E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: May 28, 2010
SUBJECT: Regulatory Headwinds and the Value of Community Banks

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Of all the things you might imagine banking regulators and Washington would be doing right now, helping stabilize the banking system and encouraging capital investment would probably be at the top of the list. Policies tailored to achieve these ends would be well-received by both the banking industry and the market. More importantly, the end result would energize the economy with greater credit availability.

Wishful thinking. Just as the economy is beginning to recover from one of the worst recessions in history and the banking industry is showing signs of life, regulators and legislators are throwing up obstacles. The examples are myriad, so we focus on just two: the new proposed rule from the Financial Accounting Standards Board (FASB) on fair value accounting for loans and the Collins Amendment. Aside from our regular complaint that bank overseers don't get it, we also highlight what these recent developments say about the market for community bank stocks.

The growth of our economy and the health of our banking system depend on rules that do not discourage both.

Proposed FASB Rule
On bank balance sheets, loans are booked at the adjusted original cost. FASB proposes to change this so loans are booked at "fair value"—the accounting term of art for the market price of an asset, in this case the loan. We've been over this before (see our August 2009 E-memo on the subject: http://www.fortresspartners.com/pdf/0809Ememo.pdf), so we'll limit ourselves to a brief summary of why this makes so little sense.

When banks lend money they are essentially investing in an income producing instrument. The real value of a loan (setting aside accounting rules for the moment) rests on the ability of the borrower to repay the loan with interest. This ability, in turn, is based on the borrower's financial health, cash flow and the value of the collateral, when required. Where the ability to repay with interest is in question, banks will "write down" loans and will add to their loan loss reserves to cover potential losses. That is, banks already account for impairments to the value of the asset. Banks also provide fair values in their audited financial statements. Look at any bank 10-K and you will find a note to the financial statements that compares the carrying value of the bank's assets to their fair value. In short, banks already report changes in value to their loans through write-downs, provisioning for loan losses, and notes regarding the fair value of their assets.

The fair value disclosure works fine where it is—in a *note* to the financial statements. However, if fair value is the new standard for reporting, it will increase volatility on the balance sheet and affect the bank's capital levels. As the market values of certain assets go up and down, so goes the bank's balance sheet and equity. In response to increasing market values, banks will relax credit; as market values decrease, banks will tighten credit. In other words, as bubbles grow, banks will become agents to stir the froth. When asset prices fall in the market, banks will restrict the availability of credit and drive prices further down.

FASB's chairman, Robert Herz, says that "[f]rom a balance-sheet perspective, a lot of people want to see what things are actually worth now." They already get to! The proposed rule is redundant, harmful, and anti-growth.

Collins Amendment

The Senate's bill to reform regulation of the financial services industry contains the so-called Collins Amendment (after Senator Susan Collins of Maine). The Collins Amendment highlights one of the major themes of regulation over the last several years: the law of unintended consequences.

The goal of the Collins Amendment is to ensure that the capital of a bank holding company (BHC) be of the same quality as the capital of the BHC's subsidiary bank. As it currently stands, BHCs are permitted to issue preferred securities through a trust (known, predictably, as trust preferred securities or TruPS). For tax purposes, TruPS are treated as debt; for purposes of the all-important Tier 1 capital ratio, TruPS are treated as equity. (This is a simplistic but mostly accurate description.) This very favorable treatment encouraged banks across the industry—from the largest to some of the smallest—to issue TruPS to increase their capital. The Collins Amendment strips this ability away. If implemented as it's written, BHCs will take an immediate hit to capital.

Not that Sen. Collins knew this would happen. She told *American Banker*, "There's some technical issues now that it's been adopted. It would have been more helpful if it would have been raised beforehand. We're working through those." Yes, technical issues. Like depleting up to 25% of a BHC's capital. As one of our colleagues in the industry dryly noted, "These are the people making important policy decisions."

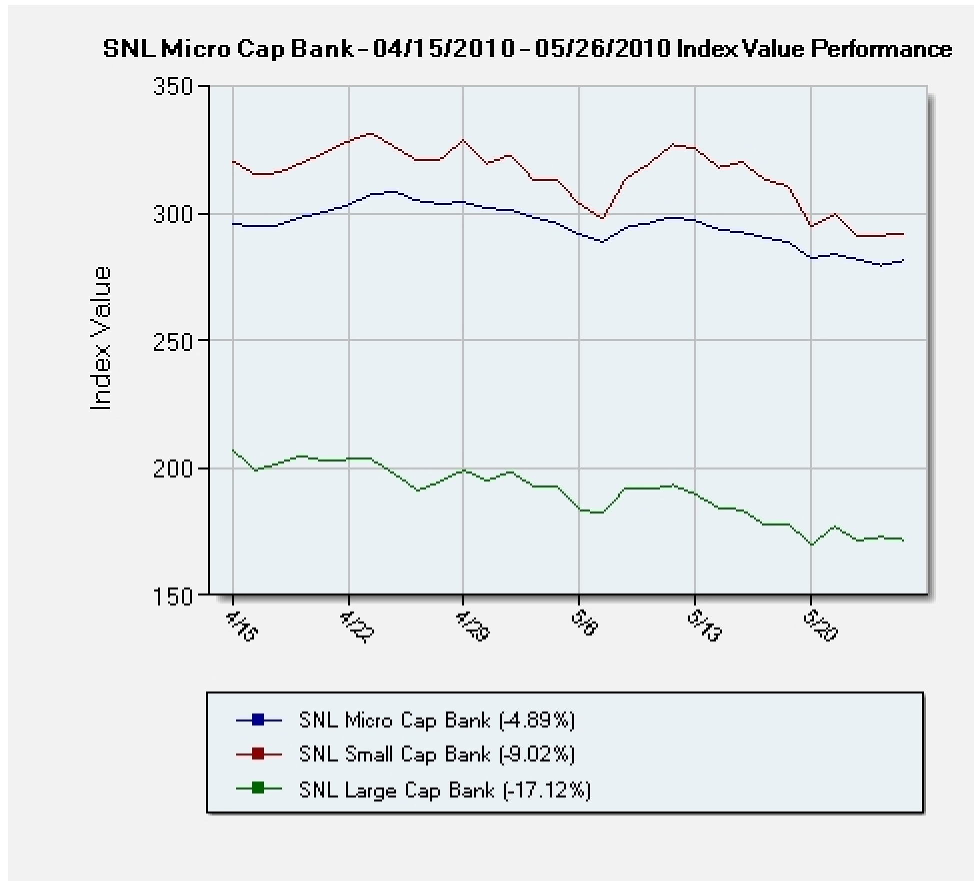
According to the American Banker's Association, the amendment "will eliminate $129 billion in capital, supporting $1.3 trillion in assets, from the banking system." And, like nearly every other action taken by the federal government over the last few years, community banks will feel the brunt. While larger banks have spent the last year issuing capital to a market enamored with their safety (see also, too-big-to-fail), smaller banks have struggled to raise even small amounts. The capital positions of larger banks have greatly improved alongside the government's willingness to support them so they can now absorb the loss of TruPS capital much more easily than community banks.

Fortunately, the response to Sen. Collins's amendment has been swift and forceful. Most of those with knowledge of Washington do not expect it to pass in its current form, if at all, but that remains to be seen. We are cautiously hopeful, but it is very little comfort that those making important policy decisions lack either the foresight or diligence to think through the consequences of those decisions.

Value of Community Banks

With obstacles like this, we might expect community bank stocks to be in the dump. In fact, they have performed quite a bit better than their larger cousins over the last month and a half. Part of this is certainly due to the exposure of large banks to Europe. The Greek debt crisis and the potential global echoes have made investors very cautious about the banking industry. But another reason is a point we've been hammering home for several months now: community bank stocks are undervalued. The market appears to finally appreciate that.

Since about April 15, when the market began to cool, most bank stocks have declined. But the larger banks have taken a much bigger hit. (See chart.) The larger the banks, the worse the performance. In fact, the stocks of large cap banks lost more than three times what micro cap banks lost. Smaller banks have retained their prices better because, in part, they were undervalued to begin with.



While the stocks of some small banks have performed extremely well over the last six to 12 months, most have not. As a result, community banks provide some of the best values in the market today. It's true, Washington does not quite know how to deal with community banks. Community banks have faced this reality in the past, however, and delivered.

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