E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
DATE: March 31, 2011
SUBJECT: Can Community Banks Raise Capital?

Recently we participated as a panelist for SNL's 2011 U.S. Banking Industry Outlook (replay link: http://w.on24.com/r.htm?e=294355&s=1&k=C6AE0ABA7BB28E463E76E83256C1A183). On the face of it, the outlook projected by the panel seemed dour. With all the incumbent costs and risks, the regulatory wall seemed impossible to climb without a Mount Everest assault team. The task seems daunting, maybe impossible, for community banks with assets of less than $200 million or $500 million or $1 billion or . . . take your pick on asset size. The fact is no one knows for sure what the cost will be for community banks. No one knows for certain how those limited parts of the Dodd-Frank Act designed for community banks (the Act defines them as banks with less than $10 billion in assets) will actually impact community banks.

For community banks there will be few if any additional surprises. For those pieces of the legislation that will impact community banks, IT vendors will impose order on the confusion created by the legislation and rule-making and develop software routines to deal with the rules. Those rules not so easily dealt with can be absorbed by existing third party vendors of compliance review services.

We realize this sounds rather glib. It isn't intended to be. But it does reflect living through five decades of commercial bank regulatory changes, providing solutions for those changes and moving on to providing shareholders with the return they expect. We cannot emphasize this enough: well-managed community banks are highly flexible companies and have repeatedly proven their long-term ability to adapt to regulatory changes. In fact, given the heavily regulated nature of the industry, efficiently and skillfully navigating regulatory change is a stock-in-trade of any good manager.

This is a side to the story that goes unreported and, thus, a pall continues to hang over community banks. The efforts of our industry associations to blunt the impact of Dodd-Frank, the Durbin Amendment (currently being heatedly challenged), and Elizabeth Warren's Consumer Financial Protection Bureau are taking up all their time and efforts. But that means community banks need to be on the investor relations offensive, making the case that additional regulation is a pain but that any costs can be recovered through fees and more aggressive loan and deposit pricing.

The point is that the misperception of just one factor—regulation—weighs on community banks and has a negative impact on bank valuations and the ability to raise capital at attractive prices. This was borne out by our fellow panelist last week, Emmett Daly of Sandler O'Neill. In his presentation we learned that 72% of the largest 25 banks have redeemed TARP. In fact, according Sandler O'Neill, 17 of the 19 so-called SCAP banks undertook offerings since 2009 raising almost $79 billion—much of which was defensive capital, used to replace TARP. Sixty percent of those banks between $5 billion in assets and $25 billion in assets have redeemed TARP. Only 15% of all banks with less than $5 billion in assets have succeeded in redeeming TARP. Why this wide disparity? Community banks aren't any more enamored of the government as an investor than their larger brethren. But having navigated the second stress test successfully, the blessed 19 largest banks will continue to benefit from the too-big-to-fail aura, further enhancing their ability to raise capital. Furthermore, after the most recent round of stress tests, the largest banks were quick to announce dividend increases and share buybacks which have the effect of trumpeting their capital positions.

As we noted last month, the capital needs created by credit write-downs and the need to repay TARP are formidable for community banks. Exacerbating that, community banks have not benefited from the capital raising spree that has occurred among the larger banks. Failing banks and the smallest of community banks will obviously be either shut out of the process or find limited opportunities to raise local money. But for well-positioned community banks, capital will become easier to raise. Turnaround banks (where new management has mapped out a path to cleaned up loan and securities portfolios) and aggressive banks (those needing capital for acquisitions and organic growth) will increasingly have little difficulty finding capital.

Community banks *can* raise capital. Where the asset quality track record is acceptable and the bank has a history of performing profitably, going back to existing shareholders has produced results at or in excess of expectations for many banks. Such a capital raise will require careful planning. Bankers reading this should consider three things they can do now to prepare for a capital raise:

1. Completely scrub the loan portfolio using an independent third party.
2. Completely scrub the investment portfolio.
3. Develop a creditable strategic capital plan describing the strategy the bank intends to pursue, how capital needs and options affect that strategy, and how that strategy will improve shareholder value.

The rest is investment banking. Doing the requisite homework up front, however, will put well-managed community banks in good stead with capital sources. But without committing the elbow grease to address credit issues as well as strategy and capital planning, investors will be hard, if not impossible, to come by.

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