See Pages 2 and 3 for comments by PBB's Terry Freeman, CFO/COO.

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Post-Occupied

Tepid demand, thin margins, new regulations, investor caution — and a lingering public-relations problem. No wonder banks are nervous.

VINCENT RYAN

Occupy Wall Street protesters aren't the only ones with a new aversion to banking. Bankers themselves have some concerns. Just ask Joseph Vitale, a partner at Schulte Roth & Zabel who advises financial institutions and their investors. "Many community- bank officers and directors are finding themselves in a changed world," says Vitale. "Running a local financial institution has traditionally been a prestigious job, helping to do things like fund community and commercial development." With lending scarce and foreclosure rates high, and both the public and regulators looking for somebody to blame, community-bank officials are more likely to be vilified than lauded. "They're worried there will be protestors picketing in their backyard," Vitale says.

Finance chiefs might be forgiven for wanting to join the protest line. After all, it's hard to maintain friendly feelings toward a partner that pulled your credit line just when business went bad. Emotions aside, though, most executives recognize that their fortunes are inextricably linked with banks'. What they really want is for financial institutions to get their house in order. Commercial banking has to perform well enough to attract investment if it's going to invest in borrowers.

But it seems certain that the wheel of fortune will take its sweet time putting banks on top again. Even if the European Union saves the skin of Greece and other "peripheral" countries, and U.S. economic growth picks up, commercial-banking CFOs are going to have a trying time in 2012, even without further public demonstrations of animosity.

Historic, perhaps long-lasting, shifts like equity-market volatility, ultralow interest rates, and new federal regulations are rattling banking's foundations. How does a bank increase revenues and profits when margins are tight, underwriting standards are high, and loan demand is tepid? How does it attract capital without the improvement to portfolios that a recovering economy might provide? And how do retail banks resurrect lending volumes without the aid of a mortgage refinancing boom?

"This is not going to be the best year for banks," admits Frank Baier, CFO of North Jersey Community Bank in Englewood Cliffs, New Jersey. "Absolute profitability will be down, due to what's going on with the yield curve; regulatory pressures will increase expenses; and having to hold more regulatory capital will cause returns to decline."

"From a local market and economic perspective, unemployment will be the anchor on the economy," says Terry Freeman, CFO and chief operating officer at Private Bank of Buckhead in Atlanta. "The demand for loans and credit will stay flat."

All this comes when bank CFOs face lower revenues as a result of new rules, such as limits on overdraft fees. For "systemically important" financial institutions, there are higher expenses for constructing wind-down plans, or "living wills," in the event of a sudden collapse.

True, many of the new costs of loss-absorbent capital and tighter regulations have yet to hit banks' financials. Indeed, earnings look bright. Portfolio credit quality is improving on average, so many banks are reducing their provisions for loan losses, which can boost total income. "The [bad loans] have pretty much washed through the system," says Bob Martins, a CFO partner at professional-services firm Tatum. Loan write-offs at all Federal Deposit Insurance Corp.–insured institutions in the first six months of 2011 were $62.2 billion, versus full-year figures of $187.2 billion in 2010 and $188.8 billion in 2009.

But those numbers mask the core business question of how banks are going to cultivate new income. "Revenue for banks has not really grown in three years," points out Lee Kidder, a senior consultant at bank adviser CCG Catalyst.

Controlled Loan Growth

Banks are highly liquid right now, but they are not highly confident in the U.S. economy; their CFOs preach caution. But they are not about to pull back from lending again. "We've lent through the cycle, and continue to show loan growth in excess of peers," says Steve Boyle, CFO of TD Bank, the U.S. arm of $665 billion (in assets) Toronto Dominion Bank. "So we want to be cognizant of the risk, but also consistent. We don't want to react in a knee-jerk fashion to the uncertainties out there."

At North Jersey Community Bank, total assets and loans increased 20% and 29% year over year, respectively, in the first quarter of 2011. But as much as finance chief Baier desires growth, it has to be profitable.

Instead of ratcheting up consumer and business deposit and service fees, North Jersey is looking to add additional lines of business that are not dependent on rate spreads — a smart move with a base of cheap deposits. North Jersey plans to increase residential-mortgage origination and then sell the loans in the secondary market to create gains on sales, for example. It also hopes to add products like wealth management and annuities.

Another way North Jersey plans to grow is by capturing the whole client relationship, which should bring in even more cheap funds. "When originating a business loan, we want to get their operating accounts; for a multifamily [building] loan, we want the rent security accounts and the building accounts," Baier says.

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In Atlanta, Private Bank of Buckhead survived while 23 banks in Georgia failed in 2011. Most of the 23 that failed operated on Atlanta's periphery, where construction was a big economic driver. Located in a more affluent section of the city, Private Bank of Buckhead moved against the market by picking up Small Business Administration lenders and entering the mortgage business when other banks were scaling back, says finance chief Freeman. "We do what made good banks good for many years — solid underwriting — and don't define success by our size, but by quality of income."

Back at TD Bank, the biggest opportunity, surprisingly, is in refinancing traditional residential mortgages, a sector in which TD has historically had a relatively small presence, says Boyle. "As we go out to core customers to meet their mortgage needs, we're originating loans without having our [booked] loans be refinanced, because we have such a small portfolio," he says. "We're seeing strong growth through this low-interest-rate cycle."

Where the Profits Are

Predominantly, though, commercial banks see lending growth coming from commercial and industrial lending. C&I loans grew by 4% in September and by 35% year-over-year in the third quarter, according to the Federal Reserve. That's good news for industrials. "It will be an excellent environment for a company to maximize the efficacy of its credit facility," says Tatum's Martins.

C&I portfolios are typically 18% to 20% of a bank's total loans, but they can generate outsized profits. LIBOR margins on business loans tend to hold up, and the risk profile of a C&I loan is "deceptively low," says Martins. The bank winds up with two sources of repayment: the borrower's cash flow and its assets. C&I loans also tend to diversify primarily along industry lines (at least in theory), unlike commercial real estate loans, which offer primarily geographic diversification. C&I credits also bring in large deposits. "Those deposits are zero cost of funds, so if you price out the C&I portfolio with the deposits it tends to be quite profitable," Martins says.

The shift to C&I will be a big change from prerecession days, when banks gorged on commercial real estate lending because it was a quick way to boost outstandings. The underwriting was also easier and less labor-intensive.

It won't be easy for some banks to switch over to C&I lending, says Bobby Hashaway, a former commercial banker and executive vice president at Commerce Street Capital, an investment bank serving financial institutions. "Their infrastructure is more real estate–oriented, and you can't just take a real estate lender and say now you're going to be a C&I lender."

The competition for C&I credits will be tremendous, especially if demand stays low. Tatum's Martins put a $15 million credit facility for a "good credit" out to bid in late October, and had three large banks competing for the business fairly heavily.

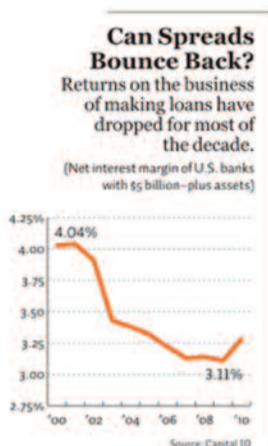
Merge and Purge

With margin issues pressing bank CFOs, consolidation seems inevitable — and most think it would benefit the entire industry.

TD Bank made numerous acquisitions in the wake of the crisis, including Chrysler Financial Services, an indirect auto lender; a Canadian credit-card portfolio from MBNA; and some distressed banks in Florida. "We've had a very low loan-to-deposit ratio — less than 50% — so we bought assets or asset-generation capability, and at good prices," CFO Boyle says.

California-based Bank of Marin ($1.4 billion in assets) closed its first acquisition ever in February, a purchase of Napa, California-based Charter Oak Bank. The deal, which was assisted by the FDIC, excluded any Charter Oak loans 60 days or more past due and the entire construction and land portfolio. "We have a continued desire to grow and expand our footprint," says Christina Cook, Bank of Marin's CFO. And although the bank's five-year strategic plan doesn't require acquisitions, Cook says the bank could raise the capital to do a more sizable deal if it wanted to.

Plenty of institutions are or will be on the block. "We're going to see consolidation," says Cook. "As the realities of the regulatory burdens hit, boards will realize they will not meet shareholders' expectations for returns, so they will try to create efficiencies by combining with other banks."



Wary Investors

A key element to a consolidation wave is capital. Houston-based Green Bank, for one, received a $100 million capital injection from three private-equity firms last year. It subsequently bought some deposits in Dallas. In early November, it closed another deal involving $160 million in deposits in Houston, according to CFO John Durie. The capital will help Green Bank pursue larger business customers — those with $5 million to $100 million in revenue. "Working with that size we see a little bit better credit quality, and they are not transactional like many real estate loans," Durie says.

But many banks in need of capital are a lot less alluring to investors than Green Bank. In Q2 2011, 865 of the nation's 7,500 banks were on the FDIC's "problem list." Other banks may be in better shape, but lack a good brand, a solid core deposit base, or a strong management team.

The spreads between buyers' and sellers' valuations are wide, says Vitale. Buyers are comfortable sitting on the sidelines and waiting for the rollout of the Dodd-Frank Act and the denouement of the current economic cycle. There could be a deluge of deal making once the dust settles, says Phillip Torrence, a partner at Honigman Miller Schwartz and Cohn. But in the meantime, some banks are faltering.

With all their "dry powder," financial sponsors would be suitable investors. But despite policy statements issued in 2008 and 2009, "the FDIC and the Federal Reserve have not made it easy for private-equity or any other substantial investors to help these banks out," says Torrence. He has seen willing investors pull out when deal approval has taken too long.

A "purge the books" approach that ring-fences troubled loans and sells them may not work for these banks either. Even if a bank can sell a bad portfolio, it does so at a deep discount, a discount probably greater than its marks on the assets. "If a bank dumps those loans, it may push itself into [being] critically undercapitalized," Torrence says.

"Theirs to Lose"

Bank management teams are going to have to tackle the problem of commoditization to get revenues and sustainable profits headed in the right direction, some suggest. In banks' traditional financial activities, the commoditization of transactions has effectively marginalized them. Payments is a perfect example: while banks have become in many aspects mere settlement agents, person-to-person payments providers like PayPal score the profits and the client relationships, says Kidder of CCG Catalyst. "Banks have to figure out how to get that [market] back," says Brian Hagan, a practice group manager at the firm.

Expense cutting will not be the answer, says Kidder, because efficiency ratios are already low. "They have to make transformational investments in technology, like cloud computing and web services," he says.

Kidder believes banks will expand into information management for customers across the horizontal enterprise, providing additional products like budgeting, interactive financial planning, and personal data storage.

It won't be easy. Still, despite the financial turmoil of the past few years, banks do have a big advantage: "Customers would still rather put their money in a bank than in PayPal [accounts]," Kidder says. "The residual of trust still belongs predominantly to banks; it's theirs to lose."

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