LOAN GROWTH, CAPITAL AND THE DEAD ZONE

by Steve Brown

If you need to generate capital, the fastest way to get out of this "dead zone" is to execute an FDIC-assisted deal. Since these transactions are relatively self-capitalizing (even under the lower loss share), they generate the cheapest form of long-term capital available to bankers right now. That is great, but what about the majority of banks that will not be doing an FDIC-assisted transaction?

Unfortunately, many banks are stuck in this dead zone of capitalization. Like food for the marine life in the BP oil slick in the Gulf, many banks are starved for capital, but cannot find it. As a result, they decided to shrink their balance sheet in order to lower risk. The ironic part is that most banks are serving to do the opposite. Some banks are letting their lower risk loans run off or get refinanced away, leaving their bank with an adversely selected portfolio. Worse yet, shrinking the bank often puts more strain, not less on capital.

Here is the issue that is often overlooked. Letting loans run down places pressure on earnings. Loans that were made between 2004 and 2008 continue to stay on the balance sheet constituting the worse risk-adjusted return trade-off banking has probably seen in decades. These loans have the highest probability of going bad and will likely eat through available capital. Even if credit stabilizes, banks are likely to produce a low ROE that may build a track record of underperformance, thereby failing to attract capital in the future. Without capital, many banks will slowly asphyxiate.

The answer to this problem is that despite the short-term risk, banks must grow customers in order to generate a higher risk-adjusted return loan portfolio, a less interest rate sensitive customer and some form of fee income. If banks can do this, loans placed on the books today have the highest risk-adjusted return since 1991 and can be most effective at reducing the risk of the overall portfolio.

Of course, booking quality loans is not easy. For starters, banks need to target profitable customers that have a positive credit future. Doctors, hospitals, transactional lawyers, energy companies, technology firms and chemical manufacturers all fit this bill. Marketing to these customers to help them purchase their own office or industrial space when interest rates and real estate values are near a low can be an easy sell, as the real estate helps diversifies the customer's balance sheet and locking rates in now will provide future value.

For the bank, this provides an average expected loss of about 30% from what is on their books right now. If a bank can make a $2mm 10Y loan (25Y amortization) at a 6.38% fixed rate, the return on economic capital is 22% and the loan generates approximately $20k of risk-adjusted capital per year net of all costs. The fixed interest rate not only benefits the customer, but also limits negative credit movement in the future as cash flow coverage would be expected to increase each year. Banks can take care of the interest rate risk by swapping the fixed rate or utilizing our unique BLP Program so that PCBB takes the interest rate risk. If a $600mm bank can generate 1 loan like this a week, that puts $1mm per year into capital, reduces the cost of future capital (by producing a superior return) and reduces the risk of the overall loan portfolio dramatically.

We worry about banks shrinking too much and missing a rare opportunity to generate an above average amount of capital from loans. With spreads wide and real estate values low, this is an opportune time to consider generating loan growth. If you need help with structuring a loan for the best risk-adjusted value or to mitigate interest rate risk, give us a call.

LOAN GROWTH

If you want to see how your bank ranks on loan growth and composition compared to other community banks across the nation, go here for an interactive view and look under "Loan Growth Ranking" at the bottom right.

BANK NEWS

M&A

Kearny Financial ($2.25B, NJ) has entered a deal to purchase Central Jersey Bancorp ($471mm, NJ) for $72.3mm. In total, Kearny will service 40 branches and $2.0B in deposits.

Accounting Changes

FASB was very busy yesterday, releasing an exposure draft on how to account for financial instruments and another one that will change how the income statement is viewed. Significant changes on how to account for financial instruments will have banks marking to market on a "fair value" all financial assets and liabilities (including loans, loan commitments, deposits, etc.), measuring loan loss reserves on a forward looking "expected loss" basis and streamlining requirements for hedge accounting. The ICBA and ABA oppose these changes and we will talk about this more in coming editions of the BID as we explore the nuances of this issue. The comment period runs through Sept. 30.

Predictions

Foresight Analytics estimates a total of 203 bank failures this year.