IN THE SHADOW OF TOO-BIG-TO-FAIL BANKS:
Finding Green Shoots for Community Banks

Remarks by

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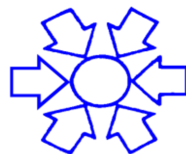

It is a great pleasure to be here in one of my most favorite parts of the country. Neither dark of night nor rain, snow and sleet can dim the majesty of the Sound, the mountains and Seattle's magnificent surroundings. In fact, I'll bet that many of you wish you had been looking out the window and contemplating these wonders instead of working so hard over the past few years. Banking has been anything but fun of late, but banking in the Pacific Northwest has been a real challenge. Although often overlooked in the calamity gripping a large state to the south, Washington State has had a remarkable number of failed and very-troubled insured depositories and may even lead the nation in supervisory enforcement actions.

So, what to do now? In the midst of the debris, is there a future for your banks? How will they stand on their own, especially given the huge, dark shadow cast by too-big-to-fail banks that are exerting growing dominance despite work under way in Washington to cut them down to size?

I see strong prospects for small and mid-sized banks – by which I mean insured depositories and holding companies with up to $10 billion in assets. However, this doesn't mean these institutions can go back to business as it was once the current crisis – at long last – concludes. New capital requirements, obstacles to asset securitization, new fee limits and – at least for a while – the unforgiving glare of regulators, customers and the public as a whole have changed the business model.

What I'll do this morning is discuss each of these issues and outline some strategic options to consider in response. None of them is easy, but many of them will, I think, be good ways to enhance the franchise value of your banks and ensure a viable business model despite all the pressures that may now seem so insurmountable. I'll draw a lot of lessons from retailing because I think the business model that defines successful stores that beat the big boxes also applies to community banking, even with all the regulation unique to banking.

The Capital Kicker

As you all know, Congress is working on legislation that will require a tough new capital regime for too-big-to-fail (TBTF) banks. The legislation is of course complex and controversial but, even if it doesn't advance, I expect the FRB to mandate a capital kicker for the biggest BHCs. This is part of a broader plan that – with or without statutory change – will over time force TBTF banks to review their business model and break themselves apart. Even when they do, though, they'll remain formidable competitors for smaller institutions because nothing now could bring banking back to the way it was a decade or so ago. Even then, of course, big banks were significant competitive challenges, but market forces left more than enough grass for everyone in the pasture. Now, the pickings are lean and they're not going to get a lot more generous even with systemic-risk reform.

One reason for my pessimistic view of the new competitive landscape is the emerging capital regime. This won't just affect TBTF banks – it will matter to each of your institutions as well. I know most small banks already maintain regulatory-capital ratios above those permitted big banks and many of you do very well despite this. However, this capital disparity was better tolerated when small-bank investors were small-town investors – most of the nation's smaller institutions are very closely held. Long-time investors, especially insiders, accepted rates of return at which private equity sneers and that was fine up to the point at which small banks needed capital from these same PE firms.

With capital depleted at many community banks and – at the same time – rising capital requirements, there's a growing capital hole at many banks and no clear way to fill it fast. I know many of you have solicited outside investors and some of you have found them. More power to you, of course, but I think you'll confirm that raising capital now and for the foreseeable future isn't easy. I'll turn to some options in a moment, but let me first finish a short discussion of the remaining challenges I see.

Shutting the Secondary Market

Almost ten years ago, I gave a talk to another group of community-bank executives on strategic challenges. Then, I looked at the increasing divide in financial markets between value-added products where knowing the customer is an advantage and commoditized ones, where it doesn't much matter. I said then and time has proven that the more a market is commoditized, the less of a role community banks play in it.

Case one is, of course, the residential-mortgage market which has become increasingly commoditized as the GSEs altered pricing to control the conventional conforming market. Regulatory lapses permitted big originators then to do the same with the non-conforming market, essentially pushing community banks out of the market. To be sure, small and mid-sized banks continue to originate for Fannie, Freddie, Ginnie and – if there were one – the private-label market. But, none of you makes much money at it, leading to the temptations to which all too many mid-sized banks succumbed in the non-conventional, non-conforming arena.

Commoditized secondary-mortgage markets will continue to provide community banks with new fee income – not as much as big originators, but at least something. However, there are several challenges to the mortgage secondary market that will also chill other venues into which your banks can off-load assets. These include:

- new FASB rules that require consolidation for many securitization-related positions. Regulators are considering the capital impact of this change, but I think banks will need to hold capital for a lot of this now and all of it down the road. This will moot much of the benefit of many securitizations;

- FDIC rights in receivership. If the FASB-related capital rules don't get you, a new rule from the FDIC will. The agency will exert potential claim to collateral in ABS, significantly complicating securitization, especially from troubled banks; and

- risk-retention legislation. Topping all this off, Congress is working on legislation to mandate a ten percent risk-retention requirement. The bill's fate is uncertain and it could apply only to securitizers, not originators. But, until we know what it does, it also casts a deep chill on ABS.

Is this all bad news for community banks? I don't think so. The problems for ABS are conversely opportunity for portfolio lenders, something each of your banks is good at. While residential mortgages will likely become even more commoditized as a result of these changes, other loan types – mid-sized corporates and auto financing, for example – could return to a more traditional banking model.

Fretting over Fees

And, that's a good thing. In recent years, many community bankers made two mistakes at the same time. First, as traditional quality loans dried up, they went big into non-traditional, risky commercial real estate activities. Second, revenue became increasingly dependent on fees, especially overdraft charges.

As you know, the FRB has just issued a final rule imposing significant new restrictions on overdraft fees. Congress is also at work on still tougher legislation, a bill that stands a very good chance of passing. As with the new credit-card law, community-bank friends in the GOP aren't especially forgiving of any practice that rubs constituents the wrong way. Overdraft fees are now top of the list and major cut-backs are thus in the works. You might have a few more months to collect big fees, but that'll be it and, even then, the charges will exacerbate ill-feeling in Congress, at the regulators and – most important – with consumers.

Many of you can and will replace overdraft fees with new checking ones. However, in part because of the response to overdraft fees, the spotlight will be on the banking industry. If these fees are seen as opportunistic and predatory, the hammer will come down fast and hard. As a result, I think your banks will be able to offset lost overdraft fees to some extent, but not in whole. This will significantly affect profit, of course, especially in the current, tough environment.

The Value-Added Store

Let me quickly summarize the three major strategic drivers I've discussed: capital will go up, secondary market relief is limited and fee revenue will be choked. What's the good news?

First, as I mentioned, the pressures aren't unique to community bank. As a result, more quality loan business will come back to small and mid-sized banks, permitting a modest resumption of traditional, high-quality portfolio lending. That's good, but I doubt it's good enough to ensure really robust community-bank franchises going forward.

The real answer, I think, is a hard look at what each of you is really good at. That's knowing your community and your customers. If you add service to this knowledge, you have a formidable business model.

The late, lamented WaMU made a lot of its "store" model for retail banking. I think it's actually a great idea as long as you don't use the store-front to peddle garbage, as WaMU did all too often. If you take the retail model and consider it in the community-bank context, significant opportunities arise.

What are they? Let me call it the value-added store. You all know lots of local retailers that compete against giant competitors because they offer something the big-box stores don't. It's usually a combination of service, unique product and the ability to deliver goods that aren't readily susceptible to commoditization. How does this apply to community banking? Your customer knowledge gives you tremendous opportunity at the low, middle and high end of the market:

- For under-served, underbanked consumers, you can provide needed services – counseling, second-language services and easy banking products. You can and should charge for most of these services so you can and will make money from them. Several banks have shown the way here, but the first step is for community banks to take the lower-income end of the market and see it as opportunity, not a market segment to be tolerated solely because CRA makes you do something for it.

- For middle-income consumers, you can fill targeted financial needs. If the residential mortgage is gone, so be it and, if overdraft income plummets, thus it is. Still, average consumers need a lot of individualized advice – retirement and college savings, credit advice and so forth. You offer some of these products and can work with third-party vendors on others, but you are a great source of trusted advice for all of them.

- Wealthier customers need a lot more than they get from asset managers up to the very highest end of this market spectrum. Before you get there, though, customers need asset-management advice, real-estate guidance and many other services only a few large banks provide well. Packaging what you do with what higher-end customers need can provide tremendous cross-selling opportunities, especially if product offerings are broadened to meet investor need. This is a small market segment and, perhaps non-existent in many of your communities. But, where it exists, it's very under-served.

The Next Step

Getting to the value-added store model won't be easy because of the challenges I've outlined and others – problems in the Home Loan Bank system, for example – that are also pressing each of you today. However, I've seen the bright light at the end of the tunnel as daylight for each of your banks, not the train many of you fear it could be.