M&A FOR COMMUNITY BANKS

by Steve Brown

We hear lots of rumbling and get plenty of questions about the landscape for community bank mergers & acquisitions. Given that as of the 2Q, there were still significant strains on the industry and there were 7,513 insured financial institutions in the US, talk like that is expected. As a matter of fact, community banks by number still dominate, as 2,550 have assets <$100mm and 4,296 have assets from $100mm to $1B. That is a total count of 6,846 or about 91% of the total outstanding number of banks. Given the count and industry stress, merger discussion is expected.

We start with a focus on the 2,550 community banks with assets below $100mm. This group back in 1990 represented 70% of the industry (in number), however it has continually declined every decade following to 55% in 2000 and 34% in 2010. Extrapolating this pace means that by 2020, this group will only represent about 15% or so of the banking industry. Since prognosticators are everywhere and they like to be heard, expect to hear more M&A noise around this group's business model for some time to come. This does not mean, however, that history is a predictor of the future, nor that this is definitely going to happen. There simply is no "magic" asset size to achieve, since assets don't equal longer-term profitability. That said, having a strong plan is more critical, so if your bank is in this group, focus efforts on making sure you don't ignore that piece.

One problem all community banks are facing (and larger ones as well for that matter) relates to the negative impact on the business model from the slew of new regulatory requirements and regulations. These range from requiring more capital and liquidity during a down market with low loan opportunity; to Dodd Frank and Basel III (which have yet to be felt in full force). Given a weak 1% GDP rate, loan growth is difficult to find, so it isn't surprising US banks in 2010 delivered just a 7% ROE on average. Even more worrisome, some 90% of profit improvement over the past few quarters has been directly tied to a reduction in loan loss provisions. That just can't be sustained over the longer term, so banks are scrambling to find something that works. On the M&A front, these pressures will push some banks to seek out partners and exit the business, while others will just struggle along until economic recovery appears and pricing improves.

One area of good news relates to loan quality, which has been stabilizing. While the loan portfolio of most banks is still in the early stages of recovery, more solid footing can be seen. This will help more acquisitive banks get comfortable about what they are buying and what loan losses to expect. That is good in theory, but the offset is that bank stock prices remain depressed, so the currency banks would use to buy doesn't have much punch. These issues will eventually work through the system, but in the meantime, we expect the hottest area to be book-to-book deals between community banks in localized markets.

Speaking of changes, things are different when you review the largest banks around the world. Here in the US, the largest banks now have $1T-sized balance sheets, so buying a smaller community bank doesn't make a dent. That, plus increased regulation due to size makes the top 25 banks much less interested in expanding down-market right now. Foreign banks have another dilemma. Expected losses from Greek exposures, pressure in the Eurozone and higher capital requirements mean these banks will not be doing much buying either.

Community banking is undergoing significant change right now and acquisitions will be part of that process, but we are not expecting thousands of banks to be absorbed in the next few years. There are simply too many things in play right now and complexity always slows things. M&A will increase, but it will probably focus on management teams of stronger banks seeking to expand franchises, grow balance sheets, deploy capital and increase earnings. As this process slowly unfolds, we look for intermittent and more regionalized M&A activity, as the industry slowly improves over the next few years.

BANK NEWS

M&A

Mt. Washington S&L ($79mm, OH) will acquire Cottage Saving Bank ($41mm, OH) for $8.9mm in cash, or 1.25x book.

FDIC

Chairman Marty Gruenberg announced the plans to hold regional roundtables and a main conference next year to better understand the future of community banking. At the conference the FDIC will release research that it is working on detailing the evolution of community banking and how changes in the business model and cost structure will likely have to change going forward. In addition, Gruenberg is looking to make the regulatory process more "efficient" and will study how community banks will manage technology, risk management and regulatory obligations going forward.

The Obama Plan:

In his $3T deficit reduction proposal, the President kept in the long rumored "financial crisis responsibility fee" which is an additional tax on banks that took TARP and that are $50B or more.

Fannie/Freddie

In an update, Edward DeMarco, Acting Director of the FHFA, alludes to the fact that guarantee fees will likely shift (lower 15Y production fees, higher 30Y fees), more origination will move into private channels and the 125% LTV limit on HARP will likely be raised. The most important thing that the speech clarified is that the FHFA is not thinking about a mass refinancing under HARP.

Mobile Payments

Google reached an agreement yesterday with Visa for the company to participate in "Google Wallet". In addition, Sprint and Google announced the rollout of Google Wallet to all Nexus S 4G (a new phone) customers.