

Bauerle's Bank Notes

June 21, 2010

Raising Capital

In early May two years ago, we co-hosted a three day program in Denver for bank clients. One of our featured speakers was an OCC executive who had just attended the agency's spring planning conference. Six weeks earlier JP Morgan had gobbled Bear Stearns and the subprime mess was upon us; but the crisis appeared to be easing as no other failures followed and bank financial performance metrics ticked higher in Q1 2008 when compared to the last two quarters of 2007.

The OCC exec began his presentation, "You all ask me, are the events of March the end, or just the beginning? They are just the beginning. Three hundred banks will fail. Many of the home loan banks exhibit stress. Capital problems will be surpassed by liquidity problems. You need to prepare for the worst." During the accompanying slide show that proved these points, a community banker from Tennessee asked, "Aren't the problems confined to the big institutions?" In an instant, the OCC speaker shot back, "No. And remember, they have sovereign wealth funds coming to their rescue. Who is going to rescue you?" Silence. When questions and answers resumed after a coffee break, the OCC executive quipped, "I went to the men's room at the break and it was filled to capacity. I guess I scared the p-s out of you." He did.

Two years later, the FDIC's official tally of bank failures stands at 251 since 2007. Insolvencies exceed 300 when "merge or fail" bank acquisitions are included. Losses to the Deposit Insurance Fund now total \$70 billion. Another approximately 800 banks received temporary capital under the Emergency Economic Stabilization Act of 2008. Without the lifeline thrown by the U.S. Treasury, many of them would have been in "troubled condition" and legally required to raise additional capital at a time when the capital markets were closed to banks. More forced mergers and outright failures were thus avoided.

As Congress hurries to complete its overhaul of the federal regulatory scheme governing banks and other financial services companies before the July 4 recess, the storm appears to have passed. FDIC data for the first quarter show banks' average return on assets reached 0.54% (0.78% pre-tax), a level not attained since Q3 2007 (with the exception of Q1 2008). Average return on equity has also rebounded, hitting 4.36% in Q1 2010 compared to -0.36% in Q4 2009. This ratio too is at its highest level since Q3 of 2007 (again excepting Q1 2008). The percentage of institutions reporting year over year earnings growth (52.2%) is greater than at any time since Q3 2006 (53.9%). Average net interest margin (3.83%) is at a level last seen in Q4 2002, when the previous recession was at its end.

Even with this good news, the fragility of the nascent recovery is evident in the ratio of accounting reserves taken for potential future loan losses to net operating income. At 30.3% in Q1 2010, this measure is down from 51.7% in Q4 2008 (an historic high), but remains at a level experienced only once in the last 25 years, in 1989-90 at the height of the financial crisis that followed the 1980's leveraged buyout boom and the insolvency of the thrift industry. Similarly, net loan charge-offs as a percentage of loans and leases were 2.84% in Q1 2010, down from 2.93% in Q4 2009, but still a 25 year high. The previous record was 1.89% in Q4 1989.

If there is a silver lining in the statistical measures of the recent banking crisis, it is most banks' relatively strong capital positions. The crisis 20 years ago prompted Congress to enact a "prompt corrective action" regime, which set required capital levels significantly higher than they had been and required regulators to compel banks to raise more capital or close their doors if their capital fell below minimum capital requirements and stayed there. This legislative reform has worked, even if not always as well as its authors intended. Thus, while the ratio of noncurrent loans and leases to Tier 1 capital plus loan loss reserves reached a recessionary high of 29.6% in Q1 2010, the ratio remains well below the ratio for the entire period 1984-1991. As the financial crisis of the late 1980's unfolded, the ratio reached 47.8% in 1987 among all institutions and 61.2% among banks having more than \$10 billion in assets.

The benefits in the recent crisis of the higher capital requirements mandated in 1989 have not been lost on legislators or regulators. Most observers expect still higher minimum levels of capital to be prescribed, first under international capital standards applicable to the largest banks and later under federal standards that apply to all banks. Also expected to be phased in over the next few years is a rule that eliminates trust preferred securities from being included in Tier 1 capital.

For community bankers especially, it is tempting to view higher capital requirements as somebody else's problem, since their banks have historically maintained higher levels of capital than large banks. For example, in Q1, the average Tier 1 capital ratio among the smallest community banks was 17.57% vs. 11.62% for >\$10 billion banks, and the average small community bank total risk based capital ratio was 18.67% vs. 14.66% for >\$10 billion banks. National averages, however, mask wide disparities in regional and local experience. The average total capital ratio among 15 Jacksonville, Florida community banks was only 7.25% at March 31. "The regulators are going to require damn near every bank in the state of Florida to raise capital," said a Jacksonville banking analyst. [1] Closer to home, of the 32 banks located in Ohio, Michigan, Indiana and Illinois that received more than \$25 million in preferred stock investments by the U.S. Treasury, only four have redeemed the government's investment. Bank stocks being out of favor on Wall Street is certainly part of the reason. Another factor is the long-overdue restructuring of the automotive industry on which those states' economy is so dependent.

The easing of the recent crisis is opportunity for action. Raising additional equity capital should be high on the agenda for most community and regional banks. Conversations with directors and executives yield a dozen excuses why "our bank is different" and "we have plenty of capital." None of them hold water, however. As a veteran of capital raising transactions, I well understand the discomfort that accompanies going to market for capital. The prospect of being rejected is daunting. But a thoughtfully constructed strategy and a realistic plan to implement it can improve the odds of success dramatically. The end of the crisis is an inflection point no less than the crisis itself was. The strong will prosper by recognizing and embracing the opportunity. The rest will continue their slow march to oblivion.

[1] <http://jacksonville.com/business/2010-05-20/story/bad-loans-mean-banks-need-raise-more-capital>.