Weathering the credit market storms
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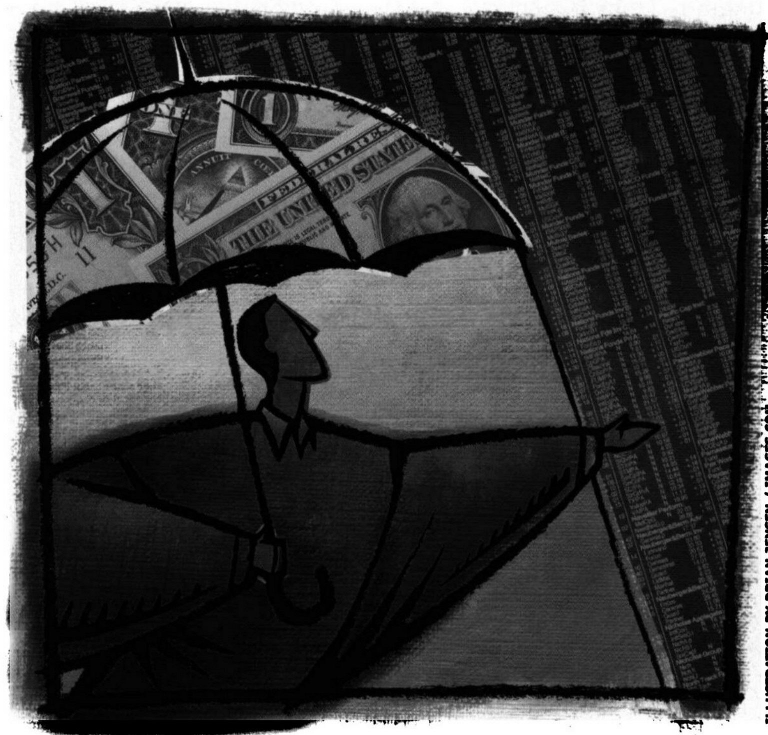
Weathering the credit market storms

A down credit cycle combined with new credit impairment accounting rules bring both challenges and opportunities



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With volatility in the credit markets creating severe whiplash, and investors flocking to the safety of U.S. Treasuries, many community bankers are in an excellent position to benefit from the chaos and from the problems facing larger institutions. As leaders in the community, local banks also need to act as responsible communicators to assure their shareholders, customers, employees, and even those not associated with the bank, that the bank was not engaged in toxic subprime lending and that the underlying financial structure remains sound and rock solid.

Unlike the Wall Street elite, most community banks have refrained from risky lending practices, and have avoided the temptation to pursue huge investment yields with difficult-to-assess risk. As a result, some community banks are better able to weather the storms associated with a downturn in the credit cycle.

In this article we present thoughts on handling the current environment in terms of communications, lending, deposit gathering, and the investment portfolio.

By Michelle Gula, president; Jamie Sumner, director of analytics; and Jay Brew, chief strategist, m.rae resources, inc., Bethlehem, Pa. www.mraeresources.com

Reputations on the line for all

Some commentators have spoken as if there were two tiers of banking, one that now has problems and the other, community banking, that doesn't. We don't believe that the impact of the current credit crisis and liquidity squeeze is going to be limited to money center banks and investment houses. We see the current turmoil as just the beginning of a situation that will affect community banks. In fact, there are already signs that community banks are seeing the beginnings of the "credit cycle." A credit cycle is defined, in part, as when nonperforming loans rise above normal averages and increase institutions' risks for large write-off's.

Our research shows that, on a national basis, nonperforming loans have been rapidly increasing. The current level of nonperforming credits matches the high seen in 2001, when the economy was at its lowest point. This is troublesome. If the U.S. economy is currently sound, why are nonperforming loans ris-

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ing so rapidly? Normally, you would see this rise as an economy slows.

The credit risk repricing that has been occurring since late July signals that the credit cycle is on the move. The previous major credit cycle repricing occurred in 1994.

How deep, widespread, and long the credit turmoil will go depends on how quickly and accurately financial entities admit to having impaired credit. The accounting firms hold a key to that, because they will be the agents who will question which assets are impaired and which are not. We have never experienced a credit cycle with impairment accounting guidelines.

Experienced veterans know that the credit cycle brings dangers, but also opportunities. Just make sure your seat belts are firmly buckled for the roller coaster ride.

Tell your bank's story now

Community banks that have avoided risky loans are not immune from the fallout of the sagging housing market and the upheavals in the credit markets. Investors and customers hear and read about shuttered mortgage firms and wonder about their mortgage and about customers with top credit scores being denied mortgages. They know small and large firms have gone under or are teetering on the brink. Some customers wonder if the money market funds sold by their bank are backed by lots of investments that have gone sour.

There is a growing murmur rising out of communities where our clients do business. Those murmurs are pointing to mounting reputation problems for community banks. In boardrooms and behind closed doors, many community bankers are saying that they did not write toxic subprime loans. Indeed, many are appalled by the fact that anyone would think they did. Outside of those closed doors, however, the public does not know the difference between the guilty and the innocent. We look at this as a risk to a bank's trust with the communities they serve. Unfortunately, the word "bank" is used so loosely that many people feel all banks were writing subprime.

"Market turmoil presents an opportunity for banks that have the treasured liquidity that some larger institutions now lack"

Community bankers need to correct that misperception. They need to communicate the truth as quickly as possible to their shareholders, their employees, their customers, and the local media. Here are three specific steps:

1. Conference calls or face-to-face meetings with some of the bank's largest shareholders might be very appropriate.

2. Community bankers need to assure everyone in the community that they are ready to help people with their financial situations. This can be done in the form of a press release or advertisement. One of our clients suggested that this could be done as a joint statement with other community banks in the market.

3. The same information should also be communicated internally so that all of your employees can speak of the bank with the highest level of confidence.

Written messages to all constituents should contain clear and simple sentences. Community bankers should avoid financial jargon and obfuscating messages that might suggest bankers are trying to hide behind words. Absolutely avoid spinning a bad situation as a positive development. People have had so much experience with political spin that they readily recognize it from other quarters.

Now, what if your community bank isn't exempt from the current troubles? Banks with subprime problems also need to present the unvarnished facts to shareholders and beyond. A decline in credit quality can create impairment problems that go right to earnings.

Get out the bad news, so that the bank can concentrate on putting its portfolio in order. Moreover, if the bank can disseminate the bad news ahead of the media, the bank will have greater control over the message and will have more time to put a plan into place to answer questions.

Overall, community bankers should cover a number of points in their communications, among them:

- The bank's situation;
- The bank's plan to fix any problems or to steer clear of the problems that plague other banks and financial institutions;
- Growth measures the bank plans to take that are appropriate for the environment.

It is *imperative* that you have legal

Today's "perfect storm," just the beginning?

For most of 2006 and into 2007, the majority of community banks have had to struggle to maintain levels of profitability, says George Darling, CEO of Darling Consulting Group, Newburyport, Mass.

Most community banks depend on net interest income for between 75% to 90% of total revenue, he says, and the combination of financial markets and the competitive environment have created the "perfect storm" for entities dependent on net interest income. The flat yield curve, the commoditization of banking products, intense pricing pressures, and narrowed credit spreads, says Darling, have put pressures on levels of liquidity, asset yields, funding costs, and increased interest rate risk for most community banking organizations.

Some banks have elected to sell. For the rest, what might the future look like?

In an article in our digital edition (go to *www.ababj.com* and click on the link), Darling describes in more detail what industry conditions will prevail if current trends continue. He also presents seven steps banks should consider in order to succeed in the current and likely future environments.

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counsel review any communication.

Review loan portfolio and strategy

Before a bank puts out a message to the community, it should take a meticulous inventory of its balance sheet, including a thorough review of its loan portfolio for overall credit risk. In some cases, it may be prudent for a bank to slice back the loan-to-deposit ratio with the riskiest assets in order to reduce the bank's overall credit risk.

On the other hand, the turmoil in the markets presents an opportunity for community banks that have the treasured liquidity that some larger institutions now lack. They may be able to make better-quality loans, and while banks may make fewer loans during this section of the credit cycle, the spreads between the cost of funds and interest-bearing assets tend to widen.

In short, banks will have a greater ability to price loans based on the associated risk. In addition to charging higher interest rates on loans, banks can demand more collateral. In some cases, of course, they may have to refuse to lend to marginal customers.

Go after money market accounts

Now is also a critical time to throw the spotlight on the bank's deposit programs. Your customers are looking for a path to quality for their funds. There has been a loss of trust in brokerage houses and investment products.

Once again, the community banking industry should look to be the provider of a safe haven for those funds. The key to remember is that the local community bank is considered a leader. People are confused. Some are losing, or fear losing, their homes. Some are taking losses on investments. This is your opportunity to make many people feel safe.

Community banks should advertise heavily to attract money market accounts. These money market accounts will reprice as rates change, but the banks will have grabbed hold of deposits and loans while Wall Street is still digging out of the credit market muck.

Bad news: a cleanup opportunity

Community banks that get hit with loan losses should consider cleaning up other aspects of the investment portfolio in 2007 in order to start 2008 in better shape. The reasoning here is that if the bank is going to have a bad year, it might as well be a very bad year. Most shareholders view a 20% drop in earnings to be as bad as a 10% drop. If earnings are down, they are down, so make it an opportunity. ***BJ***

Snapshot

Trends in branch deals

Branch deal activity has slowed significantly in 2007 with 36 deals announced as of Sept. 4, 2007. To put the decline in perspective, in 2006 the industry saw 104 deals, in 2005 there were 86, and in 2004 there were 112. The all time high over the last 20 years was 246 in the M&A heyday of 1997. Deal activity hasn't been this low since the late 1980s. But with margins pinched and the operating environment stressed it makes sense that more banks are placing efficiency before expansion, and taking a close look at their current networks.

A more detailed look (see chart) shows that on a state level, year-to-date 2007, California was the most expensive to do a branch acquisition. The average franchise premium/deposits ratio was 13% on one deal between Capital Corp. of the West and Zions Bancorp, in which their County Bank and National Bank of Arizona units traded 11 branches. Earlier in the year Zions trimmed three Las Vegas-based in-store branches from its network in a deal between its Nevada State Bank and Amalgamated Bank.

New York led the nation in terms of the number of branches changing hands at 20. New York Community Bancorp's 11-branch deal with Doral Financial Corp. comprised the bulk of that. The other branches were sold by First Niagara Financial Corp. to Elmira Savings Bank (four) and Legacy Bancorp (five).

Illinois saw 13 branches change hands in three deals, with an average premium to deposits of 11.35%. The largest of the deals, in terms of number of branches, was Hometown Community Bancorp unit Morton Community Bank's acquisition of seven Associated Banc-Corp branches.

The leader in terms of number of deals was Wisconsin where Associated Banc-Corp sold nine branches in three deals, which along with the deal in Illinois, made Associated the most prolific branch seller of the year. In a move that perhaps characterizes the mood of the time, Associated said it sold the branches to redeploy capital and resources to its core markets.

—John McCune, SNL Financial
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10 most expensive states for bank branch deals
Year-to-date 2007

Target branch states	Number of branches	Number of deals	Aggregate deposits ($000)	Average franchise premium/deposits (%)
CA	11	1	209,000	13.00
IL	13	3	280,000	11.35
NY	20	3	546,500	10.28
MT	1	1	30,200	8.61
OH	2	2	48,166	8.52
MD	1	1	52,000	8.50
IA	4	2	40,930	8.26
PA	3	2	24,769	7.50
KS	2	1	38,813	6.44
WI	12	6	147,120	6.35
All states	98	36	2,030,461	7.99

Source: SNL Financial; Data as of Sept. 4, 2007

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