CHANGE IS INEVITABLE

by Steve Brown

Did you know the top tax rate has changed 33 times since federal income taxes began in 1913? While bankers hopefully won't have to deal with 33 changes to their business model this year (given Dodd Frank, regulatory pressures, etc.), the industry is already seeing material shifts. Take commercial and industrial (C&I) loan volumes for example. They have been expanding over the past 4 months and the largest banks are showing signs they wish to remain significant players in this sector. The common explanation for this is that larger borrowers have more loan demand right now than smaller borrowers, so the large banks are seeing more deals than community banks. While this may be the case, another important element is that larger banks also seem to be ramping up the competition.

Indeed, Fed Statistical Release E.2 seems to show larger banks are indeed targeting smaller borrowers. For the latest survey period (Nov. 2010), the average C&I loan size for large banks (defined as $3.3B in assets or larger) was $447,000, which is a 49% decrease over a 10Y period. The data seems to indicate that larger banks are targeting community bank customers.

This could be occurring for a number of strategic reasons. Some of them include: 1) larger banks are seeking to expand small business lending to capture larger deposits and expand cross-selling opportunities; 2) larger banks recognize smaller customers tend to concentrate their relationship, so if you can break it loose, you can capture the lion share of the business; 3) larger banks are expecting rates to rise down the road, so are focused on capturing customers that typically have floating rate loans; and 4) the pool of borrowers that qualify for a business loan has decreased, however, the pool of loans that qualify for a commercial real estate (CRE) loan has decreased even more. Credit quality remains of paramount importance to banks and the C&I sector is seen currently as a better credit alternative to CRE.

Every banker knows that cross-sell opportunities are valuable and C&I customers can d-liver DDA deposit balances, trust services and fee revenue. In addition, as the economy recovers, smaller C&I loans will grow as the business grows, delivering further potential cross-selling opportunities for banks.

At this point, the market anticipates that rates could begin to rise in late 2011, so banks are beginning to position their balance sheets for that. Today's steep yield curve is also a reflection of this expectation. The key at this point is not to become complacent by the term structure of interest rates. What we mean by that is while a 5Y CRE loan priced at a 6.00% fixed rate may look good, it is really the equivalent of a Prime + 0.50% floater over that term. Interest rate risk is just around the corner, if the tea leaves are right and ignoring this could hurt future bank performance. If your bank prefers to do CRE over C&I due to greater in-house expertise, it is important to keep in mind the current NIM for the fixed rate structure may be higher right now (in CRE vs. C&I) but it does not compensate the bank for the risk.

The CRE sector is currently under stress, while the average probability of default on C&I loans is lower. In fact, some quick analysis finds the average community bank's probability of default on C&I loans (across the country) has recently averaged 4.80% per annum, while retail real estate is almost 80bps higher. In short, the differential in pricing to compensate a bank for the added risk (to make the bank indifferent) is somewhere between 50bp and 150bps in spread (depending on loan size, cost of funding, acquisition costs and other variables). Again, this assumes the CRE market does not revert back to the mean over time, but the point remains - the C&I sector right now is generally less risky than CRE.

The industry is changing and community banks continue to face strong competition, while finding quality customers to lend to remains next to impossible. If you are seeking a simple way to diversify some portion of the portfolio into C&I, we can help. It won't solve all of your problems, but this can be a nice place to put some funding to work, as you wait for the CRE sector to return to better times. Contact us if you would like to see a pipeline of C&I loans available for sale to community banks.

M&A

Susquehanna Bancorp ($14B, PA) has agreed to buy Abington Bancorp ($1.2B, PA) in an all-stock transaction for about $273mm, or 1.55x book value.

BANK NEWS

Say-On-Pay

The SEC approved the executive compensation guidance as mandated by Dodd-Frank. Additional disclosures on golden parachutes are now required as well as large public banks (float of $75mm or more) will now have to take a say-on-pay vote once every 3Ys starting this year. Smaller public banks will have to do the same starting in 2013.

Social Media

Research finds about 50% of people are now members of at least one social network and that this group spends 1.5x more time online than the typical internet surfer.

Muni Fears

A survey by Investment News finds 77% of those surveyed think the municipal bond market will crash this year.

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