

Regulation -- The Unmanageable Risk?

Over the years, we have frequently heard bankers complain about the burden of dealing with their regulators. We have tended to downplay the complaints -- not that the burdens have not been real, but that they needed to be balanced off against the benefits of being able to raise funds (FDIC insured deposits) at attractive rates, often below the Treasury curve. It has been our contention that the economic value of these low-cost funds probably more than offset the negatives of regulation.

We would argue that this was particularly true in the middle years of the previous decade, when a long-lasting benign economic environment and an apparently endless uptrend in real estate values seem to have led to relatively complacent regulatory oversight. Big banks, particularly Wall Street banks, were allowed to carry on risky businesses (e.g., exotic derivatives, large-volume packaging and selling of carelessly-underwritten mortgages) at the same time as they were trimming their capital ratios. Smaller banks were allowed to outgrow their core operating bases and core competencies via rapid expansion of aggressive real estate lending, loan participations, and the use of non-core funding such as brokered deposits, with the oversupply of new *de novo* banks often being the worst offenders. In many cases, exam reports that highlighted concerns about these practices (and a broader list of bank management deficiencies) were not followed by adequate enforcement by the regulators. We should all remember that most asset quality problems are created during generally good economic conditions coupled by management and regulatory laxness, and the reins need to be tightened when current results seem too good, before the need is obvious.

In any case, bubbles always end, and usually painfully. As a result, the pendulum of regulatory intensity has (not surprisingly) swung back to the restrictive side; we see evidence that regulatory-driven loan loss recognition has gone from being too permissive to (arguably) overly severe. Some examiners seem to be acting like religious converts, making up for past transgressions by adopting somewhat draconian assumptions about the loss potential of stressed loans, and then immediately requiring the setting aside of very high reserves to easily cover those potential losses. In effect, we are seeing a form of “mark to market” accounting being applied by regulators, which can make a loan appear under water even if it is likely to be repaid in full. Some of this is good, of course; if the banks had been more diligent in recognizing and reserving for the potential losses, the industry would now be in much better shape. But by requiring the banks to immediately put up reserves on something approaching a worst-case basis, the examiners are probably pushing the banks to “flush” some assets, reducing the prospects for full recovery of asset values and forcing major hits to capital.

At the same time, ironically, the banks are also being forced to sharply increase capital ratios. Once again, this is a good idea up to a point; the industry was allowed to run with too-low core capital and loan loss reserve ratios (though not anywhere near those of the highly-leveraged European banks), so weakness in the economy and in real estate values has left capital ratios impaired to the point of many banks being unable to support loan growth. To make matters worse, it appears that capital ratio standards are being increased – for example, it would appear the new “well” capitalized bank will need to maintain a Total Risk-Based Capital Ratio of closer to 12% compared to the 10% standard. So it should not be a surprise that many banks are reacting to this pressure (and the difficulty in attracting new capital) by shrinking their asset bases in order to improve their capital/asset ratios. This is hardly what Washington should want as we try to push our economy into a solid recovery.

But the biggest problem may be the host of uncertainties within the total regulatory system. Ground rules have been changed (e.g., TARP), some regulatory expectations seem to be in force but not explicit, and we have heard several credible reports of exams that stated asset valuation and reserve adequacy guidelines that were both arbitrary and changeable. To top it all off, the new Dodd-Frank financial reform legislation is hugely important but very indefinable, at least until the actual regulations (perhaps 500 of them) are developed so as to translate the legislation into actual guidance.

Consequently, bankers and investors alike have become less willing to take risk and act, given seemingly justified fears that the rules might change right in the middle of a bank's/investor group's strategic thrust. While a well-managed bank can usually deal with specific issues such as higher capital requirements and relatively severe asset quality assumptions, there is little any bank can do when the rules of the game are in flux. Unpredictability is, after all, one of the major impediments to investment. It seems particularly ironic that Congress and the regulators are pressuring the banks to make more loans even though they have made the landscape more threatening.

So -- Down Into the Foxholes?

Given the regulatory uncertainties in this highly-regulated industry, the probability that asset quality pressures will remain quite high (though probably not increasing much) well into next year, and the prospect for no more than a muted recovery in a de-leveraging economy, it would not be surprising to see a lot of basically sound banks decide to pull back into their shells until they could look into the future with more clarity and confidence.

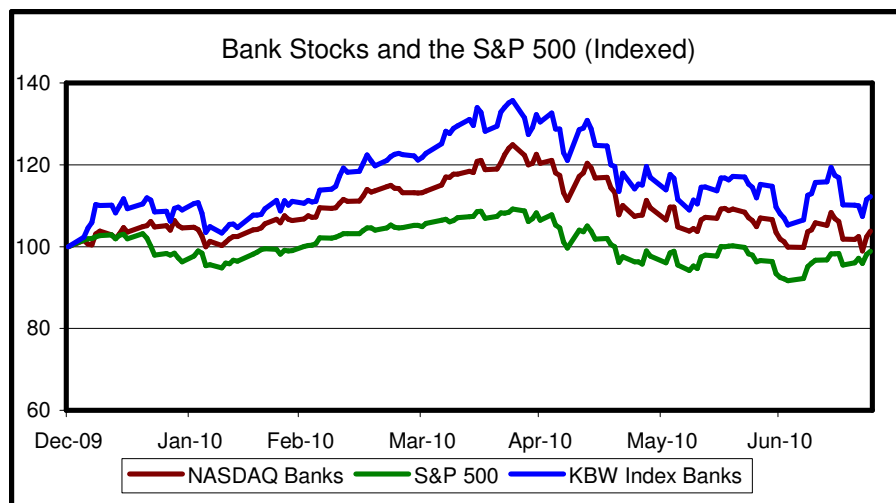
Ultimately, that may not prove to be the best strategy, however; the confluence of pressures on profitability and balance sheet ratios, the increase regulatory burdens, and the poor odds that the industry will get "bailed out" by a strong economic rebound should mean that the bank industry will be in a period of significant restructuring and market share shifts. Banks that are highly threatened by this environment are likely to at best stay dead in the water, and are more likely to shrink. This will mean that banks that are well positioned with strong management, capital ratios that are clearly more than adequate, a loan portfolio that has truly been scrubbed, "best practices" in all important procedures and policies, and healthy regulatory relationships can make substantial market share gains by taking customers away from weaker banks and/or actually expanding via accretive acquisitions, thereby taking advantage of the industry turmoil that will almost surely occur.

First Read on the Second Quarter: How Good Are the Numbers, Really?

Based on the early second-quarter earnings releases, it appears that the healing process that showed in the first quarter is being extended. Looking at a large handful of major early-reporting banks, earnings per share comparisons have typically been quite strong, and generally better than expected.

Lest we get too excited about this, however, we should note that revenue and loan growth has been minimal to negative, with sharp cuts in loan loss provisions accounting for a huge percentage -- in fact, typically well more than 100% -- of the earnings gains. While the industry's reserving levels of the past year or so were clearly extraordinary, and were certainly due to decline, we should also note that nonperforming loans, though retreating, did not drop commensurately, nor did actual charge-offs -- with a few exceptions, such as Wells Fargo and KeyCorp. Consequently, provisions were often notably lower than charge-offs, which effectively meant that reserve releases were the dominant earnings drivers. Indeed, looking at the popular and useful measure of pre-tax, pre-provision earnings as a measure of underlying fundamental progress, we see a picture of minimal to negative change, both sequentially and year/year. Managements may justify the reserve releases (in effect, reserve reductions) based on what they see happening in underlying credit quality metrics, but it strikes us that it might be a little early in this somewhat tenuous economic recovery to feel comfortable with major loss reserve reductions. We would prefer that provisions stay close enough to charge-offs to keep loss reserve ratios high.

Moreover, reserve releases are certainly not high-quality earnings drivers, nor are they sustainable over the longer term. And given the prospects for no more than modest economic growth over the next few quarters (due largely to the need to de-leverage), we remain convinced that key bank operating fundamentals (balance sheet and revenue growth) are likely to be fairly sluggish for some time. It is perhaps because of this concern about underlying momentum that bank stocks (as well as the overall market) have tended to give back earlier gains during the past couple of months, even as it became apparent that second-quarter earnings report headlines were likely to seem pretty positive.



Source: Highline Financial data, Oak Ridge calculations

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