ANALYSIS AROUND PRODUCING RESULTS

by Steve Brown

In a strange series of events, police in Santa Fe, NM were recently called out to an alarm at a bank in town. When they arrived on the scene, they found a broken window (the bank was undergoing construction), so they went in to investigate. There, they found a man asleep on the floor behind a desk. They roused the man and asked him what he was doing inside the bank. The weird part is that the man reportedly told police that while he couldn't recall breaking into the bank, he did remember smoking marijuana and drinking heavily that day. These probably weren't quite the results he was expecting from his night out on the town. Speaking of results, we were intrigued by a recent review of community banks by credit rating agency Fitch. The review focused on bank with assets below $10B that operate in a limited number of markets and act as a traditional lender. The findings were interesting to us because they surfaced areas where community bankers well below that $10B threshold are facing challenges and a few opportunities where an edge may exist vs. the largest banks. On the challenge front, the report began by highlighting some of the basic concerns for community banks. These included more sensitivity to economic conditions, operations within a smaller geographic footprint, earnings that are more reliant on spread revenue and limited fee income opportunities. While these are not new to community bankers, they were noted as primary issues facing this group of banks. Drilling further, the report next surfaced other challenges many community banks are facing including a weak economy, a prolonged low rate environment and increased regulatory costs. The takeaway here was that community banks will have to improve compliance and risk management functions to meet new regulations, but doing so will reduce earning performance by increasing costs. Unfortunately, regulatory requirements are not disappearing, so banks have little choice but to spend the money. The final set of challenges surfaced in the report for community banks revolved around weak loan demand and extremely high levels of liquidity. The report pointed out that these conditions have led to high competition, limited lending opportunities and higher prepayments/payoffs than expected. Given investment options in the market have yields that are below the cost of operations for many banks, this is adding more stress. These factors are pushing many banks to reach for yield, extend duration or go into new lending areas in an effort to boost spread income. The takeaway here is that while all of these options may be within limits, bankers will need to be sure they have reviewed the risk of doing each one, have strong procedures and brush up policies as may be needed. As the report points out above, many challenges remain for community banks right now, but such an environment can also produce opportunities. Here, the report pointed out key strengths of community banks it analyzed, pointing to a strong funding profile (mostly based on core customers that are both sticky and stable); a strong business position (within each bank's respective footprint); the simplicity of the balance sheet (easy for investors to value, lower earnings volatility and simpler for a bank to manage risk). These positives bode well for community banks, despite the current stresses and also reflect a nimble and customer centric approach to doing business. The next few years won't be the easiest ones in your career, but as the report shows, community bank challenges are offset by strengths. In this environment, having a plan, executing, tinkering with new things to stay innovative and holding the line on costs are some key ways community banks are producing strong results.

BANK NEWS

M&A

MVB Financial ($613mm, VA) will buy Potomac Mortgage Group (VA) for $19mm in cash and stock, as it seeks to expand further into mortgage production. MVB is the parent company of MVB Bank.

M&A

Equifax will buy CSC Credit Services for $1B in cash. CSC is a unit of Computer Sciences Corp and provides credit services to companies that include banks; mortgage originators; medical services; utilities; retail; automotive and others.

TAG Extension

Yesterday, the ICBA and ABA joined forces in urging Senate Banking Leaders to support a temporary 2Y extension unlimited insurance on noninterest bearing accounts.

Reg E

The CFPB will issue a proposal for comment this month on its international consumer remittance rule. Changes will refine elements related to incorrect account number supplied by the sender and the disclosure of foreign taxes and third party fees. The CFPB expects to delay the original implementation date of February 7, 2013 to sometime during the spring of 2013.

No Supply

Research by JPMorgan finds that as the Fed purchases $45B of Treasuries and $40B of mortgages each month next year, it will effectively soak up 90% of all net new dollar denominated fixed income assets. That means banks will pay very high prices for these investments or will have to move to other sectors in 2013.

Longer Borrowing

The Financial Times is reporting that U.S. bank regulators are reportedly considering new rules that would force the industry to fund itself with more long-term debt to reduce risk and reduce reliance on short term funding.

Less Ownership

The home ownership rate has fallen from 66.1% in 3Q 2011 to 65.6% in 2Q 2012 and 65.3% in 3Q 2012.