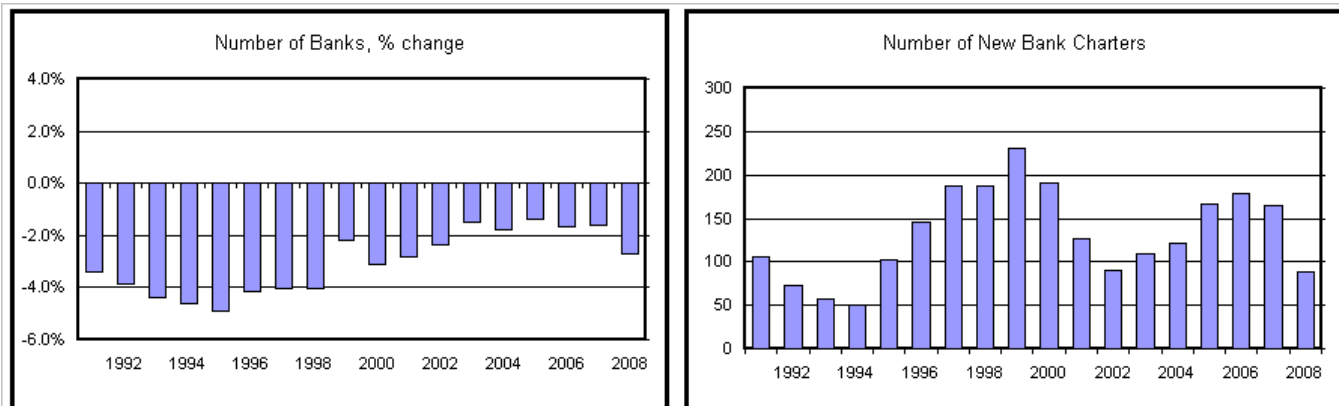


Too Many Banks?

As a long-time observer of the banking industry, we can't help remembering that there was a time a couple of decades ago when many forecasters were predicting a dramatic shrinkage in the number of banks, suggesting that the U.S. bank industry would become much more like those in most other developed economies. Back then, one often heard expectations that the population of banks would go from the then-current 10,000+ to perhaps 1,000 within a couple of decades.

While the number of banks has indeed continued to shrink, and is now down around 7,000, the chart below left shows that the pace of that shrinkage has slowed significantly this decade; while there was an acceleration in 2008, we suspect that bank failures (as contrasted to the desires of the banks owners) played an increased role.



Source: Highline Financial

Part of the reason for the slowdown would seem to lie in the slower pace of bank mergers that we discussed in last month's newsletter, but we also infer a contribution from the pick-up in new bank formations, as shown in the right-hand chart.

While the total market share of these new banks is relatively small – certainly less than 2% -- we believe that their expanded presence has had negative implications for bank industry profitability, for several reasons:

- It's elementary economics -- when the supply of a service increases faster than the accompanying increase in demand for the service, you drive down the price of that service. We saw many more new banks out trying to establish market share, but no real increase in new customers; in other words, we saw more bank competition for existing pool of depositors and borrowers.
- A little less visible but also important in our view has been a limited supply of good bankers – the large-bank training programs that previously supplied the industry with experienced bankers have been curtailed, even eliminated. This not only drives up the cost of skilled lenders, but it tends to put less-experienced lenders out into the market. This leads to:

- Putting on the loans that were relatively easy to generate (e.g., loans to builders) rather than go through the slower build-up of true franchise value in commercial & industrial loans, or non-price-driven consumer loans.

	2002-2007 Growth Rates			
	Constr.	1-4 Res.	CRE	Total Loans
\$100 mil.-\$1 bil. Assets	162%	13%	38%	33%
Industry	170%	73%	56%	60%

Source: FDIC

And as we will discuss in an upcoming newsletter, commercial real estate loans are almost sure to be the next source of major credit quality pressure on the banking industry, in particular the community bank sector. It is interesting to note that 1-4 family lending, the primary driver of overall industry credit quality problems up to this point, was not an important growth element for smaller banks. This is actually worrisome; if the major credit quality issues up to this point have not been in an important segment of community bank portfolios, but the developing credit quality issue is in their area of focus, it suggests that loan portfolio credit problems might be just beginning for the community banks

While the growth in commercial real estate loans was certainly not directly driven by the de novo banks, we are persuaded that the new capital “burning a hole in their pockets” and their perceived need to build earning assets in order to quickly break into the black made them an outsized competitive factor in the segment. This in turn seems to have pushed existing community banks to bend their own standards to respond – being too loose on loan pricing and credit underwriting and too generous on deposit rates -- and as a result the new banks put pressure on bank industry profits well beyond what might be implied just by their share of bank industry assets. This was substantially exacerbated by the sharp expansion of the non-bank lenders, whose low securitization-based funding costs led them to grant credit with irrationally low credit spreads and an apparent near-absence of credit underwriting. The “perfect storm” cliché might apply here.

- The rush to build balance sheets, in order to show quick progress to the bank’s investors, also led many young banks to pay up too generously for deposits, often including the aggressive use of brokered deposits (which have no positive implications for franchise value) rather than local, relationship-based deposits (which do).
- Finally, the desire to reward investors with relatively early profits seems to have led quite a few smaller banks to stretch for yield in their investment portfolios by assuming untoward levels of credit risk or interest rate risk. We have seen this result in disastrous consequences in several cases, even becoming the primary cause of some bank failures.

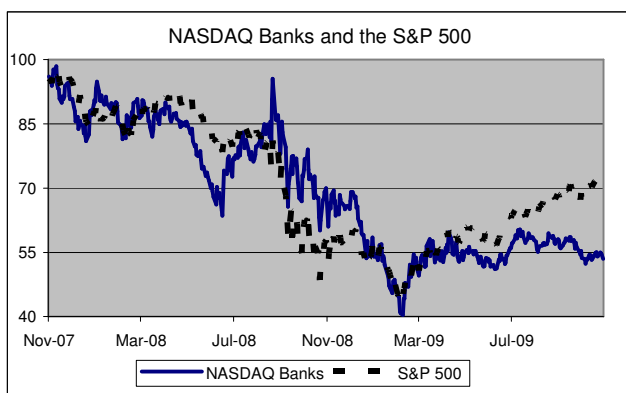
While some might argue that more competition is inherently good, we suggest that the banking industry is something of a special case – it’s easier for a bank management to fool itself on the key factors of credit risk and interest rate risk than it is for a retailer (for example) to be way off in understanding its true costs, and the implications for the economy from bank failures is far more significant than the failure of other businesses such as retailers or small manufacturers. Perhaps this is why part of the post-Depression banking regulations were aimed at controlling the excessive bank competition that was thought to have led to, or at least intensified the pain of the Depression. In other words, it may not always be completely true that “when banks compete, you win”.

In any case, we're convinced that the slowing pace of the bank industry's shrinkage, aggravated by the acceleration in new bank formation, has been a meaningful force pushing down bank earnings. Add this to a weak economy, and you have the pieces for clearly inadequate bank profitability. While bank industry profits will probably recover in 2010 and especially 2011 due to lower credit loss reserve building and a positive yield curve, we believe that core operating fundamental profitability will remain substandard not only until there has been a sustainable increase in credit demand (i.e., a solid economic recovery), but also some more shrinkage in the number of banks competing for their slice of the pie.

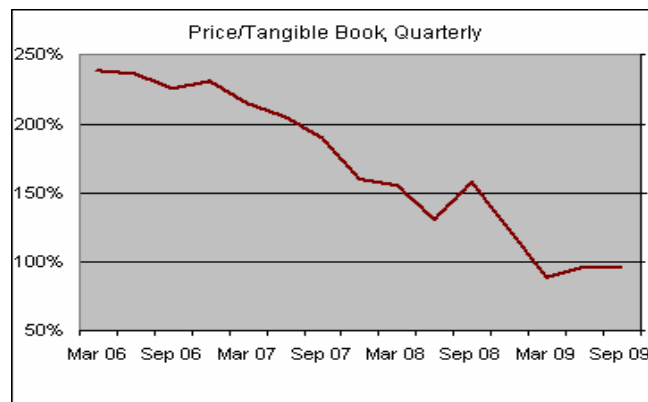
So, what's the message to community bankers in all of this? In our view, it is that you should not assume any near-term bail-out because "things will get better", and that you should do what needs to be done to get through a tough period that could last a year or two: rigorously examine and deal with your credit issues (don't kid yourselves, face reality), figure out how to build capital if yours is skinny, build the management depth to take market share from (or acquire) weak competitors, and maintain (or intensify) your focus on your long-term business plan. This is the time to hunker down and stick to what you do well – what truly drives your franchise value -- and avoid taking flyers on schemes that might promise a quick fix.

Bank Stock Valuation Trends

As the chart below left shows, bank stock prices have been pretty stable the last few months, presumably as investors have moved to the sidelines while waiting for a little more clarity regarding the outlook for economic activity, inflation and interest rates – all headlines in the papers, and all very uncertain. The same uncertainties would seem to explain a similar stability in the broader market; although the S&P 500 has outperformed the NASDAQ bank index over the last three months (+5.5% vs. -2.3%), the broad market modestly lagged behind the banks in the latest month (+1.8% vs. +3.3%). Looking at the forest rather than the trees, however, the performance of smaller bank stocks seems a pretty clear statement that, while we no longer seem to be teetering on the edge of the abyss, the outlook for growth and a full fundamental recovery is either unclear or uninspiring, or both. And the low price/tangible book value ratio shown in the second chart makes it clear that investors are still far from enthusiastic in their evaluation of the appeal of the banking business.



Source: Yahoo Finance



Source: Highline Financial data, Oak Ridge calculations

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