Chapter 1

# A New Era for Community Banking



Seldom has this country faced such uncertain times. The U.S. economy and, by extension, the global economy, has slogged through the first consumer-led recession in twenty-five years. This downturn has been the worst since the Great Depression despite massive fiscal and monetary stimulus. The repercussions from Paul Volcker's battle with inflation, the consequences of the savings and loan (S&L) crisis, and the economic effects of the September 11 terrorist attacks are all likely to pale in comparison to what we will see over the next five to ten years. Why? Because the economic gains since the mid-1990s arguably were built upon a financial system awash in cheap credit and largely neglectful of fundamentals. The mortgage mess is only the latest manifestation of the same trend that brought the technology bubble and four-dollar-per-gallon gasoline.

The era of easy credit is over. Zero-percent financing may have come back as a marketing tool to move SUVs off the lot, but the Federal Reserve Board (Fed) will not be able to engineer a recovery simply by making it cheaper for homeowners to spend whatever equity is left in their homes. Gone, too, are the days when the largest financial institutions had essentially unlimited access to leverage through the combination of securitization and investors were willing to believe that the credit strength of a structured deal and the quality of the underlying assets were two different things.

Needless to say, community bankers who stuck with a conservative, traditional view of credit and underwriting standards had a tough time of it. Borrowers could always find someone else, whether it was an investment bank leveraged 30-to-1 or an asset-backed commercial paper conduit that could lend more cheaply and with less regard to the quality of the loan. The tables have turned. Those same stodgy bankers who tempered their bets and always kept an eye on fundamentals are among the handful of financial institutions that will be left standing. They will be among the most critical components of the recovery from this mess.

Community banks now have the opportunity—and it will not last forever—to take advantage of a broad localization of the banking industry. That idea may seem counterintuitive as the biggest names (e.g., Bank of America and Wells Fargo) sweep up eye-popping percentages of deposits, and investment banks have bank holding-company charters. No megabank has escaped the specter of nationalization or breakup, however. More important, the securitization engine has only haltingly restarted. A lack of borrowing power leaves the biggest players with significantly less room on their balance sheets for new business than was the case even two or three years ago. That is not a permanent change, most likely. Leverage will build in the financial system. In the meantime, though, the crisis hands community banks the most important strategic advantage that they have ever had. They can increase their share of core deposits and true relationship lending, but only if management teams use sophisticated tools and strategies. A typical example, if a pedestrian one, is auto lending and leasing. The bond and money markets, the collapse of asset-backed securitization, and then the prepackaged bankruptcies of Chrysler and General Motors Corp. (GM) forced automakers to pull back from financing their own products. Nationwide and regional banks had little additional appetite for auto loans, and that opened a door for the community banker.

Economic recoveries can only happen with the expansion of credit, and only a healthy banking system can bring that about. Few would argue that the U.S. banking system—even one that finds itself reeling after a massive, unexpected consolidation among the largest players and a broader partial nationalization—is in a position to increase lending. The write-downs of the past three years mark the beginning of this credit cycle, not the end. Credit cycles are normal, even if the severity of this one is historic in its proportions. The big difference between the past two decades and what we will experience over the next ten years is this: The ability of lenders to remove the consequences of their credit decisions from their own balance sheets has vanished.

A massive global deleveraging by consumers, businesses, and the biggest balance sheets on Wall Street means that majority of regional and national lenders simply do not have the room on their balance sheets to fund a recovery. Bridge and off-balance-sheet financing morphed into on-balance-sheet assets for the biggest commercial and investment banks, and the peak in write-downs and write-offs may well be ahead of us.

Community bankers face a new era, one in which they are significantly more relevant to the national economy. The challenge is to manage the opportunity in a way that allows them to capitalize on this paradigm shift while effectively managing risk. This book outlines the strategies, products, and tactics that community banks will need to employ to perform both those functions. The following chapters will do so with an examination of the broad themes that I have seen develop in my time as an analyst and more recently as a salesman over the past sixteen years, a look at the current environment, and the deployment of the tools and ways of thinking that will be critical in maintaining a new leadership position in the U.S. economy.

## A Five-Forces Analysis of the Competitive Position of Community Banks

One of the best ways to think about an industry's competitive landscape is a Porter five-forces analysis, whereby one examines rivalry within an industry, the threat of new entrants, the bargaining power of suppliers and of customers, and the threat of substitute products. It works like a charm in thinking about what business lines General Electric should enter and exit or explaining why GM has gotten itself into so much trouble. However, I have found few useful applications of the analysis to the financial services industry in general and to community banks in particular. The following provides a framework for a rigorous if simplified discussion about the competitive landscape that community banks face, how it has changed, and how it is likely to change again once the regional banks and national franchises recover and securitization outside of the housing agencies again becomes widely available.

The conclusion of even a cursory industry analysis is that healthy community banks have two basic strategic choices. The easiest choice is to conduct business as usual. Banks that have not gotten into too much credit trouble during the housing bubble will post good results for the next couple of years and eventually return to becoming price takers from both their lending clients and their depositors. The better choice is to proactively prepare for an inevitable releveraging of the financial markets. Community bank managers can do that by taking two steps. First, they must lure away clients from both smaller and larger competitors—clients that less-sophisticated institutions cannot service and that regional and national franchises can accommodate only with great difficulty. Those clients want to do business with community banks right now. Second, community banks must retain those clients and develop comprehensive relationships in order to build a stable and cheap funding base that is the community bank's primary advantage over rivals that depend on wholesale funding.

Doing nothing ensures that what is now a temporary advantage will remain—well, a temporary advantage. A proactive strategy—which in many cases will include buying less-sophisticated and troubled franchises for their deposit bases—can serve to give community banks a degree of pricing power even as larger rivals are restored to health. Execution will be the key. Community bank managers will find that the strategies and tools discussed throughout this book are vital in creating long-term value by pushing weakened rivals out of community banks' core business. Equity investors will benefit by looking for franchises that do so successfully.

Defining community banking in the context of a nonfinancial industry, as closely as possible, is critical to fitting this analysis into the Porter framework. To that end, let's say that community banks have two different business lines: a core business consisting of traditional retail and commercial banking funded with deposits, and a leveraged wholesale-asset–management business made up of investments funded with wholesale liabilities. An entire chapter covers that idea in more depth later on.

The basic output of the community bank is credit, and the basic input is borrowed money. Credit comes in two basic flavors: retail and wholesale. Banks lend retail whenever they give a loan to an actual customer, and they lend wholesale when they buy obligations in the capital markets—primarily bonds. (This analysis ignores participations, purchased loans, and indirect lending because those products fall into a gray area.) Borrowed money also comes in retail or wholesale form; community banks take deposits from their own customers and, in most cases, gather wholesale funding in the form of brokered certificates of deposit (CDs), repurchase agreements (repos), or Federal Home Loan Bank (FHLB) advances.

If we simplify the structure of community banks themselves, we need to do the same when defining their client bases and suppliers. Something very different about community banks compared to manufacturers or even money center banks is that the banks' consumers and suppliers in their core business are often one in the same. Community banks have traditionally concentrated on individuals and small and medium-sized local firms in their lending books. They take deposits from those same people and organizations. The wholesale business presents a different situation. Community banks buy bonds in the capital markets—in effect, lending to large financial organizations like Fannie Mae and Freddie Mac in the form of debentures, or financing industries like housing or autos by buying securitized assets. They get the wholesale funding to buy those assets from a limited number of sources, including the FHLB. The FHLB, incidentally, presents the one major exception to this framework. The FHLB often serves as both a supplier of funds and a (wholesale) customer as community banks buy FHLB debt.

The primary issue that faced the industry in the decades leading up to the mortgage meltdown was one of competition, and not necessarily from other community banks. *De novos* and thrift conversions needing to lever new capital played a part in driving up liability costs and making lending more difficult. Credit unions, with their tax-exempt status and ever-expanding member bases, have been a continual headache for the industry. The most serious competition, however, tended to come from larger players such as regional banks and even national organizations, whether in the form of money center banks with national franchises or specialty lenders such as mortgage companies.

Until the past few years, regional banks had access to and employed risk management tools superior to those used at most community banks. Those tools allowed regionals to make loans that community banks were reluctant to put on their balance sheets. Making the right kind of loans facilitated true relationship lending in the case of the regionals, whereby commercial borrowers also became sources of inexpensive deposits. Large footprints also gave them access to potentially cheaper retail deposits than might be available to an individual community bank in a competitive local market. The regionals had capital bases that allowed them to offer larger loans than community banks could, although that was perhaps an issue of secondary importance if one defines community banks' target clientele narrowly enough.

The big national franchises enjoyed these same advantages, along with essentially unlimited access to funding through securitization. Access to securitization and cheap wholesale funding also drove the ascent of the national specialty lenders. One should include the investment banks and captive finance companies with newly minted banking charters in this category. These big players tended to focus on a handful of products, most notably first and second lien single family mortgages, auto loans, and credit cards. They enjoyed the further benefit of enormous economies of scale. The money center banks and the national specialty lenders also took advantage of the widespread use of the Internet, turning CDs (and even savings accounts) into a truly national market for consumers.

I wrote the last two paragraphs in the past tense for a reason. Things have changed. The regionals still use sophisticated risk management tools and easily manage the interest-rate risk of new loans that do not fit their asset-and-liability (A/L) profile. The ability to make new loans is limited, however. Many of their credit decisions during the housing boom could hardly have been worse. Those decisions not only eroded their capital bases and took away their appetite for new lending but also sent them scurrying for retail deposits. The big national players, whether banks or finance companies, have experienced the same phenomenon—in fact, one can call all of them *banks* at this point because the majority of large financial services firms are part of or encompass a bank holding company. Securitization outside of the housing agencies has more or less gone away, forcing them to balloon their balance sheets with loans that they otherwise would have sold directly to investors or financed off the books through a commercial paper conduit.

Community banks, on the other hand, enjoy renewed pricing power among their loan customers. Alternative sources for lending have all but disappeared. They also have access to relatively cheap and stable retail deposit bases, partly because the Fed pushed overnight rates close to zero and partly because the big banks cannot seem to keep themselves off the front page. This is a favorable state of affairs, and community banks realistically have the option of sitting back for the next couple of years and conducting business in the way that they always have. They will post some pretty good-looking results, too, as long as their managers can resolve major credit and goodwill issues in a timely fashion. I would argue, however, that these good times for the community banking industry are a temporary state of affairs. The biggest players, and the wholesale financial system on which they ultimately rely, will reemerge as healthy competitors at some point. They may employ less leverage than in the past, but they still will have all of the tools that used to let them eat community banks' lunches. Let's take a look at each one of Porter's five competitive forces in turn, combining a few of them to provide a better fit for the actual business of community banking.

## Rivalry Within the Industry and New (Really Returning) Entrants

Applying this idea as narrowly as possible would compare community banks only to other community banks. As I mention above, some of the competition for established community banks came from new entrants into the space, either in the form of *de novos*, sometimes formed by alumnus of regional banks, or thrift conversions. Newly created institutions always face tremendous pressure to get their operations up and running, and they have traditionally done so by working within the margins of existing community banks—paying more for deposits (usually CDs) and offering better terms on loans (most notably, commercial real estate deals). Despite some high-profile equity offerings, capital is still relatively difficult to come by in the financial sector despite a number of small public offerings and private equity investments in troubled small cap banks, and the creation of new, relatively inexperienced small players in the community banking space has dried up because of that. The entry of these competitors is unlikely to resume until the economy and bank-equity valuations improve significantly. Both developments are a long way off. Strong community bank franchises are likely to find numerous acquisition targets among the current group of small competitors. Acquirers, incidentally should focus on deposits rather than assets; any institution with capital that simply wants to lend has a ready audience among consumers and small and medium business, all which have seen borrowing options narrow considerably.

The key to managing the risk presented by the inevitable next wave of new, small rivals is locking them out of their potential client base. The best community banks need to be able to give their clients the kind of loans they want regardless of the interest-rate environment—something that most de novos and converted thrifts will be unable to do. At the same time, managers also need to make sure that they wrap those clients up by tying lending to as many aspects of their banking and cash-management needs as possible. A client relationship that crosses products and touches both sides of the bank's balance sheet should serve, in effect, to increase clients' cost of moving either to smaller credit providers or back to regional or specialized lenders.

Most community bank management teams would agree with the statement that the competitors they spend the most time thinking about tend to be other community banks, regardless of their size. Paradoxically, the most important reason that the industry came under so much pressure until the last few years was competition from regionals and, in an indirect way, big national banks and specialty lenders. The massive deleveraging of the financial system has seriously curtailed the availability of the wholesale credit on which the biggest franchises relied. In most cases, the capital positions of larger institutions are so impaired that they have little room left for additional assets, even if they could fund them.

The federal government is doing its best to recapitalize the top and middle tiers of the banking industry through what arguably amounts to favoritism and public subsidy based on asset size. Unwinding the capital injections will be a long process and likely an expensive one, regardless of the merits of the ultimate policy goals. In aggregate, the number and size of national and regional franchises will continue to shrink along with their still-eroding capital bases. Healthier, if smaller, rivals will eventually emerge—rivals that at some point will again gain access to cheap, if not unlimited, wholesale funding and significant economies of scale. Rebuilding and rescaling those operations cannot happen overnight, but community banks at some point will face fierce competition from above. That means the reintroduction of rivals with the ability to make the right kind of loans at the right time while fully servicing their clients' other banking needs. The basic solution for community banks in this case is the same one I offer for dealing with the eventual reemergence of smaller rivals: Managers must attempt to increase clients' switching costs as much as possible while not giving them a reason to look elsewhere for the products they want.

## The Bargaining Power of Suppliers and Customers

The issues facing community banks in terms of bargaining power differ depending upon where on the balance sheet one focuses. Today, lenders in whatever form have the upper hand. That is an unabashed positive in regard to community banks' core business. The current financial and economic environment simply does not offer many borrowing alternatives to individuals and small and midsized companies. That should allow banks to force once price-sensitive borrowers into more productive, deeper relationships that ultimately result in higher levels of inexpensive retail funding along with loans on favorable terms for the banks that make them. A lack of bargaining power may not be as bitter a pill for the customer and supplier to swallow as it might sound. Well-run community banks currently enjoy a significant reputational advantage among financial service providers. Deposit rates and products still need to be competitive; savers have demonstrated a willingness to put their money in an insured, high-rate CD marketed by a zombie regional or a failing national franchise. Risk aversion, however, often does work in community banks' favor when it comes to deposit (input) gathering.

The story changes if one moves to the wholesale-asset–management operation that is a part of every community bank. The supplier of liabilities in this case becomes larger financial institutions, including the FHLBs and the money center banks. Nationwide and regional banks have pulled back from retail lending, and many of their downstream regional and even community bank borrowers face similar issues of not enough capital and too many bad loans and investments. Community banks have little bargaining power in this case, regardless of whether one is talking about a fed funds line, repo, or an advance from the FHLB. Community banks have always been price takers in the wholesale funding market, but seldom have supply constraints made such a pronounced difference in the ability to secure wholesale funding. The situation regarding brokered CDs is better. High-quality community banks, regardless of the broader environment, seldom have difficulty placing time deposits. Regulators effectively place limits on that source of funding, however, and analysts often interpret heavy reliance on brokered CDs as a sign of weakness. Constraints on the supply of wholesale funding, which peaked from mid-2007 through 2009, clearly demonstrated just how important building a stable base of core deposits should be for community banks.

The implications of the financial crisis are more positive for community banks' wholesale investments, at least in terms of new purchases (which one can think about as additional production of credit). Community banks, along with all investors with cash to spend when liquidity is at a premium in the debt markets, have enjoyed increased bargaining power versus the suppliers of wholesale assets. In a broad sense, yields and yield spreads of even on-the-run sectors depend heavily on the supply of and demand for particular products. An appetite for taking risk is slowly returning to the bond markets, as evidenced by the dramatic recovery in the whole-loan collateralized mortgage obligation (CMO) market and a sharp reduction in the Treasury to Eurodollar (TED) spread. The TED spread fell by more than 90 percent from October 2008 through the beginning of August 2009. Whole-loan CMO pricing increased at a clip of five points per week shortly after the Treasury announced the eligibility of legacy whole-loan CMOs for the Public–Private Investment Program (PPIP). Clearly, many investors and lenders have become more comfortable since the darkest days of the financial crisis.

Even the smartest people tend to have short memories when things appear to be going well, and no manager should forget the absolute rejection of risk that led to a run on U.S. Treasuries, negative short-term rates, and long-term government bond yields that fell to their lowest levels since the 1950s. Treasuries typically make up a small percentage of community banks' investment portfolios, so the immediate, direct implication of low Treasury yields per se was minor. The yields of spread products such as mortgages and loans did not decline nearly as dramatically—at least until the Fed and Treasury began directly purchasing mortgage and agency mortgage-backed securities (MBSs) and debentures. Sharply lower interest rates have had a direct effect on the retail portion of community banks' businesses. Floating-rate lending has become less profitable to the extent that the yields of loans tied to floating-rate benchmarks have fallen even faster than retail funding (input) costs, a state of affairs that applies primarily to loans that banks made before the extent of the current crisis became apparent. Interest-rate floors and higher yield spreads written into newer loan agreements have mitigated that pressure on margins to some extent. The ability of lenders (suppliers of credit) to set favorable terms with their borrowers (buyers of that credit) has improved.

With more investors willing to take on some measure of risk, various financing programs from the Fed and the Treasury, and direct government purchases of MBSs and agency debt, the yields of on-the-run wholesale fixed-income product and the London interbank offered rate (LIBOR) swaps curve that they price off of did eventually follow Treasury rates lower. A few remain, most notably troubled sectors such as collateralized-debt obligations (CDOs). But absolute yields are a secondary concern when thinking about the wholesale portion of community banks' business. Spreads between the wholesale assets that community banks tend to buy, like agency MBS, and wholesale liabilities in many cases widened to favorable levels—when suppliers such as the FHLB make that wholesale funding available. The situation became even more pronounced when one compared the purchase of wholesale assets, an output in this framework, to the input of retail liabilities.

If wide yield spreads on bonds had a potentially negative implication for community banks' current investment holdings, then it has a positive one for the profitability of their wholesale business going forward. Lower-credit-risk fixed-income products producing high-yield spreads as compared to funding costs will likely turn out to be long-term state of affairs, especially when direct government purchases of secondary bonds ends. Why? The answer is less global appetite for risk. The supply of securitized product has fallen, but the general decrease in the leverage of the financial system as a whole and the contraction—and even disappearance—of some of Wall Street's biggest, most highly leveraged balance sheets cut the capacity to hold that product even more severely.

The implication for community banks is that the wholesale portions of their business, although of secondary strategic important to management and of even less consideration for investors, should become less of a drag on overall profitability. Community banks, of course, still need to find wholesale funding in reasonable volume and at reasonable levels. Better yet, managers should substitute retail for wholesale liabilities. Wide wholesale-asset spreads tend to affect community banks' smaller and larger competitors in a similar fashion—if not to a similar degree—and therefore confer no major strategic advantage to community banks except to the extent that (1) they hold fewer troubled wholesale assets than their competitors, and (2) they develop the ability to fund more of their wholesale-investment–management business with retail deposits.

## The Threat of New Products

The threat of new products is an interesting issue when applied to banking and financial services in the wake of the housing crash and subsequent recession. Financial innovation ran at a breakneck pace until 2007. It created new products, the means to finance them, and, more important, new ways to remove the associated risk from the originators' balance sheets. A renewed, if limited, appetite for risk taking, both among borrowers and in the global investment community, emerged in 2009, but the days of interest-only, single-family mortgages with optional payments and a forty-year term are over for now. Years will pass before funding long-term assets with potentially skittish overnight money again becomes a widely acceptable practice. Investors in securitized products are going to force originators to keep a lot more risk on their balance sheets once securitization becomes broadly available. Permanently less leverage in the financial system and a sharpened investor focus on the credit quality of the assets that underlie future securitizations imply two outcomes: (1) What is left of Wall Street will place a heavier emphasis on the on-the-run wholesale products that community banks know best, and (2) community banks will have an increasingly important role as the ultimate buyers of those products.

Community banks' competitive advantage is temporary, but clear steps exist to make the return of competitors more difficult by increasing the strength of client relationships as well as to limit the bargaining power of suppliers and customers by increasing switching costs. Financial innovation has slowed and, arguably, even stopped in many sectors. Community banks have become a more important outlet for the simpler financial products that remain, with the implication that the investment banks that structure those products increasingly will have to take community bank preferences into account.

## Has the Community Banking Model Changed?

The previous section employs a very simple model of the community bank. Does a different macroenvironment mean that the industry's model has changed? Yes. The new position of community banks in the national economy could be similar to the central place that community thrifts held in the housing-finance system before mortgages truly became a national market. It will be a temporary position, though, unless the primary focus of the community bank becomes deposit gathering and retention. Hometown thrifts all but disappeared as the result of partial deregulation, poor risk management (both in terms of credit and interest-rate risk), and the desperate bets that often followed. The situation that community banks face today is different, certainly, but the late 1980s and the early 1990s hold critical lessons that managers ignore at their peril.

Today's environmental shift has done the most damage to the largest financial institutions rather than the smallest—a change in fortune that ultimately came from market discipline rather than regulation. Community banks have taken a chair at the center of American finance, and they can hold onto it with a focus on building the right kind of relationships with their customers, partnerships with their vendors, and employing tools and balance-sheet management techniques once reserved for regional and even national rivals. If there is a lesson for community banks from the thrift debacle and the mortgage meltdown, it is the importance of forward-looking and active risk management. Good risk management allows a separation of the credit decision from the interest-rate-risk decision, and in doing so frees management to attract and retain customers that positively affect both sides of the balance sheet.

Community banks cannot manage and take advantage of change without first thinking about their long-term competitive advantage of gathering and maintaining core deposits and crafting all of their strategies around that core competency. Gone are the days of simply managing credit and being price takers on the liability side of the balance sheet. Tools such as derivatives and strategies such as loan sales allow the development of true relationship lending within a framework of maintaining interest-rate risk at acceptable levels.

## Winners and Losers

Along with the question of whether the community banking model has actually changed—the environment certainly has—a discussion about the competitive landscape should include another broad question: Which institutions will become the eventual winners? The answer must come within the context of the injection of government capital into the banking system. Washington has put itself in the position of picking winners—or at least survivors—and losers, forcing them into bankruptcy or into the arms of stronger suitors. The capital injections had two implicit purposes aside from the stated intent to boost lending, which incidentally has yet to materalize. Banks, no matter the size, cannot just turn on a spigot and make large numbers of loans in a profitable or prudent way, particularly in the midst of a deep recession. At any rate, the first of those purposes was to provide a signal to other market participants, and the second was to accelerate inevitable consolidation at a cost to equity holders in troubled institutions as opposed to the FDIC insurance fund.

Community bank managers and directors hotly debated the public's reaction to federal investment immediately after the first nine banks took down Troubled Asset Relief Program (TARP) capital in an arm-twisting session with then-Treasury Secretary Paulson. Would depositors interpret taking the capital as a sign that the capital position of a particular institution was weak? Would it give the equity markets the same queasy feeling? The immediate answer turned out to be quite the opposite. With few exceptions, investors, depositors, and borrowers interpreted TARP capital as a necessary, if not sufficient, step to signal that recipient institutions were among the elect—even for those that did not, strictly speaking, need the capital in the first place. The stock market in general and bank stocks in particular tanked and then partially recovered after the initial optimism engendered by the Treasury's capital-purchase program, but the idea of picking winners and losers still holds. The eventual winners in the small and mid cap bank space may turn out to be conspicuous holdouts such as Cullen/Frost Bankers in Texas and Capitol Federal in Kansas, both of which declined government investment, or those with the ability to pay back the investment as quickly as possible (Granted, the earliest repayments of government capital came from household names like JP Morgan and Goldman Sachs.)

The spirit, and really the letter, of the capital-purchase agreements pushed recipients toward additional lending and the modification of outstanding loans. Congress was thinking largely about single-family mortgages in both cases, no doubt. As I allude to above, that is difficult to do in any sort of timely manner. Paying attention to credit and limiting leverage surely should be the most important lessons learned from the mortgage crisis.

We will see little difference between what happens over the next five years and what happened before the housing bubble burst if federal regulators (who are now, in a roundabout way, investors in many institutions) push lending too hard and too fast: namely, throwing capital at the hottest sectors in a race to the marginal borrower without regard to credit quality. Surely regulators know that even if some members of Congress may not, and because of that I suspect that the second implicit aim of the capital injection was to give healthy institutions the wherewithal to acquire not just troubled assets, as was the case in the Resolution Trust Corporation (RTC) days, but troubled franchises before they become a burden on the FDIC insurance fund—or at least more of a burden than they would be in the case of a total failure as opposed to part of a loss-sharing transaction. An unprecedented wave of bank mergers and acquisitions (M&As) is upon us. It began among the largest institutions, and has started to hit community banks, too.

There is no way to know just how much regulatory attitudes will change over the coming months and years, even as we stand midway through the Obama administration. What I do know, however, is how many times the rules of the game changed once the government began responding to the crisis. Save Bear Stearns, in a manner of speaking, because it posed so much systemic risk, but let Lehman Brothers go because it supposedly did not. Give Goldman Sachs and Morgan Stanley banking licenses and effectively nationalize Citibank and American International Group (AIG). Shut down IndyMac Bancorp but allow Wells Fargo to buy Wachovia and its deposit franchise in a bid to become too big to fail. And so on. It has been a process in which most major decisions, with the exception of saving the automakers, were initially made by an outgoing and deeply unpopular Bush administration. But the overall response to the banking crisis has a small chance of historical vindication regardless of how it is wound down.

That new capital came into the industry at a point when bank stock prices were historically cheap, regardless of the loss forecasts and valuation metrics being used. It took some time, but sellers have become increasingly realistic about pricing. The ability of an acquirer to enter into a loss-sharing agreement with the FDIC and favorable treatment of a target's residual losses make assisted transactions possible in cases where credit issues would likely outweigh the value of a target's core deposit franchise.

*Those four factors imply that the eventual winners in the community space will be the consolidators that can manage risk and build and retain core deposits. Management teams with experience in paying the right price and successfully integrating purchased operations, whether internally developed or brought in from the outside, will have a tremendous advantage over rivals without that expertise.*

If the race will go to those community banks with facility in mergers and acquisitions, then those same institutions must also be able to effectively manage the risk of larger operations. The equity market has put a premium on low-risk balance sheets even as stocks in general have rebounded, perhaps prematurely, in anticipation of a sustained economic recovery. That investor emphasis primarily applies to credit, although it will also eventually encompass interest-rate risk as the Fed ends its unprecedented accommodations and rates begin to trend upward. One of the most valuable lessons that I have taken away from the formal study of financial risk management is the value of stress testing beyond the historical experience—whether one is looking at a bond portfolio, an options position, or an entire business operation. Hedge fund after hedge fund and regional bank after regional bank has learned that lesson the hard way. Interest-rate and currency relationships can break down. Housing prices can fall regardless of the strength of the demographic or economic arguments for a particular region. Liquidity and funding can dry up literally overnight.

With that in mind, it is worth thinking about the most important environmental changes that have taken place so far—ones that very few people (including myself) saw coming—and the implications of what the next five to ten years might hold from a macroeconomic and environmental perspective.

## The Revolution of 2008

The year 2008 will turn out to have been the pivotal point of this crisis. A complete list and analysis of the ways in which the macro-environment has changed during the housing crisis and its aftermath could fill a book itself, and there have already been a lot of them. Excluding what happened to equity valuations since that point—the swoon in stock prices really were more a symptom than a cause of the new era in community banking—we have seen . . .

### THE NATIONALIZATION OF FANNIE, FREDDIE, AND POOF! NO MORE PRIVATE SECURITIZATION

The federal government has long used both Fannie and Freddie to enact a policy of maximizing home ownership without actually putting the funds on budget to do so. Fannie and Freddie are, unfortunately, more important than ever to the housing market; along with the Federal Housing Administration (FHA) and Veterans Administration (VA), they will finance the vast majority of newly underwritten mortgages until the private label MBS and CMO markets recover. The Obama administration, as became the case with the Bush administration, appears set on regulating the agencies primarily as vehicles for trying to pull the housing market out of its slump rather than regulating them with an eye toward reducing risk at the institutions themselves. Although political pressure to stop pouring billions of dollars into nominally shareholder-owned companies will likely build, current policy goals mean larger balance sheets and more leverage, not less.

The idea of the portfolios eventually going into runoff, floated when Treasury pushed both Fannie and Freddie into receivership, no doubt still holds appeal for the largest commercial banks and the handful of big surviving thrifts. It certainly sounds good from a free-market perspective. Government subsidies, if present, should be explicit rather than implicit, and at least debt from Fannie and Freddie now carries an absolute federal guarantee through the end of 2012. The agencies have long played an outsized role in housing, especially as management dramatically increased the size of their retained portfolios in the late 1990s, and they play an even bigger role now in the context of a shrunken mortgage market. That makes the prospect of portfolio runoff and a split into several small GSEs or a separation of their portfolio and guarantee businesses less and less likely, particularly under a Democratically controlled Congress and White House.

Fannie, Freddie, and the FHA and VA having become the sole outlet for mortgage securitization (with the exception of a small residential deal done in April, 2010) carries a positive implication for community banks and thrifts.

Aside from losses in community banks' bond portfolios generated by private-label MBS and CDOs of various stripes, the shutdown of nonagency securitization has turned into a real business positive for the majority of smaller, more focused lenders, particularly in the jumbo single-family mortgage spaces and commercial real estate (CRE). Lenders that can originate and retain their own nonconforming mortgage production can more or less name their price. The availability of the product from the big national and regional lenders is just not there without the room or the appetite to keep it on their own balance sheets. Similarly, some of the fiercest competition for smaller CRE deals before the financial crisis had come indirectly from asset-backed commercial paper conduits and explicitly from inexperienced capital in the form of de novos and thrift conversions. The disappearance of the former and the sharp slowdown of the latter have improved both pricing and availability of CRE deals available to community banks. The trick for the best community banks will be turning those transactional lending opportunities into long-term profitable relationships.

The current situation of the GSEs does present a potential, if less important, negative for community banks. Explicitly becoming a part of the government's recovery plan for housing, in part by refinancing underwater borrowers, also means more credit risk in the GSEs' portfolios. More credit risk on Fannie and Freddie's balance sheets and more leverage are fundamentally bad for their bondholders, even in light of the explicit short-term federal support that followed conservatorship. The markets will likely reflect that over time through elevated funding costs for the GSEs. Nearly every community bank owns Fannie and Freddie debentures in their bond portfolios. Despite the limited advantages of holding callable and bullet agencies versus comparable products such as MBS, banks and money managers around the world will likely shift their agency holdings toward more securitized product (i.e., Fannie and Freddie MBS and CMOs) and away from straight agency debt. It's always better to have assets behind a bond position than simply a promise to pay, even assets with deteriorating credit quality. Just ask holders of Fannie and Freddie preferreds.

## THE LOSS OF WALL STREET BALANCE SHEETS: WHO MOVED MY PRIMARY DEALER?

I have spent the vast majority of my career working for securities firms, so this might loom larger to me than it does to most people, but it is still difficult to overstate the importance of so many primary dealers either being merged into larger operations or disappearing completely. The restructuring of Wall Street has significantly decreased the liquidity of the secondary markets for plain vanilla products such as agency MBS and agency debentures in times of stress, and indeed it has limited the ability of the secondary bond markets to function during a crisis. Readers involved in the capital markets may recall that getting a bid on anything other than a Treasury at the end of 2008's third quarter was functionally impossible. That was symptomatic of Wall Street being much less willing to take on additional risk when the rest of the market wants to shed it.

One implication has been a sharp reduction in the liquidity of most banks' bond portfolios when market conditions are poor. Banks tend to buy spread products such as MBS and agencies as a balance between liquidity and earnings. Although buying Treasury bonds is something of a rarity among community bank portfolio managers, banks have increased their holdings in response both to liquidity concerns and higher rates. Banks' aggregate Treasury holdings rose more than 15 percent in the twelve months ending in August 2009, and that trend will likely continue going forward. Another implication for the markets is the increasing importance of regional dealers to banks and money managers. A handful of mid-sized dealers became primaries in 2009, but the scale of those operations is far smaller than the ones that they replace, and because of that they will have limited implications outside of the Treasury market. The disappearance of so many large balance sheets also means far fewer active players in the repo market, structured or otherwise. Repo had become an important source of funds for a number of community institutions as the FHLBs began to price advances at increasingly expensive levels, a function of the need to deleverage their own balance sheets and the higher-term funding costs that they now face. Community banks will rely more heavily on brokered CDs as a funding source—and those are technically deposits—but building true core-deposit franchises will always be a better option.

## THE COLLAPSE OF THE CONSUMER: AN ESCALADE FOR EVERY DRIVEWAY

One can see it in auto sales, despite a temporary bump that came from Cash for Clunkers. One can see it in people reconsidering their four-dollar lattes. Consumers' reluctance to spend will get worse—probably much worse than what most economists think—before it gets better, and it will take years rather than months or quarters to do so. This is the first time since the Reagan administration that consumption will fail to lead the rest of the economy out of its slump. Incomes continue to fall across the board even if wages are rising for some workers, and home-equity lines are not available to take up the slack. Lenders facing 10-percent and 15-percent default rates on their card portfolios are not eager to increase credit limits. The labor market, the housing market, and the lack of credit availability are all feeding into one another, creating a negative feedback mechanism that even massive fiscal stimulus may do little to reverse in a timely fashion. The downward spiral will not stop until the housing market levels out through significantly lower prices and the labor market stabilizes. That may happen in 2010, but it most likely will not. Further, the economy cannot actually begin a path toward sustainable growth until the banking system returns to health—in large part through consolidation—and credit expands.

## THE COLLAPSE OF THE HOUSING MARKET: JINGLE MAIL, JINGLE MAIL, JINGLE ALL THE WAY

Broadly defined, the collapse of the housing market was the root cause of every other problem the economy and the markets have faced during this crisis. Its problems did not manifest themselves all at once. Indiscriminate lending and, in more than a few instances, fraud drove the bubble and then the bust. The damage is done, though, and the economy will not enter into a sustained expansion until housing prices fall far enough to clear the current inventory with whatever credit is available in the mortgage market. Prices fell by about 15 percent in 2008; despite some signs of life in the housing market in some areas of the country, it certainly does not feel like we are close to a bottom as of early 2010. How much farther do they have to fall, and how long will it take? A good analysis from the Milken Institute sets the long-term average rent-to-price ratio for houses in the United States at about 5 percent, which implies that home prices should stabilize at around 2006 levels. Things seemed more than a little frothy even then, to be honest. The bottom may be farther away than what many of us think.

Taking 2006 as a baseline, a simple extrapolation of the current national trend in the rent-to-price ratio puts the bottom sometime during the second half of 2011. That is similar to the baseline projections that at least two big dealers use in forecasting defaults and severities of whole-loan mortgage deals. One could say those projections are where the rubber meets the road in terms of putting dollars at risk as opposed to simply being abstract economic forecasts. If 2011 does not seem too far off, then keep in mind three things: (1) Prices will very likely continue to fall beyond 2011 in areas with the largest inventories of unsold homes and most fundamental imbalances such as Florida, Southern California, and Nevada; (2) rents in most markets are falling, which implies lower fair-value home prices for a given rent-to-price ratio; and (3) the housing market may well overshoot to the downside—that is, push prices below the point where one could argue that the housing stock is fairly valued, not cheap. Given the performance of equities over the past couple of years, that is a bet I would be reluctant to take.

## A Look Forward

Most of the developments above were unthinkable except by the best and boldest economists, analysts, managers, and investors. The rest of us certainly wish we had asked ourselves, "What happens to my operation or to my investments if people decide to just walk away from their homes?" or "What if global liquidity dries up for an extended period of time?" Just because we failed to do that two or three years ago doesn't mean that we cannot go through the same exercise now. Here, then, is a forward look at the world over the next five to ten years along with key implications. The thought behind the exercise is that scenario analysis helps manage risk, regardless of any specific outcome's likelihood.

## CONSOLIDATION AND LESS COMPETITION FOR COMMUNITY BANKS FROM LARGER INSTITUTIONS

This is a key idea, and it will be an unabashed positive for the survivors in the community banks' space—for a time. Client relationships are there for the picking. It also implies that the best community banks will be larger in terms of assets and will have to offer a broader array of products than many do now. The use of derivatives for client development and for interest-rate risk management is a prime example of community bank management teams having to follow more sophisticated strategies in order to cement temporary market advantages.

## SIGNIFICANTLY IMPROVED LIABILITY PRICING

Improvements in liability pricing already is a positive for community banks, but one that carries a significant amount of risk in terms of timing. Perhaps the most pressing problem on the liability side for community banks has been competition from the remaining deeply troubled regional franchises—the zombie banks—all of which arguably have priced time deposits uneconomically in a bid for survival. Some have either been taken over or taken out by stronger players. The consolidation at the top of the industry is by no means over, though, and the trend will affect community banks regardless of their ownership structure. Similarly, many community banks had experienced a push from the bottom, with *de novos* and converted thrifts following an aggressive pricing strategy in the name of balance-sheet growth. That pressure will begin again as equity valuations continue to improve. Established community banks will likely find that buying branches or entire institutions has become less expensive than building out new markets—just as it is cheaper to buy an existing house than build a new one.

That consolidation will take time, and a pending merger-and-acquisition wave does not absolve community bank management teams from actively trying to improve their existing deposit mix in hopes of picking up new liabilities on the cheap through purchase transactions. The goal of long-term value creation dictates a focus on decreasing dependence on single-product time depositors and toward true relationship lending, helping to drive the creation of new core deposits.

## MORE BIG FAILURES

What if, in two or three year's time, more big regionals go under or a big national franchise fails? It could happen. The capital injection equal to 3 percent of risk-weighted assets in the first round of the program does not even begin to cover many institutions' mortgage, CDO, and residential exposure, as evidenced by Citigroup. Commercial real estate will suffer further as the economy moves in and out of recession for an extended period of time, as will credit-card portfolios. In many cases, troubled banks will be unable to earn their way out of their credit problems. Additional large failures certainly would present more opportunities for community banks to take away lending and deposit business from bigger players. But a drawn-out recovery of regional and national lenders would also mean an extended period of predatory CD pricing by the zombies. That is all the more reason for community banks to focus on their liability mixes even though the yield curve is steep and short CDs and MMDAs are inexpensive.

## A RECESSION DEEPER THAN THE EARLY 1980s

A massive recession is a problem with little upside for any bank, large or small, from the standpoint of credit. Although the macroeconomic consequence of helping to keep inflation under control could arguably become a long-term positive, the costs of getting there are immense, and the benefit uncertain in the face of massive fiscal and monetary stimulus. Even mild slowdowns in the national economy have resulted in significantly worse performance in both the consumer and commercial loan books of community banks and their competitors. Maintaining lending standards will become even more important than it has been up to this point. Community banks are positioned to take a bigger piece of a shrinking pie, and even though many good credits are looking for new lenders, many managers may find that maintaining standards is challenging as the total volume of available lending opportunities falls.

## HOUSING PRICES FAIL TO RISE

Prices could simply bottom and stay flat out for five or ten years. It has happened before: in the mid-1920s through the mid-1930s, in the late 1950s through the mid-1960s, and most recently in the early 1990s. This scenario means an even slower recovery from the current recession and no recovery in overall mortgage volume from current levels. Community banks may eventually find that taking jumbo mortgage business away from troubled national players is not enough to keep pipelines at reasonable levels.

## THE SECURITIZATION ENGINE FAILS TO RESTART

The longer it takes investors' appetites for securitized products outside of agency mortgages to come back, the deeper the denationalization of the credit markets becomes. That will help the competitive position of community banks, but it also means less credit available in aggregate, slower overall economic growth, and fewer lending opportunities.

## THE TREASURY EFFECTIVELY BECOMES AN ACTIVIST SHAREHOLDER

The Treasury is here to stay not only in the most troubled institutions but also in any institution that has accepted TARP capital.

The government cannot put its own guys on capital recipients' boards unless they miss six payments on the senior preferreds. This is something that a handful of banks that have suspended preferred dividends look like they are on their way toward doing. But either way the feds certainly can influence what those management teams do and how they do it in the meantime. This possibility would mean Community Reinvestment Act on steroids—coercion through regulation—and pressure for boosting loan modifications, cram downs, and subprime and nonprime mortgage lending in particular at a time when maintaining credit standards is already of the utmost importance. Capital recipients are not the only institutions at risk, but they will be the first targets. Extinguishing the Treasury's senior preferreds, even with more expensive private equity, would likely be preferable to this indirect shareholder activism.

## CROWDING OUT BY THE TREASURY

Warren Buffett called the late 2008 run-up in Treasury prices a bubble unto itself driven by risk aversion. I would tend to characterize bubbles as driven by greed rather than fear, but he is a lot smarter guy than I am and everyone knows how this one is going to play out, if not when: Benchmark yields are going to rise, perhaps sharply. Simple oversupply of Treasuries could turn out to be the cause, regardless of the prospects for overall growth or inflation. At the most basic level, crowding out comes from the idea that global savers make a finite amount of credit available. Government bond rates can rise if the federal government borrows too much of that credit, and interest costs go up for everyone. Crowding out under that narrow definition does not seem to have proven true in practice as the federal debt has risen over the past nine years, largely because massive trade deficits force overseas investors and central banks to do something with all of those dollars we send overseas. That something has often turned out to be buying Treasuries and U.S. agencies, but the appetite may diminish. The idea of a limited amount of global credit sounded far-fetched until the current crisis. A tremendous amount of Treasury issuance has already hit the bond markets, both from outright stimulus and what may become a TARP II as more banks own up to the depth of their credit problems and troubled industries besides autos and banks fight for a place on the list of Critical Industries That Must Not Fail.

One problem that borrowers face in the meantime is that the Treasury yield curve is not a realistic liability curve for any borrower except the federal government. The swap curve and corporate curves are better measures of private-sector borrowing costs. The breakdowns of the commercial paper and interbank lending markets in 2008 coupled with sometimes negative interest rates in the Treasury bill market demonstrate that the government's ability to borrow at rock-bottom rates does not matter all that much to the private sector. A more traditional relationship between public and private interest rates has since reasserted itself, in large part through the Fed's quantitative easing program. If the Treasury finds itself in the position of overestimating the demand for new paper, the benchmark markets could force rates sharply higher, and private-sector borrowing costs would no doubt follow. Swap spreads have occasionally moved negative as the financial system has recovered, but not by large amounts.

Higher borrowing costs across the board would be something of a double-edged sword for community banks. In the scenario of the Fed keeping target rates low coupled with significantly higher private-sector interest rates—that has already happened once during this crisis—higher floating rates on commercial and home loans priced off of a short-term LIBOR rate and not off of prime would partially offset more expensive time and MMDA deposit costs. The majority of community bank commercial (and home-equity) lending is based off of prime, however. One course of action to head off what is in effect massive basis risk between interest rates set in the course of policy making and those set in the marketplace would be for community banks to shift a portion of their loan books toward a market rate like three month LIBOR rather than prime. Policymakers, at least in the post-Volcker era, have tended to err on the side of promoting growth rather than stemming potential inflationary pressures, implying that fed funds targets and by extension prime will often price short-term credit more cheaply than the market.

## A PROLONGED PERIOD OF STAGFLATION DRIVEN BY SKYROCKETING ENERGY COSTS AND PERMANENTLY HIGHER TAX RATES

Oil and gas have gotten cheap again, but the economic situation of the 1970s still feels uncomfortably close. A contracting labor market tends to temper overall inflation, and the prospects for growing employment seem dim even as signs of economic improvement come into view. But prolonged periods of negative real fed funds targets inevitably result in rising prices, whether for goods as evidenced by inflation or in the form of an asset bubble. Tech, housing, energy, and commodities bubbles have all come and gone over the past fifteen years. Energy and commodities, the last bubbles, have subsided for the moment but could easily reinflate as credit conditions ease and speculators reenter the markets. Broadly speaking, an asset-sensitive bank will fare better in an environment where goods (as opposed to asset) prices are rising as the nominal cost of liabilities rise. Slower economic growth also implies fewer creditworthy borrowers.

## Where, Incidentally, Is the Next Bubble Going to Be If Not in Goods Prices?

Two ways to think about a bubble are (1) as a market move driven by vastly inflated prospects for future demand, sometimes coupled with forecasts of limited supply, or (2) simply as equity price appreciation in the presence of illusory earnings. Too much leverage usually fuels these ultimately unwarranted booms. The reader may remember reading equity analysts' reports in the late 1990s about valuing the number of clicks on a website as opposed to actual revenue. Many financial institutions have lost more in the current downturn than they made over the previous decade. Talk about illusory earnings. The last set of bubbles moved in rapid succession from tech to housing to financials to commodities and energy. Putting aside the idea of a flight to safety driving a sort of bubble in the government bond market, perhaps the next overvalued asset class will be anything connected with alternative energy—once the appetite for risk reappears in a sustained fashion. Tapping reserves of petroleum that rely on very high energy prices, such as oil sands, have already slowed considerably after being touted as the new hot thing for petroleum producers. Strictly speaking, oil sands are a new source of conventional energy, but the rapid move from headline to footnote was symptomatic of what may ultimately face industries such as biofuel or wind and solar power. Alternative energy is a great idea in the abstract with a lot of long-term growth potential but one that ultimately relies on the price of oil, which can move downward just as sharply as it can move up, for its long-term viability.

With a broad, sort of sci-fi look ahead out of the way, a look back at three past credit crises is instructive and perhaps more concrete.

Along with a subsequent look at valuations, the following survey should provide an idea of where the equity markets and active acquirers tend to find value in community banks over time as well as guidance in terms of how community banks can position themselves for the inevitable recovery in bank stocks—no matter how far down the road that turns out to be.