

## Earnings Challenges, Compliance Burden to Define Community Banking in 2012, Experts Say

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Dodd-Frank implementation, more bank failures, FDIC lawsuits. Most bankers won't remember 2011 fondly. But what is in store for community banks in 2012? Can community bankers look forward to easier access to capital, better profit margins, or a way out of bad CRE credit purgatory? In short, will things get better?

We surveyed a broad swath of industry observers, from regulatory attorneys to CRE workout specialists and board chairs for their 2012 predictions. And the results aren't particularly sanguine. If the community banking business does get better in 2012, it will only happen after working through a long list of thorny challenges, our experts say.

Compliance costs are bad and getting worse for community bankers who, thanks to their smaller staffs, won't have the capacity to absorb all the new compliance challenges rolling out of Washington. All that plus continued poor earnings, market challenges and another year of CRE credit malaise add up to another year community bankers might just as soon forget before it starts, experts say.

### M&A

Slimming margins plus rising compliance plus hard-to-come-by capital equals insane consolidation, right? That's the equation industry watchers have pointed to when predicting a giant wave of M&A activity on the horizon. That prediction may turn out to be true, but our experts don't see it happening in 2012.

"I do think we will see increased M&A activity in 2012 but perhaps not the frenzied level predicted by some pundits," says Chet Fenimore, a managing partner with Fenimore, Kay & Harrison LLP, Austin, Texas. "The successful banks will have a war chest of capital and take advantage of the opportunities created by the market disruption over the last several years. The losers will maintain a status quo strategy and not revamp their business models to conform to the 'new normal.' Successful banks will enhance corporate governance practices and focus on improving enterprise risk management practices."

Any significant M&A activity will depend on conditions being just right, adds Marcus Faust, SVP of ERM with RP Financial, Alexandria, Va.

"I think that the big question mark for 2012 will be whether or not the long anticipated M&A wave will occur," Faust says. "There was anticipation in 2010

that 2011 would be the year, but with the market volatility and additional decline in bank stock valuations during the year, the 2011 M&A wave never occurred. For it to occur in 2012, we need to see some market stability and improvement in valuation of bank stocks to give would be acquirers more confidence and a currency that they can use to shop.”

## **Risk Management**

A lot of banks have made great improvements in risk management in the last few years, but there are some areas in which they’ll still need to improve in 2012, says Eric Holmquist, an ERM Consultant and Managing Director with Accume Partners, New York, N.Y.

“Some areas [of risk management] have achieved a certain level of maturity – notably within credit and market risk,” he says. “In other areas, such as enterprise and operational risk, banks still have much room for improvement. Risk programs are still largely segmented by risk type and the next level of maturity involves moving to a more holistic, enterprise-wide view of risk. This will enable much better connecting points between strategy and risk alignment rather than trying to define risk by type.”

## **Compliance and Dodd-Frank**

As practically everyone in the industry has noticed, the cost of compliance has gone up and it will have a big impact on banking operations in 2012.

“The cost of compliance, and the risks presented by compliance, are real, and are bigger than ever,” says Mark Kanaly, a partner with Alston & Bird LLP, Atlanta. “This has become a real hot button with the FDIC, and the forward momentum on this front is going to continue to heighten the need to be in front of this issue.”

Not only are banks facing more compliance issues, but they’re also seeing harsher penalties for compliance violations, says Peter Weinstock, a partner with Hunton & Williams, LLP in Dallas. More compliance and stiffer regulatory penalties will magnify one another, like a feedback loop in 2012, he adds.

“Compliance is the earthquake that keeps shaking the banking industry,” says Peter Weinstock, “The bank regulators have been seeking enforcement penalties for matters that previously warranted a ‘fix it for next time’ response by examiners. The penalties, costs of responding and reputational harm are exponentially worse than any damages attributable to the violation.”

The arrival of the Consumer Financial Protection Bureau (CFPB) will only intensify the compliance blitzkrieg, he says.

“The earthquake appears to keep rumbling up the Richter Scale now that the Consumer Financial Protection Bureau, with its virtually unlimited budget, is taking the reins on compliance issues,” he adds. “Community banks that thought they had dodged the breaking of the dishes when Dodd-Frank was negotiated now feel as if even the fine china is vulnerable.”

“Dodd-Frank is likely the tipping point for small community banks,” adds Ralph Dowling, a consultant with Dowling & Co. Consultants and a bank turn-around specialist. “It will severely impact their ability to make small loans while adding substantially to their compliance cost.”

Thanks to spiking compliance and the CFPB, the performance gap between big banks and community banks will only widen next year, predicts Jeff Worthan, a partner with Katten Muchin Rosenman LLP in Washington, D.C.

“Most bankers feel that the avalanche of regulations and guidance flowing and yet to flow from Dodd-Frank is unmanageable, but for small banks, the problem will be particularly troublesome,” he says. “They simply do not have the resources to cope with the avalanche. The best they can do is leverage off of their trade groups’ resources and, when that may not be enough, use good common sense regarding when to bring in outside legal or consulting help. For the big shops, the good news is that they have internal legal staffs that can be of great value if used wisely.”

Bigger banks with in-house general counsels may be better equipped to handle Dodd-Frank, but the law will swamp everyone in 2012. Big banks will need to significantly increase compliance budgets, too, Worthan adds.

“General counsels need to be able to accurately assess the strengths and weaknesses of their staff,” he says. “They should not be afraid to tell their CEO and their directors to increase their budgets given the unprecedented amount of new regulations coming out of DC as a result of DF, and hire or bring in the right professionals when they feel they are overwhelmed. And most general counsels that I know do feel overwhelmed right now.”

One issue all bankers need to mind, no matter how big their compliance staff, is the regulators’ new focus on abusive consumer practices. This will be an issue for banks early in 2012, Worthan predicts.

“In the old days, safety and soundness issues were paramount,” he says. “While still very important, consumerism now shares the spotlight. This is especially

important for shops offering cutting edge products such as pre-paid cards, mobile cards, and new and innovative credit products, especially to the unbanked, but it is also important to the plain-vanilla bank that offers overdraft protection. The agencies also have a new weapon that is as of yet untested, but ready to be deployed; the brand new ‘abusive’ standard, which will be added to the older concepts of ‘unfair’ and ‘deceptive.’ If banks have any concerns about their credit products, they would be smart to get help now, before their next examination.”

## **D&O**

Whenever the FDIC plans lawsuits against bank officers and directors, it puts D&O insurance in the spotlight. Banks should be thinking hard about this issue in 2012, says Hal Reichwald, a partner with Manatt, Phelps & Phillips, LLP, Los Angeles.

“Inasmuch as there continues to be a focus by the FDIC on pursuing former bank officers and directors of failed banks, there will be further attention paid to the adequacy of D&O insurance and the application of exclusionary terms and conditions,” he says. “The insurance industry is likely to begin offering new products at additional cost to cover the risk of investigations and litigation.”

## **TARP**

A number of small community banks find themselves burdened with TARP funding years after taking it. Those facing 2013 TARP repricing deadlines will definitely be thinking hard about their TARP capital in 2012.

“You have the TARP banks that need to do something by 2013 to repay TARP, pay 9% when TARP reprices or sell themselves,” says RP Financial’s Faust. “They are thinking about it now and will have to start acting in 2012.”

## **CRE**

A lot of banks took an honest look at their portfolio and have been diligently working through problem CRE assets in the last few years. But, for a lot of banks, those recession-era CRE woes will still be with us in 2012.

“We’re going to see similar issues to what banks are currently facing, [and it] will drag into 2012 and probably the first 6 months of 2013, depending on election results and one party gaining majority control,” says Dan Kronlund, a bank consultant and president of Community Banking Solutions, LLC in St. Cloud, Minn. “Community banks will continue to struggle with depressed real estate

investment property loans, including, but not limited to residential subdivision developments and commercial small business rental properties retaining tenants that are struggling to survive. Landlords in small business rental properties will struggle to retain occupancy levels stable and will probably see a need to keep tenants through reduced rent amounts. Vacancies are hard to fill when new businesses aren't starting up.”

The CRE hangover will continue, with eroding bank capital and/or earnings through OREO write-downs, albeit with less intensity, he adds.

“I do believe we will start to see more banks stabilize earnings at a much lower level than in past heyday years, but the banks that started the clean up process early on in this down cycle are not going to have large loan losses and reserve requirements,” he says. “Accordingly, the numbers of new problem banks should start declining at a reasonable pace in 2012.”

## **Politics**

Businesses and consumers are waiting on the federal government to work out their seemingly intractable differences on a whole host of issues that impact budgets and wallets. And the 2012 elections will bring to power or preserve in power one of two parties with diverging views on taxation, deficits and federal spending. No one likes uncertainty, but thanks to Washington politics, we'll be swimming in it, and that will put a real drag on the recovery, experts say.

“Political and economic uncertainty will continue to slow a real recovery and 2012 could be another year of waiting that out,” says Alston & Bird's Kanaly.

And that waiting will have a negative impact on community banks, adds Kronlund.

“I believe community banks will continue to struggle with growth in earning assets until the government fixes the excessive debt problem, settles on tax rates, deductions, and thus allows small businesses to plan for the future knowing tax costs, medical costs, etc.,” he says. “This election year will probably be a real bear on all industries.”

## **Getting by in a tough market**

Though most losses have been wrung out of loan portfolios over the last three years, a sustained poor, or worsening, economy could cause additional write-downs woes. Moreover, many lenders are still gun shy; they are asking themselves whether it is smart to be lending into the wind of a still rocky

economy. For those shops that have thin capital and a poor local economy, balance sheet management, including capital raising, will be key.

The industry will face a litany of operational challenges in 2012, says Chet Fenimore, a managing partner with Fenimore, Kay & Harrison LLP, Austin, Texas. On the revenue side, those challenges will be in the net interest margin and loss of traditional non-interest income sources. On the expense side, banks will have trouble managing increasing cost, attracting and retaining human talent and embracing technology changes that will drive efficiencies and further enhance the customer experience and reduce customer attrition. It's a lesson bankers could learn from Steve Jobs, he adds.

In short, the market will simply demand better strategy and skill from banks in 2012, Fenimore says.

“Bankers need to understand the importance of scale in their business models and look at right-sizing their franchise, both from a brick and mortar standpoint as well as FTEs. The key to surviving and thriving will be ‘knowledge’ and understanding the evolving nature of the industry and being smarter than the competition.”

The sad truth is, some community banks just won't be up to this challenge – in 2012 or ever, says Pat Dalrymple, a bank workout consultant with Western Colo-based BancReps and a former CEO.

Banks that entered the recession with capital cushions – what was at the time considered excess capital – are slowly returning to health, Dalrymple says. “Their problem assets are not increasing in value, but, generally, they appear to have stopped decreasing. What has increased is management's awareness that the sick assets are very sick, as compared to their healthy profile, and are not going to get better in the immediate future. Thus, bullets are being bitten and losses charged to capital.”

The situation is considerably different for those community banks that didn't have the foresight (or good fortune) to enter the recession with enough capital to counterbalance their problem assets, Dalrymple adds.

“There are still a lot of small and medium-sized institutions that can't get better, and every quarter sees capital dwindling,” he says. “Three years ago, the boards and management of these banks figured that, push comes to shove, they could sell at a small premium despite their problems. Then, as the ships began to take on so much water that it was evident they could sink, everybody figured that their franchises were worth so much that they could sell for book, and their

stockholders would get the benefit of remaining undivided profits, as well as get their initial investments back.”

That scenario probably won't materialize in 2012, if ever, he says. Bank net worth continued to shrink and the hopes, for many, that the bank could be sold at fire-sale prices have evaporated.

“Now, these same directors and CEO's are hoping to find somebody just to take over the business, so the FDIC doesn't shut it down, with officers and directors facing the threat of FDIC lawsuits,” he says. “But they may still be behind the curve.”

A problem that all banks face, and it's a severe one for smaller institutions, is how to make money in the new financial environment, he says. The loan assets that once were so plentiful won't be for at least a few years, and maybe more. Yet surprisingly few banks have a clear strategic plan that is attuned to current reality.

“Recently, I asked a CEO point blank: ‘Assuming that all of your problem loans are gone, what is the plan going forward?’” he says. “The banker replied that he planned on being a community bank to serve the local people and that he'd ‘probably make construction loans, since we didn't have many problems with those.’”

In other words, he plans to do what he did, but less of it once he cuts out commercial CRE loans, Dalrymple says. But it's a good bet that there won't be enough construction loans to support the bank because much less will be built over the next few years. Fewer borrowers will qualify, and everybody will be competing for the good loans.

“From what I've seen, there are some very savvy community bankers that are still wondering how to enhance that bottom line, and not coming up with very good answers,” he says.