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INVICTUS

Bank Insights

Looming Problems Portend Hard Times Ahead for Community Banks

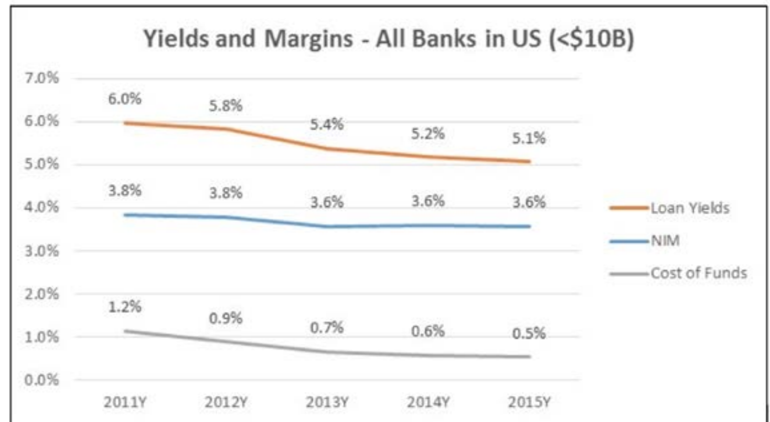
Unsettling trends that may not be obvious now – but are vivid when quantified with the right analytics – indicate more trouble ahead for community banks. Survival, from a shareholder value perspective, will require a radical new approach to M&A.

By Kamal Mustafa, Invictus Consulting Group Chairman

Community bankers have reinvented themselves in the last eight post-recession years. Between the capital losses of 2008 and 2009, increased regulatory constraints, an extended slow recovery and the artificial interest rate environment, senior executives have faced and overcome challenges of an unprecedented nature and magnitude. They have accomplished this – in most cases – without analytical systems that can quantify, analyze and project the impact of the aforementioned changes.

Due to the limitations of legacy analytical and reporting systems, all their actions have been defensive and reactive, rather than offensive and proactive. Unfortunately, there are serious community banking issues that have been bubbling below the surface that are due to see the light of day in the upcoming years. These issues will affect practically every community bank, no matter its profitability.

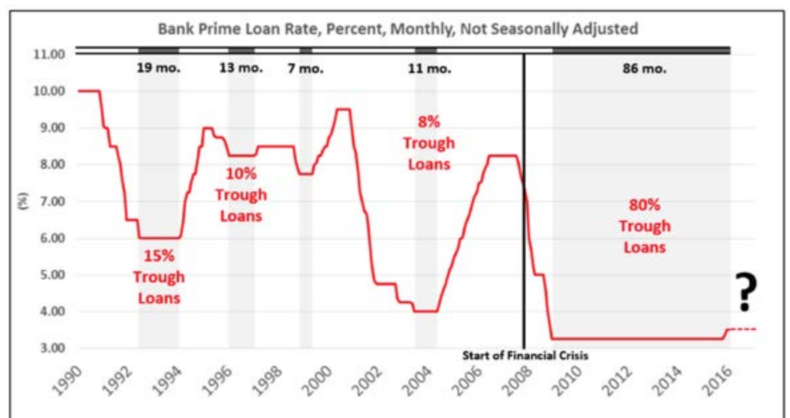
Traditional analytics and financial reporting show that practically all community banks are facing some level of earnings compression. Most of these systems indicate a fairly slow but steady decline in gross yield on assets, with this decline historically offset by steady or marginally improving net interest margins. (See chart). Traditional extrapolation of these results would indicate a shallow but slightly declining trend in community bank earnings. The response to this dollar earnings compression has been – and continues to be – an increased emphasis on organic growth.



Unfortunately, these historical financial statements and existing pro forma models are repeating the errors of the post-recession world. The assumption that historical trends can be simply extrapolated based on recent history is wrong. Even worse, it is masking the underlying turbulence that is about to strike the community banking market. It is only when you break down and quantify the components and patterns that affect gross loan yield and the different timing patterns affecting the cost of funds (deposits) that one can measure the magnitude of the problems bubbling just below the surface.

To best illustrate and quantify these potential problems, it's important to first review the community bank market's post-recession performance, using appropriate analytics that take into account the considerable impact of monetary policy.

As illustrated in this next chart, which shows the prime rate since 1990, interest rate troughs are not a new phenomenon. However the present trough, created by the post-recession monetary policy, is unprecedented in not only its depth but more importantly by its extended duration. It has lasted long enough to influence more than 80 percent of existing loan portfolios.



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info@invictusgrp.com ▪ 212.661.1999 ▪ 275 Madison Avenue ▪ New York, NY ▪ *www.invictusgrp.com*

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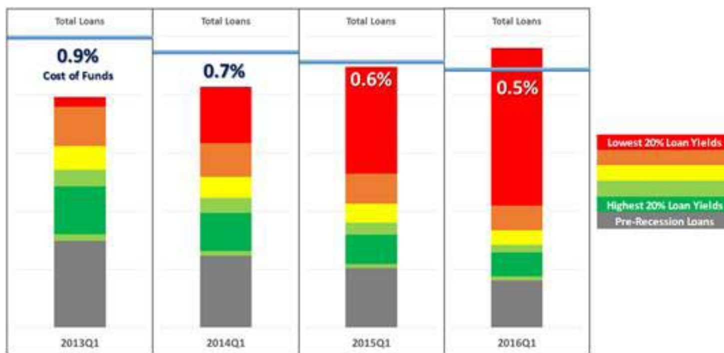
The following chart shows the distribution of loans for every community bank in the country by gross loan yield based on loan vintage, for the past four years. One can clearly see the increased "poisoning" of the balance sheet as higher yielding loans continue to run off the banks' books and are replaced by lower yielding "trough" loans. As is evident from the graphs, there has been a steady decline in gross loan yields across the community banking system. Ongoing organic growth will continue to make this situation worse.

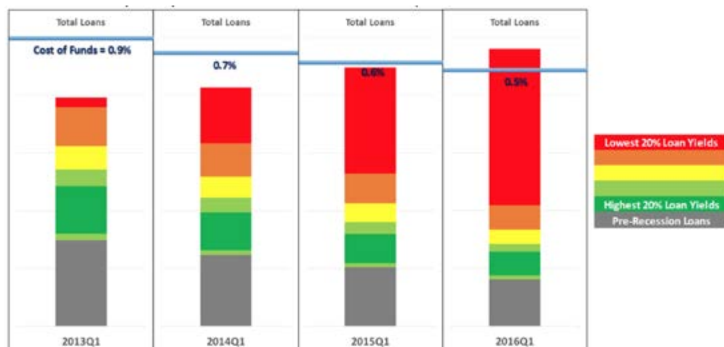


So what does this mean? Here comes the insidious part. In spite of this increasing poisoning of loan portfolios (declining gross yields), the actual net interest margins and profitability declines have not displayed a corresponding deterioration.

Traditional analytical tools and accounting systems indicate increased pressure on NIM spreads and net profits, but they do not even approximate the magnitude and rate of decline in gross yields. As mentioned earlier, extrapolation of these trends using legacy tools would merely show a shallow slope to this deterioration that could be easily mitigated by an eventual uptick in interest rates.

All the while, analysts and shareholders are pressuring bank management to increase dollar earnings. Their answer: increased asset growth. And that is part of the problem. Bankers are flying blind by relying on these outdated analytics.

Let's analyze the impact of gross yields in asset portfolios. The trend will become easier to see if we superimpose the cost of funds on the prior chart.



As can be seen from this chart, the decline in gross loan yields has been effectively offset with a corresponding decline in the cost of deposits, resulting in a net, relatively minor, degradation in bank net interest margins. If banks are using traditional analytical processes and accounting methods, they would assume that increasing asset volume is a partial but seemingly effective solution to the degradation in dollar earnings. This approach is dangerous. It is actually driving the community bank ship directly into the reefs.

Appropriate analytics provide far greater clarity. Consider the following two critical facts:

- As pre-recession and pre-Bernanke-era loans (with their higher yields) run off the bank's books, they are replaced by post-Bernanke-era low yielding loans. All incremental growth is also booked at these low rates. Each year the percentage of pre-recession and pre-Bernanke-era loans (with their higher yields) decreases at a fairly rapid rate, while new and replacement loans (with low gross yields) continue to grow as a percentage of the total portfolio.
- Historically, the post-Bernanke deposits continued to follow the same pattern, with rates declining across the deposit base. However, the near matching decline in deposits has year-to-date positively affected the funding of the *entire asset portfolio* (pre-and post-Bernanke). As a net result, the net spreads of the declining, but still present, on the books (pre-Bernanke) higher yielding portfolios has widened, largely compensating for the new and replacement loans written at the post-Bernanke depressed rates. This is extremely important.

Unfortunately, the stage is now set for this process to reverse itself, a reversal that is far from evident if one were to rely on traditional financial statements and legacy forecasting systems.

Deposit rates have now plateaued close to their lowest possible level. As a result, the compensating increasing spreads across total loan porfolios have come to a grinding halt.

The higher rate pre-Bernanke loans will continue to amortize fairly rapidly, continually being replaced by low gross yielding market loans. The net effect of this ongoing reduction in total portfolio gross yields and *plateaued cost of funds* will have a massive and cumulative impact on bank profitability and returns in the next few years.

This impact will be dramatically different than trends extrapolated using legacy analytics and bank financial

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accounting statements. Banks that do not recognize these key trends and take appropriate action immediately will be left in fairly dire straits.

A rising interest rate environment will make the situation even worse. The cost of all deposits will increase very rapidly, while loan portfolios will turn over at a far slower rate, further compressing spreads. It goes without saying that recent and near-term organic growth substantially increases the amplitude and duration of these previously undiscovered negative trends.

There are some very practical solutions to this scenario, which will be explored in a future issue of *Bank Insights*, but the problem must first be recognized and quantified. ▪

Regulatory Write-ups Point to Emerging Risks in Community Banking

Don't be surprised if your bank receives a write-up about supervisory concerns after your next exam, whether it's a Matter Requiring Board Attention (MRBA) from the FDIC, or a Matter Requiring Attention (MRA) from the OCC.

The FDIC reveals in the **summer issue** of Supervisory Insights that 36 percent of banks rated 1 or 2 received an MRBA in 2015. The OCC **reports** that it had more than 4,000 outstanding MRAs in 2015, but it won't say what percentage of banks that entails.

Though the numbers are down – the FDIC says 55 percent of satisfactory-rated banks received MRBAs in 2011 and the OCC had more than 9,000 outstanding MRAs in 2012 – issues such as commercial real estate concentration management may lead to an uptick in the coming years.

The FDIC article, "'Matters Requiring Board Attention' Underscore Evolving Risks in Banking," says the write-ups act as an early warning system so potential problems can be fixed before it is too late. The article notes that MRBA trends "can provide a picture of risks that may be developing within the industry." An OCC spokesman noted that MRAs are a normal outcome of the examination process.

While write-ups may be directed at senior management, regulators expect the board of directors to be in charge of the process to correct deficiencies.

Management-related issues and loans most frequently lead to MRBAs, the FDIC noted, with deficiencies related to audits, policies and procedures and then strategic planning the most common triggers. But while MRBAs in the loan category have decreased, issues related to concentration risk management are increasing.

"Since community banks typically serve a relatively small market area and generally specialize in a limited number of loan types, concentration risks are a part of doing business," the FDIC article notes. "Consequently, the way these banks manage their concentration risk is important. In 2014, approximately 12 percent of loan-related MRBAs addressed concerns with the risk management practices governing concentrated loan exposures; in 2015, credit concentration-related MRBAs rose to 22 percent."

Regulators issued a warning late last year that they would pay particular attention to CRE concentration risk management in 2016. Banks are reporting that they already have received MRAs and MRBAs as a result of their concentrations.

The FDIC noted that banks with MRBAs that also had high concentration levels of CRE, ADC or agriculture also tended to have an increased in warnings about liquidity risk. That's consistent with Call Report data that showed the proportion of liquid assets to total assets held by smaller banks has been declining. Loan-related MRBAs also involved ALLL issues and problem assets.

The OCC reported that the top MRA categories for small banks were credit, enterprise governance and bank IT (also an issue with the FDIC).

Regulators expect board of directors to respond and correct the weaknesses that examiners have identified. The FDIC noted that in about 70 percent of the MRBAs in 2014 and 2015, banks addressed the problems in their first response to the agency. The OCC updated its MRA **guidance** in 2014, noting that banks must submit a board-approved action plan within 30 days of receiving an MRA if they don't provide a plan during the actual exam. ▪

What MRAs Must Include

The Comptroller's Bank Supervision **handbook** outlines how examiners should write MRAs. They must:

- ✓ Describe the issue, its root cause and contributing factors
- ✓ Lay out potential consequences of inaction
- ✓ Describe expectations for corrective measures
- ✓ Document management's commitment to fixing the problem, including a timeline and names of who are responsible

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

FDIC Preparing De Novo Guide

The Federal Deposit Insurance Corp. is working on a practical guide that will help would-be bank investors understand the process of starting a bank. The publication, which is due out before the end of the year, will take organizing groups from the initial concept through the application process and post-approval, the FDIC announced in the **summer issue** of *Supervisory Insights*, which also has an article about de novos. Included in the guide will be information about sound business plans, raising capital, recruiting management and other issues that have been obstacles to new bank organizers.

Most Bank Assessments to Decline

Community banks should expect to pay less for deposit insurance, now that the Deposit Insurance Fund's reserve ratio has reached 1.17 percent, the highest level in more than eight years. "Assessment rates for 93 percent of institutions with less than $10 billion in assets are expected to decline," FDIC Chairman Martin J. Gruenberg **said**. "On average, regular quarterly assessments are expected to decline by about one-third for these smaller institutions." The FDIC is changing the way it determines risk-based assessment rates, though it maintains the change will be revenue neutral.

Federal Reserve Community Banking Conference to Be Interactive

The fourth annual Federal Reserve/Conference of State Bank Supervisors community banking **conference**, which will take place on Sept. 28 and 29 in St. Louis, will offer an interactive webcast feature for those who can't make the research and policy conference in person. The webcast will be accessible through **www.communitybanking.org**. A video will feature banker success stories from Idaho, Montana, Oklahoma and Tennessee. Results of an annual survey of community bankers will be discussed, as well as the findings of research projects on business models, bank profitability, the cost of compliance and the role of capital.

Fed Paper Explores Relationship between Bank Size and Profitability

Two Kansas City Fed economists have concluded that the competitive disadvantage of community banks in the post-recession era has been overstated. Their **paper**, "Has the Relationship between Bank Size and Profitability Changed?" concludes that the decline of profitability in recent years is more tied to economic factors such as unemployment rates than to the size of the bank itself. While the economists find that there are significant scale economies for the smallest community banks, this has not changed since the crisis. "While the smallest banks can benefit significantly from growth, the advantages of growth become progressively smaller until they are exhausted," the economists write. "For most midsized community banks, the increase in returns relative to size is modest; these banks would need large increases in size to realize significantly higher returns."

Shorter Call Reports Proposed for Community Banks

Regulators want banks to comment on a **proposal** to streamline Call Reports. The proposal, which would apply to banks with less than $1 billion in total assets, would reduce the existing Call Report from 85 to 61 pages, and combine five schedules into a new supplemental schedule. The agencies say they are trying to balance banks' requests for a less burdensome reporting process with their need to ensure the safety and soundness of the banking system.

Boston Fed President Cites CRE Risks in Interest Rate Moves

Low interest rates have led to rapid price appreciation in commercial real estate, Boston Fed President Eric Rosengren said at a **speech** at the Shanghai Advanced Institute of Finance in China. If the U.S. economy weakens, a decline in CRE collateral values could lead to losses for banks and erode their capital ratios. He suggested that U.S. monetary policymakers need to consider the CRE market as part of their decision-making. "Very low interest rates may move the economy closer to the central bank's dual mandate goals more quickly than would higher interest rates, but it is important to evaluate 'at what cost,' "he said. ▪

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the ***Invictus website****.*

For editorial, email Lisa Getter at ***lgetter@invictusgrp.com****.*
For information about Invictus, email ***info@invictusgrp.com****.*