2,000 BANKS WILL FAIL OR BE CLOSED IN THE NEXT 3YS

by Steve Brown

The sad thing about insane attention grabbing headlines is that they often do not do justice to the underlying message. While the one above is a doozy, the reasons behind it may get you thinking about where things are heading and whether that number is close to reality or far from it. Sure it sounds like a huge number at the get-go, but when you delve deeper into the data, it may have more reality behind it than expected.

To do so, we begin our analysis with the universe of FDIC insured financial institutions ("banks") using 2Q Call Report data and adjusting it for failures that have already occurred to date. Our starting universe and beginning point is therefore 7,807.

Our next step is to adjust that number for expected bank failures. To do this, we take into account banks with a Texas Ratio of 100% or greater. Recall that a ratio of 100% or greater has been shown historically (in the 1980's and 1990's) to be an indicator of increased potential bank failure. The Texas Ratio is calculated here as (loans past due 90 days or more + non-accrual loans + OREO) / (Tier 1 Capital + ALLL). Given there are currently 383 banks in this situation, assuming all of these fail, our universe decreases about 5% to 7,424.

Our next level of analysis focuses in on a likely consolidation wave that will be caused more by extreme industry pressure and as a byproduct of sweeping financial regulation than anything else. Here, a multiple-bank holding company will move to consolidate operations into a single bank in order to save on regulatory and operational costs. After counting every single bank holding company with multiple banks underneath it and making the assumption that all of them roll into a singular bank, the universe of banks overall consolidates by another 1,112. That is an additional decrease of 15% and takes the number of banks outstanding down to 6,312.

The rest of our analysis focuses in more on industry exhaustion than anything else. No one can keep running at full speed on a treadmill for days on end without eventually collapsing and we certainly don't have to tell any of our community bank readers that the industry has been doing that for about 2Ys already. Management teams, boards of directors and even shareholders are exhausted. Everyone wants things to get back to normal, but this just isn't likely to happen anytime soon. As a result, we project roughly 10% of the banks that remain and make it to this point to send in a little jingle mail of their own as the M&A wave begins. If that occurs, another 631 banks could disappear, taking the universe down to 5,681.

If you add everything up, you will find the math works out to about a 27% reduction in the total number of banks when all is said and done. However, back to our original question - is that realistic? Certainly, it sounds like a lot and it makes headlines, but other factors are also in play. For instance, consider that it could be easily argued that the 1,112 banks that are already grouped under a singular parent company here and there are already consolidated (so our starting point was too high to begin with), or won't change the way they operate (after all, they are set up this way for some financial reason to begin with). It could also easily be argued that not all banks with a Texas Ratio of 100% or more will fail. In fact, some of these probably aren't even strained, given the unique oddities of Call

Reporting related to strong banks that take over failed banks (as part of an FDIC sale with loss guarantees). Finally, while mergers could hit 10% overall, they also might not. If things start to turn around, credit losses abate and the general malaise lifts; it is likely that seller expectations (of higher prices) could also occur, pushing potential buyers to the sidelines.

Obviously, no one knows which projections are real and which need a straight jacket. For us, we assume roughly 75% of the Texas Ratio group disappears, 25% get consolidated and 5% eventually merge - a total of roughly 600 banks. As this crisis has taught us all, sometimes you have to look beyond insane headlines to find the reality about what is really going on in the banking industry.

BANK NEWS

M&A

First Federal Savings And Loan ($1.2B, OH) will purchase Century Bank ($135mm, OH) for an undisclosed sum. The combined bank will have 18 branches.

M&A

BancFirst ($4.6B, OK) will purchase Exchange Bancshares of Moore ($146mm, OK) for an undisclosed sum. This marks the 3rd deal for BancFirst this year.

Presidential Update

President Obama will make a 2pm ET announcement that will include $50B of infrastructure spending, expand and make permanent the R&D business tax credit, allow accelerated depreciation on plant and equipment and extend the tax rates for all but the wealthiest households. No matter what he says, traction in Congress will be limited before the Nov. 2 election.

Shorter Mortgages

Through June, CoreLogic reports 26% of homeowners who refinanced chose a 15Y fixed-rate mortgage, compared to 18.5% during all of 2009 Ã¢Â€" on a percentage change basis, this equates to nearly a 41% jump.

Retail Stress

Analysis by property research firm REIS finds retail vacancies are at 10.9%, just below the 11% hit in 1991.