

The \$553 million-asset American River Bankshares in Sacramento originally planned to stop accepting the IOUs on Friday. But Diana Walery, a spokeswoman for the company, said Friday that "after today, we will conduct a risk analysis and determine if we can continue accepting the warrants. Our analysis will keep in mind our clients' needs, which prompted our decision to accept them in the first place."

American River had picked July 10 as the initial cutoff because that was "the consensus among the other banks in our market," Walery said.

She also said that so far, American River "has accepted only a few warrants."

Julianna Balicka, an analyst at KBW Inc.'s Keefe, Bruyette & Woods Inc., wrote in a note to clients Friday that the IOUs will be "beneficial" to banks' net interest income and margins.

The 3.75% interest rate is tax-free, which translates into a 6.5% yield, Balicka wrote, assuming a 1.5% cost of funds.

"In a national context, the problem is manageable," Balicka wrote, equating California's \$26.3 billion budget deficit to half of the Treasury's investment in Citigroup.

A source at one California bank said the amount of time and energy that has gone in to handling the warrants is "mind-boggling." All the IOUs have to be scanned and sent to the state for verification — which can take 24 to 48 hours — before funding.

Even if the IOUs are redeemed in October, banks will have to send paper copies to the state, which will process them manually, rather than allow for an electronic transfer of funds, the source said. So it is unclear how long it would take to get paid.

Some check cashers are accepting the IOUs.

California Check Cashing Stores LLC, which has more than 100 locations in northern California, said on its Web site Friday that it would cash the state IOUs, with its usual fee of 2.5% on any IOU under \$1,500 and a 2.75% fee on amounts above that. (It is also advertising that service on Craigslist.)

However, Richard Lake, the Oakland company's CEO, said late Friday it might have to stop accepting the IOUs, because both of its banks — Wells and Union Bank of California — would stop taking them Friday.

Greg Larsen, a spokesman for the California Financial Service Providers Association, a trade group for check cashers, said many of them face the same challenge.

"When a check casher takes a check, they have to move it through the system somehow," he said.

"If the financial institution with which they have a relationship ... isn't accepting the IOUs," it can be hard for the check casher to cash them.

*Contributions from Kate Berry, Robert Barba, Katie Kuehner-Hebert, Marissa Fajt and Maria Aspan.*

© 2009 American Banker and SourceMedia, Inc. All Rights Reserved.

SourceMedia is an Investcorp company. Use, duplication, or sale of this service, or data contained herein, except as described in the Subscription Agreement, is strictly prohibited.

For information regarding Reprint Services please visit: <http://www.americanbanker.com/reprint-services-rates.html>