Business model risk at community banks

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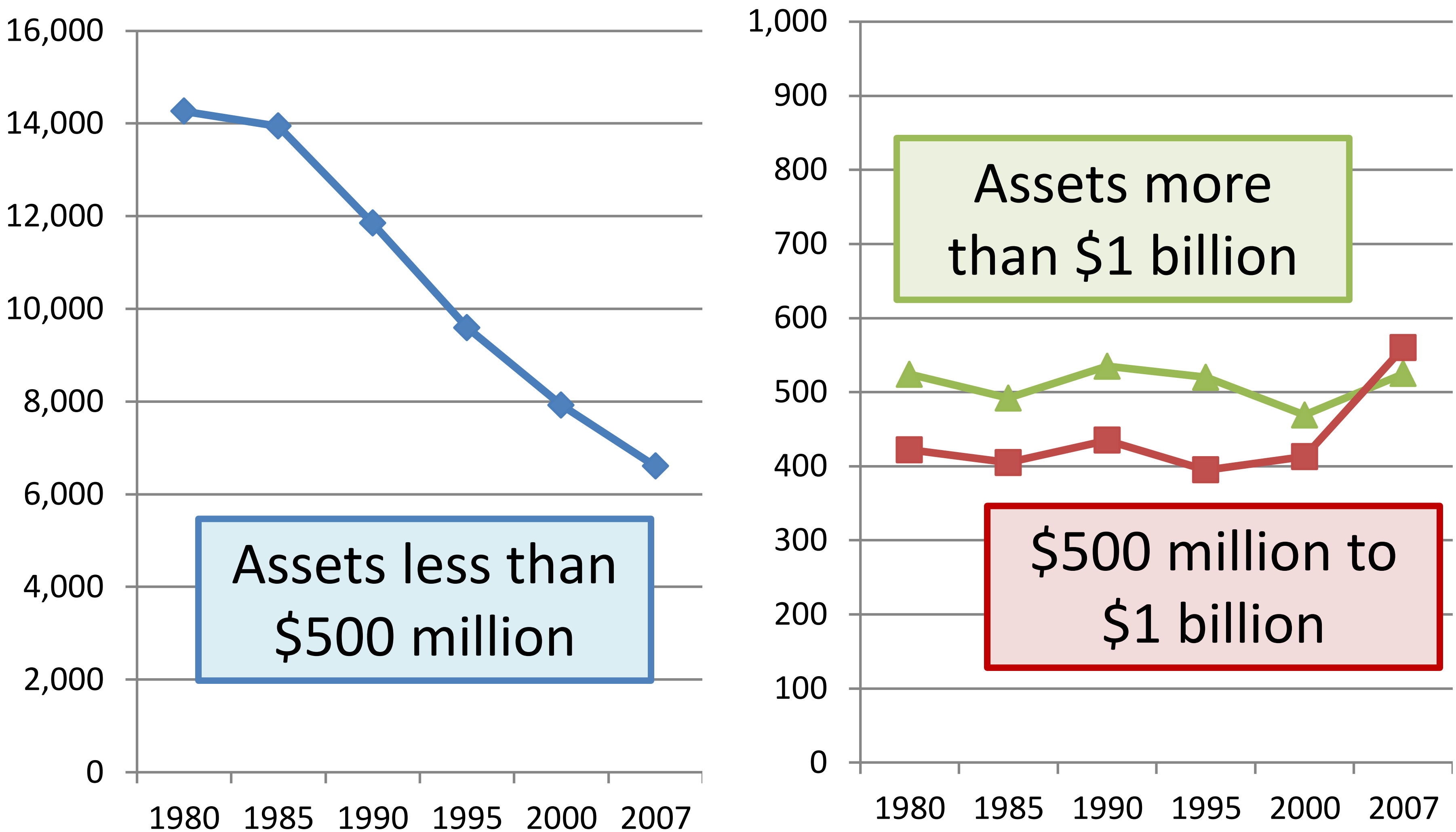
I want to briefly discuss four themes

1. Is the small bank business model still viable?
2. Regulatory risk.
3. Demographic risk.
4. Interest rate risk.

How big does a community bank have to be?

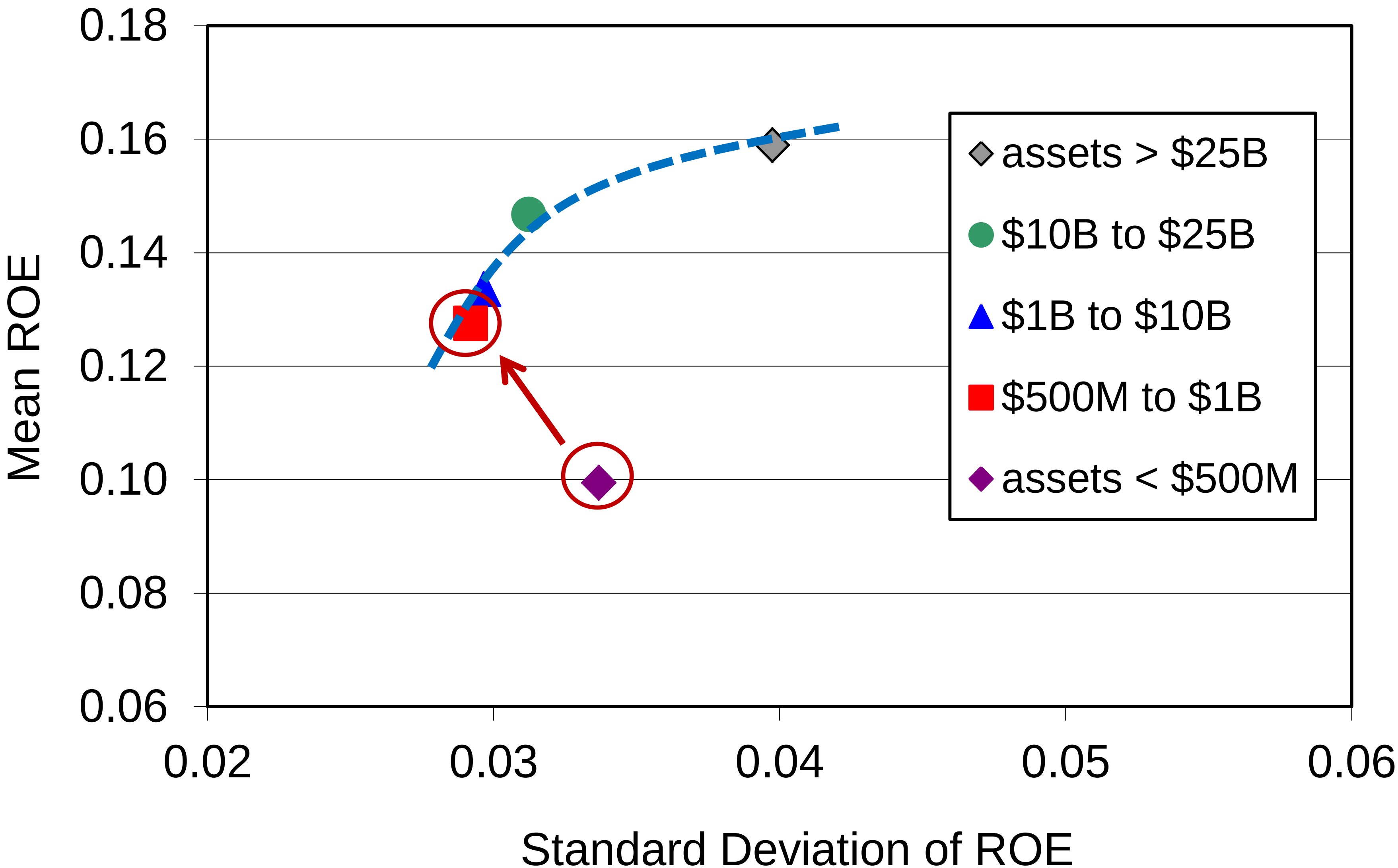
- <u>Small</u> banks are financially viable.
- Exceptions:
  - <u>Tiny</u> banks
  - Poorly managed banks

Change in # of U.S. banks since 1980



Data: FDIC.

ROE-Risk for U.S. banks and BHCs in 1998-2007. (Annualized averages based on quarterly data.)



Data: Federal Reserve, author's calculations.

Largest Financial Holding Companies

by Asset Size, 2007

40% failed

1	Citigroup	$2,220,866	Insolvent, Bailed Out
2	Bank of America	$1,535,684	Insolvent, Bailed Out
3	JPMorgan Chase	$1,458,042	
4	Wachovia	$719,922	Insolvent, M&A arranged
5	Deut		
6	MetL		
7	Wells		
8	Washington Mutual	$349,140	Insolvent, M&A arranged
9	U.S. Bancorp	$222,530	
10	SunTrust Banks	$180,314	

Only about 6% of smaller banks failed since 2007!

Data: Federal Reserve, FDIC.

Why did so few small banks fail?

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ROE	11.8%	11.1%
Provisions-to-assets	.0029	.0024

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	2005 performance for banks with assets less than $500 million	
	Banks that failed in 2008-2010	Banks that survived
ROA	1.07%	1.17%
ROE	[illegible]	[illegible]
Provi[illegible]	[illegible]	[illegible]
Asset[illegible]	[illegible]	[illegible]
Core deposits-to-assets	55.6%	68.1%
Loans-to-assets	74.8%	63.1%
C & D loans-to-total	23.6%	7.6%
Business loans-to-total	18.0%	23.5%

These data are consistent with recent, more careful research done by Rebel Cole (DePaul) and Larry White (NYU).

"New regulations are making the small bank model less viable."

- CFPB (at least for now) is aiming at banks with assets over $10 or $20 billion.
- Basel III requires more capital and higher quality capital. Especially expensive for community banks.

Where will equity capital come from?

- Cheapest source of capital is retained earnings.
- <u>Example</u>: A $150 million bank with ROA = 1% and leverage ratio of 10%.
  - Retain 100% of earnings → equity increases by 10%.
    - Bank can quickly meet higher capital standards.
  - At this 10% growth rate, equity will <u>double</u> in 7 years.
    - If ROA=1% opportunities exist, assets can grow at 10%.
- Is 10% real growth fast? Between 1990 and 2007:
  - the median U.S. bank grew at a 2.8% real annual rate.
  - moving from median to 75th required a 7.8% real annual rate.
- Less useful for S banks (distributions to pay taxes).

The next generation of retail customers wants a different type of banking relationship.

- “High touch” customers.
- “No touch” customers.

Small banks <u>must be</u> relationship based.

- Re-think what a retail banking relationship means.
  - Adding mobile banking is <u>necessary</u> but not sufficient.
  - Cultivate a "low-touch" relationship.

- Your coffee is <u>never</u> going to be as good as Starbucks.

- Two contrasting images for the Internet generation:
  - Bankers are part of the "1 percent."
  - Small/local banks are "sustainable."

Waiting for Bernanke.

Large banks betting on rate increases? Smaller banks close to neutral.

U.S. Bank Holding Companies Median Averages 2012 Fourth Quarter Data	
Asset Size	**Re-pricing Gap (% of assets)**
More than \$100 billion	+22.2%
\$10 to \$100 billion	+15.2%
\$2 to \$10 billion	+8.3%
Less than \$2 billion	+3.8%

Moreover: These re-pricing gaps have been growing more positive since 2009 for all sizes of BHCs.

Interest rate exposure

- Interpretation?
  - Small banks <u>poorly positioned</u> to exploit coming rate spike?
  - Small banks <u>well hedged</u> against coming rate changes?
- We all know rates will eventually go up.
  - But when?
  - Small bank business model is about relationships, not interest rate speculation!
- Floating rate loans are the best hedge. But…
  - Your market may demand long-term fixed rate loans.
  - The initial premium on fixed rate loans: Use it to purchase interest rate swaps.

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