Roe, Roa Swan Song

by Steve Brown

There are a number of positions associated with the British monarchy that remind us of simpler times. One such position in place since the 13th Century is the "Warden of the Swans." The warden even has an assistant called the "Marker of the Swans." Believe it or not, the monarchy so loves these majestic birds that the warden and marker conduct an annual census of swans on the Thames River. That's right, their job is to count and mark the Queen's swans. Some may think this is all nuts, but we beg to differ and think there is significant risk in this job. After all, the swans are a species called Mute Swans and while they may not speak up much, these 20 to 30 pound birds are known for their mean temperament, aggressive territorial instincts and large amounts of waste they deposit. Watch your step warden and protect the marker!

Other things that spring to mind in banking that seem to belong in the past and do not fit the present are the levels of ROE/ROA that were possible pre-crisis when banks were growing. Back then, interest rates were higher and banks could expect a strong ROE (15%) and ROA (1%) with growth from year to year. Of course, times have changed, the regulators have sounded their duck calls and the Fed has cut rates to extremely low levels to jump start the economy. Banks have been swept down river with all of these events and have seen earnings crumble. First, credit problems caused capital levels to dwindle and then bank management had the choice to shrink the bank by running off assets or go long at lower yields.

The economy is on the upswing now, but it is painfully slow and the competition for loans remains extreme. Now banks have lots of capital, but getting any return on it has been difficult. Loan portfolios are still shrinking in the aggregate for banks under $1B in assets, prepayments are still high and yields are much lower, so return is declining over time. As if that weren't enough, the yield on securities isn't even high enough to keep the doors open and the OTTI risk there is huge, so bankers are in a quandary. These factors have pushed NIM lower for banks than a year ago and this is not an easy scenario for growing earnings.

Another issue still comes with highly capitalized banks. Many of these raised capital from institutional investors or investment firms and the pressure is rising. Expectations for increasing revenue are high and not easily attained, yet exit strategies for some loom large in the coming years. Pressure to sell for some is rising, but in the end the data shows so far the M&A market is not that strong. Recent SNL analysis in fact shows M&A activity has decreased about 1% since 2012 and that year was viewed as a pullback year. M&A advisory fees too have declined some 15% YOY according to Thomson Reuters and Freeman Consulting. This is in spite of many elements being in place for robust M&A, as banks have excess cash on their balance sheets, interest rates are low and the slow economic improvement has made organic growth difficult. Issues abound, but recovering stock values for sellers, expectations for better future performance, waning credit risk, a shifting business model, low interest rates and other factors are all impediments to more M&A.

For 2014, community bankers can expect to see an increase in dividend payout rates and share buybacks, as banks seek to placate investors and enhance shareholder value. While either tactic may increase shareholder value in the short run, these are generally not things that create long term franchise value. Eventually, banks must pay for buybacks or dividends and most likely may do so by unwinding cash positions or other low yielding assets. That isn't bad, but the result is that banks will likely once again end up shrinking their balance sheets.

That takes us back to our original discussion around swans. While a smaller balance sheet may improve ROE/ROA, fixed costs remain and efficiency ratios are becoming more difficult to control. To improve this year, set your bank on the right path by not only counting the ROE/ROA swans, but also set a plan in place to work areas that can be controlled (like lowering funding costs and controlling expenses to increase net revenue). It's not the swan song for ROE/ROA just yet, but challenges remain.

BANK NEWS

M&A

Square 1 Bank ($2.2B, NC) will acquire accounts receivable financing company Sand Hill Finance (CA) for an undisclosed sum. Sand Hill provides financing to emerging growth companies.

Yields

In 2013, the 10Y Treasury yield increased from 1.75% to about 3.03% or roughly 73%. If that were to happen again in 2014, the 10Y yield would end up at about 5.25%. This is one reason regulators are so keenly focused on interest rate risk management this year, so be sure to stress test and discuss.

Volker Hit

Community Bank ($7.3B, NY) sold its portfolio of collateralized debt obligation (CDO) securities at year-end in order to comply with the Volker rule disallowing banks to hold such securities. In addition, Community extinguished $226.4mm in FHLB advances, sold $471.6mm in Treasury securities classified as HTM, took a $6.9mm pretax loss ($15.5mm loss on the CDO portfolio) and reinvested $246mm in proceeds back into Treasury securities. Meanwhile, The Fidelity Deposit and Discount Bank ($640mm, PA) also liquidated their pooled trust preferred securities portfolio, taking a gain of $2.9mm. Finally, Zions Bank took a $387mm charge on its portfolio.

More Volker

Regulators are looking at the unintended consequences of forcing banks to divest trust preferred CDOs and say they will address the issue by Jan. 15. If regulators hold their ground, all banks will have to divest ownership in the CDOs by July 21, 2015 & most will likely need to write them off.