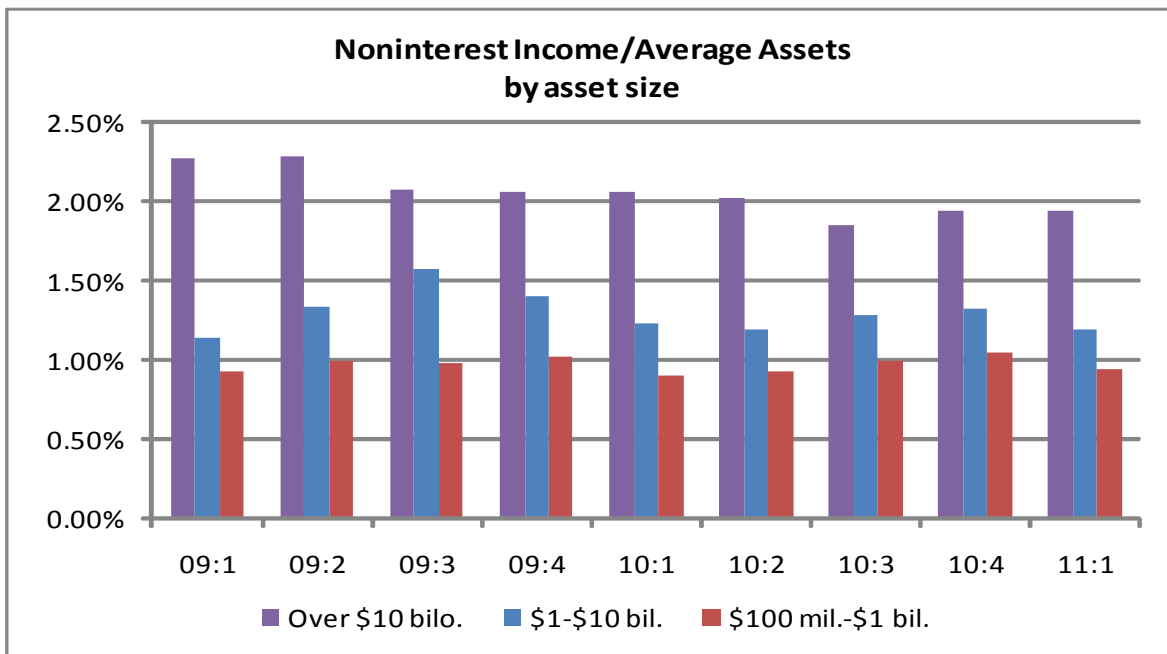


## The Real Dual Banking System

The United States has a highly unusual banking structure, with a dual system of regulation – by state regulators and by national regulators. In this report, however, we are looking at a different kind of dual banking system: the division between big banks and smaller regional/community banks – which leads us to this headline from the Wall Street Journal on May 20: *Flood of Fees Flows Into Bank Coffers*. When we saw it, we couldn't help thinking that community bankers would ask themselves "Which banks? Certainly not mine." In fact, the paper was slipping into what we view as sloppy terminology – the "banks" doing well are investment banks and those few large commercial banks that have capital markets activities, rather than the "take deposits and make loans" businesses that we think of when we hear the word "bank". As the chart below shows, first-quarter fee income trends are negative for smaller banks, but somewhat positive for larger banks.

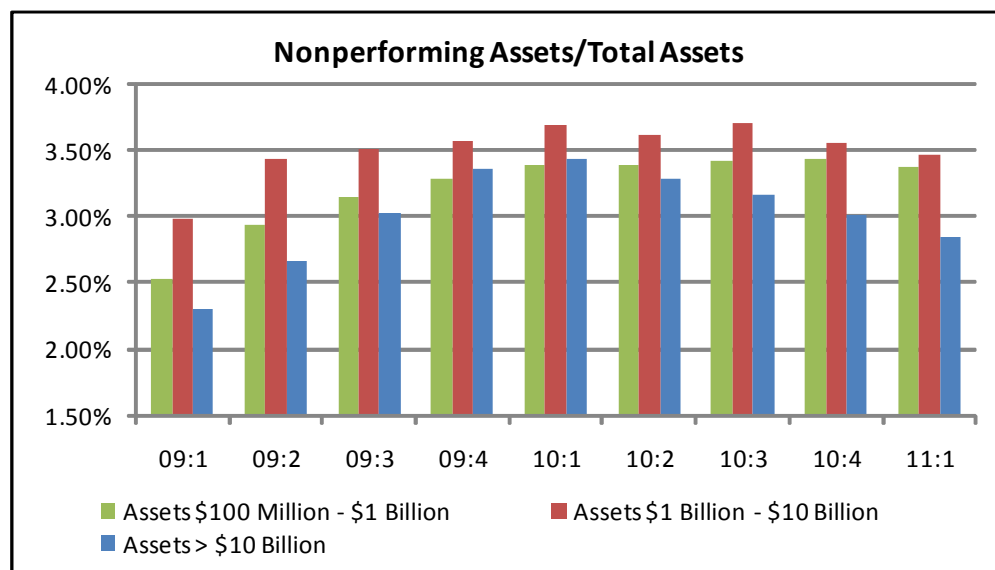


Source: FDIC

Equally important is the fact that big banks generate a lot more fee income relative to their size than do smaller banks, and that they have more sources of fee income – such as capital markets-related fees, which have been much stronger lately than the deposit-related fees that are important to smaller banks. In sum, large banks have more ways of making money than do smaller banks, a fact which is especially important in times (such as currently) when loan demand is sluggish.

Another point of differentiation that we view as being quite important is that large banks have access to the capital markets while smaller banks generally do not, at least in the current environment. The significance of this goes far beyond the ability to satisfy regulator's demands

for additional capital – it allows the larger bank to be more aggressive in dealing with problem assets and then re-filling the capital hole with new equity infusions. We view this ability, plus the fact that smaller banks tend to have a larger weighting of commercial real estate loans in their portfolios, explains why the larger banks have shown so much more progress in reducing their nonperforming assets (nonperforming loans plus real estate owned) than have the smaller banks:



This does not mean that large money-center banking is a better business than community banking, however; it just means that the large banks have been able to come out of the banking recession faster than their smaller brethren. In fact, we see some important advantages on the side of the community banks. In particular, we argue that their customers need them more than the large companies need the big banks; large companies have ready access to the capital markets, and typically have lower costs of capital than do the banks. As a result, the basic business of banking is more commodity-like for the big banks, which shows up in their lower margins over the long run.

So there is reason to be optimistic about the relative earnings prospects of the community banks as the economy recovers. Unfortunately, there is another source of pressure on the smaller banks, at least in our opinion: regulatory disregard. Although neither an official nor admitted policy, it seems fairly clear to us that regulatory remedial efforts have been focused mostly on the larger banks (notably the group with assets over \$50 billion that is considered systemically important) while the smaller problem banks have been dealt with much less sympathetically: make them write all the problem assets down to current (and quite conservative) realizable values, push them to fill the resulting capital hole with new equity (even though it is not realistically available to most community banks), if that doesn't work find a buyer (rarely achievable), and if that doesn't work then the bank will fail. The FDIC will take over the bank, close it and "sell" it to another bank, at a considerable cost to the FDIC, by the way. While this environment will eventually pass, we doubt that the regulators will become any less of a burden for community banks over the next year or two. Community banks will of course prosper as their local and regional economies prosper, but that is a slowly-developing trends in most parts of the upper Midwest, and indeed the whole country.

## First-Quarter Community Bank Scorecard

Despite our somewhat negative tone so far, it is important to note that profitability continues to improve on a fairly broad front in the community banking sector, with returns on assets beginning to approach respectable levels, particularly for banks on the small end of the spectrum:

2011 First Quarter Midwestern Banks By Asset Size	Return On Average Assets	Net Interest Margin	Nonperf. Loans/ Gross Loans	Nonperf. Assets/ Total Assets	Loss Reserve/ Gross Loans	Loss Reserve/ Nonperf. Loans	Net Charge- Offs/ Loans	Texas Ratio	Tang. Equity/ Assets
\$4-\$8 bil. Median (5 banks)	0.89	4.37	4.48	4.82	4.03	68	2.36	46	7.4
\$2-\$4 bil. Median (11 banks)	0.58	3.60	2.78	2.68	2.15	63	1.08	22	8.6
\$1-\$2 bil. Median (48 banks)	0.73	3.73	2.91	2.95	1.96	63	0.34	27	9.0
\$500 mil - \$1 bil. Median (99 banks)	0.81	3.71	2.52	3.00	1.69	73	0.49	27	9.1
\$200 - \$500 mil. Median (304 banks)	0.85	3.78	2.03	2.28	1.74	82	0.18	18	9.3
\$100 - \$200 mil. Median (509 banks)	0.92	3.85	1.69	1.72	1.57	87	0.07	15	9.4

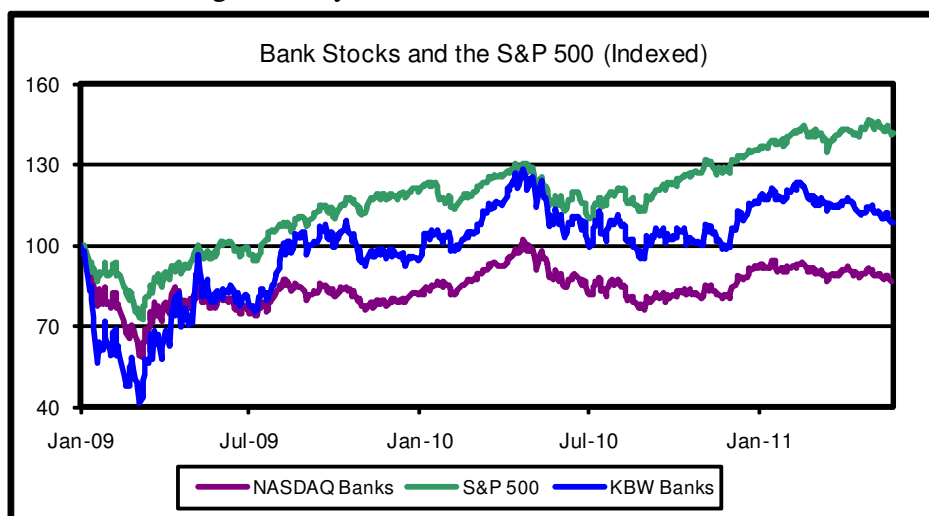
2010 Fourth Quarter Midwestern Banks By Asset Size	Return On Average Assets	Net Interest Margin	Nonperf. Loans/ Gross Loans	Nonperf. Assets/ Total Assets	Loss Reserve/ Gross Loans	Loss Reserve/ Nonperf. Loans	Net Charge- Offs/ Loans	Texas Ratio	Tang. Equity/ Assets
\$4-\$8 bil. Median (5 banks)	-0.48	4.31	4.83	4.54	3.76	66	3.85	42	7.2
\$2-\$4 bil. Median (11 banks)	0.59	3.48	3.02	2.83	2.26	59	1.18	23	8.5
\$1-\$2 bil. Median (48 banks)	0.66	3.84	2.96	3.27	1.77	61	1.23	28	8.9
\$500 mil - \$1 bil. Median (99 banks)	0.61	3.81	2.24	2.73	1.67	74	0.98	22	9.1
\$200 - \$500 mil. Median (304 banks)	0.75	3.85	1.93	2.35	1.63	80	0.64	18	9.2
\$100 - \$200 mil. Median (509 banks)	0.77	3.92	1.75	1.90	1.49	84	0.38	16	9.4

Source: Highline Financial data, Oak Ridge Financial calculations

As the table also suggests, and as has been true for the past several quarters, the improved profitability has primarily been due to lower loan loss provisions justified by lower charge-offs; the basic spread business remains moribund, with loans continuing their slow shrinkage and net interest margins being flat to down. Given the increasing flow of lethargic macro-economic data, it seems likely that this combination of sluggish revenues and slow profit growth will continue for a while.

### Treading Water

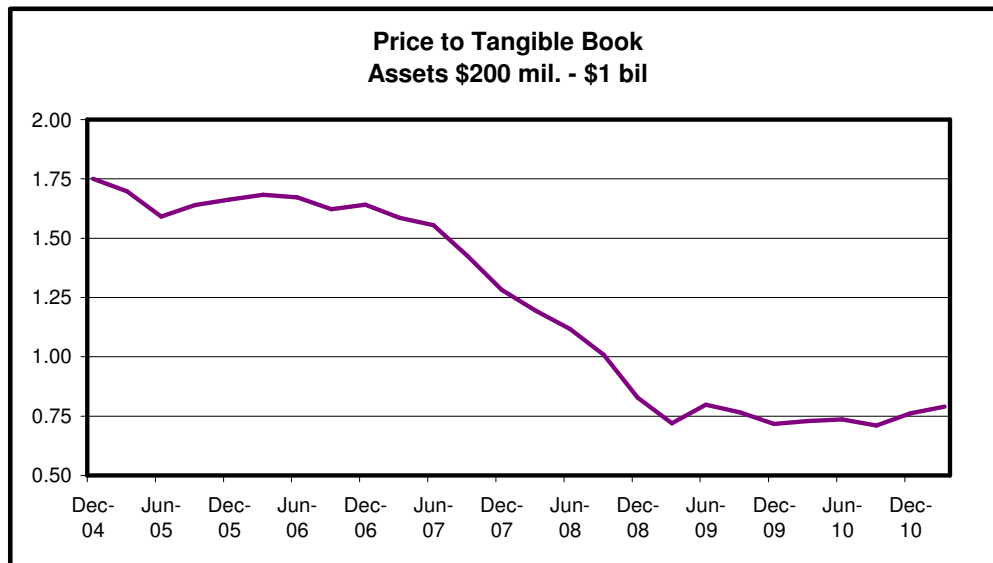
This slow recovery of bank earnings and a very slow build-up of whole-bank acquisition activity have led to what could be called a trendless bank stock market; as indicated by the following chart, both the NASDAQ and the KBW bank indices were at almost exactly the same levels in late May 2011 as they were a year earlier, despite the improvements we have seen in earnings, charge-offs, and even nonperforming assets. One might say that investors have gone from being afraid of bank stocks to being bored by bank stocks.



Source: Highline Financial data, Oak Ridge calculations

Given our expectation of a continuing slow economic recovery and a resulting slow growth in bank earnings, we suspect that it will require a notable pickup in whole-bank (versus FDIC-assisted) acquisitions to ignite more investor interest in the group. In our view, this is likely to begin within the next 12-18 months, as potential acquirers get more confident of their ability to accurately judge the risks within a potential target’s balance sheet, and as the difficulty in achieving organic revenue growth begins to weigh on them.

As the following chart shows, smaller bank stocks are historically cheap now, but this is unlikely to last forever. So if you happen to have a strong capital base, and a management team that is up to the challenge, it could serve you well to be anticipatory and negotiate your acquisitions before the pool gets crowded.



Source: Highline Financial data, Oak Ridge calculations

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