

Community Banks Tapping the Capital Markets: Big Trend or Passing Fad?

During the first week of September, the *Wall Street Journal* published an article on community banks tapping the capital markets in ways normally limited to the largest US banks. The editorial noted that Kroll Bond Rating Agency had rated nine small commercial banks, six of which went on to sell bonds to investors. Kroll reported that another 10 community banks will receive ratings by the end of October.

One example provided in the report was Cadence Bancorp, of Houston, Texas. The \$7 billion bank originally sought \$175 million, but that was upped to approximately \$245 million due to strong investor demand. The *Wall Street Journal* indicated that the 5- and 15-year offerings yielded 4.875% and 7.25%, respectively.

What was it that made Cadence so interesting to investors? First, on an as-is basis, the firm is “well capitalized” according to measures defined by the regulators. The firm’s Tier 1 Leverage, Tier 1 Risk Based Capital, and Total Risk Based Capital ratios were 10.34%, 10.81% and 11.55%, respectively, as of Q2 2014. The bank has also been profitable for seven consecutive quarters and has been on a rapid growth clip, growing assets at a 31% annualized rate during the last two years.

More impressively, the bank holds up very well according to Trepp’s Capital Adequacy Stress Test (T-CAST) projections. Modeled after the rules mandated by the Federal Reserve, OCC, and FDIC, the T-CAST analysis projects how a bank’s capital performs under three regulator defined scenarios. Under each of the baseline, adverse, and severely adverse scenarios, Cadence’s Tier 1 Leverage and Tier 1 Risk Based Capital would exceed 9%, while its Total Risk Based Capital would exceed 11%. Both of those figures would easily allow a bank like Cadence to pass the numerical part of the regulatory tests if it was required to conduct one.

For those unfamiliar with the regulator scenarios, the forecasts require large banks to project their income and balance sheets for nine quarters using 16 macro-economic variables. The regulators were not fooling around when they determined the inputs: the Severely Adverse case assumes unemployment of 11%, GDP of negative 6%, and a reduction of the value of commercial property assets of over 35%.

The story was equally impressive for a second bank mentioned in the article, the nearly \$4 billion Eagle Bancorp of Bethesda, Maryland. The firm’s Tier 1 Leverage, Tier 1 Risk Based Capital, and Total Risk Based Capital ratios were 10.89%, 11.29% and 12.71%, respectively as of Q2 2014—enough to garner a “well capitalized” designation from the regulators as of Q2 2014. In addition, the bank has had a long streak of consecutive quarterly profits and has been growing rapidly, at a 16% annualized rate since 2014, which compares to the total industry rate of 4% over the same period.

On a stressed basis, Eagle’s capital ratios hold up very well. Under the baseline, the adverse, and the severely adverse scenarios, the Eagle Tier 1 Leverage and Tier 1 Risk Based Capital would exceed 11% while its Total Risk Based Capital would exceed 12%. Again, these numbers would easily allow a bank like Eagle to pass the numerical part of the regulatory tests if Eagle were required to perform one.

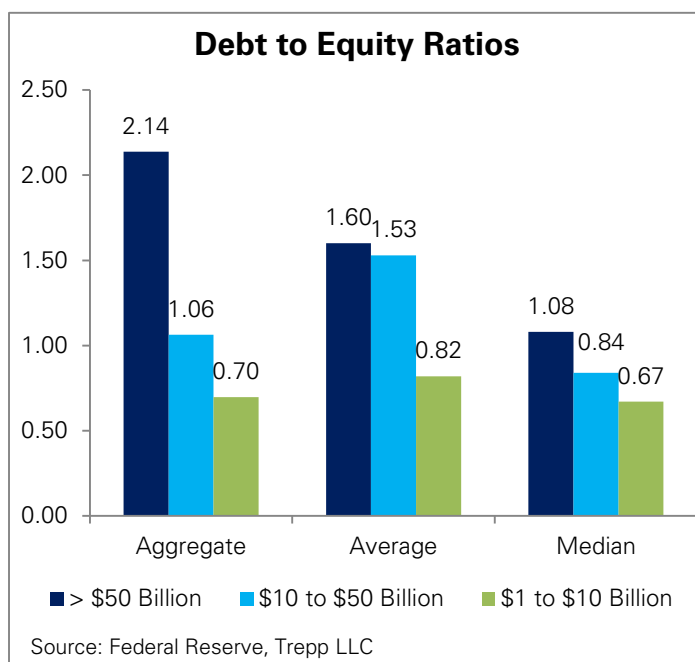
Sizing the Market

Tapping the debt markets is a relatively new idea for community banks. These smaller banks have been more reliant on deposits and less reliant on debt as a funding source than larger banks. For community banks in the \$1 to \$10 billion asset size range, debt comprises just over 10% of their liabilities. That figure rises to 19% for banks in the \$10 to \$50 billion size

range, and 26% for banks with over \$50 billion in assets.¹

Community banks appear to have a significant amount of untapped borrowing capacity, as measured by their debt-to-equity ratios. As shown in the graph below, smaller banks as a group have lower leverage than larger banks.

- At the aggregate level, community banks in the \$1 to \$10 billion size range carry debt that is 0.70 (70%) of their total equity, which compares to 1.06 for mid-sized banks (\$10 to \$50 billion) and 2.14 for large banks (> \$50 billion).
- For the average community bank, the debt-to-equity ratio is 0.82, only about half the 1.53 ratio for mid-sized banks and the 1.60 ratio for large banks.
- Median debt-to-equity ratios show a similar pattern across the size groups, with the community bank median at 0.67, as compared to 0.84 for mid-sized banks and 1.08 for large banks.



If relatively modest goals were set for the community bank group, which would allow their debt-to-equity ratios to rise to comparable levels with the mid-sized banks, they could boost their debt by \$28.5 to \$118.1 billion, amounting to increases of 24% to 101% from their current debt load. For example, if community banks' debt ratios rose by 0.17 to match mid-sized banks' median debt-to-equity ratio of 0.84, they could expand their borrowing by \$28.5 billion. If their debt ratios rose by a larger 0.71 to match the mid-sized banks' 1.53 average ratio, they could boost their debt loads by \$118.1 billion. If their aggregate borrowing rose to match the mid-sized banks' 1.06 aggregate debt-to-equity ratio, that would imply additional borrowing of \$61.4 billion.

In the case of the two banks mentioned above, Cadence increased its debt-to-equity ratio by only 0.24 (to 0.29) and Eagle's planned issue of \$70 million of subordinated debt would increase its debt-to-equity ratio by just 0.16 (to 0.40). Even after raising debt, these banks still carry debt loads that are well below the average for community banks, not to mention mid-sized and large banks.

Finding Opportunities - Rating the Banks

In order for community banks to tap the capital markets for additional debt, a necessary first step is to acquire debt ratings. Investors use ratings to assess banks' riskiness and to determine appropriate risk spreads on new and existing debt.

Both current and stressed capital ratios are important components of banks' debt ratings. Indeed, Kroll cites both reported and stressed capital as quantitative inputs in its description of its credit ratings methodology.

Current capital ratios are easily obtained from banks' regulatory filings and Trepp's T-CAST model serves as a source for stressed capital ratios. T-CAST produces scenario-based forecasts for bank income, balance sheets, and capital, using the same macro-economic inputs as the CCAR and DFAST stress tests required of larger banks.

¹ The figures in this section are based on Q2 2014 data for bank holding companies with assets of \$1 billion or more.

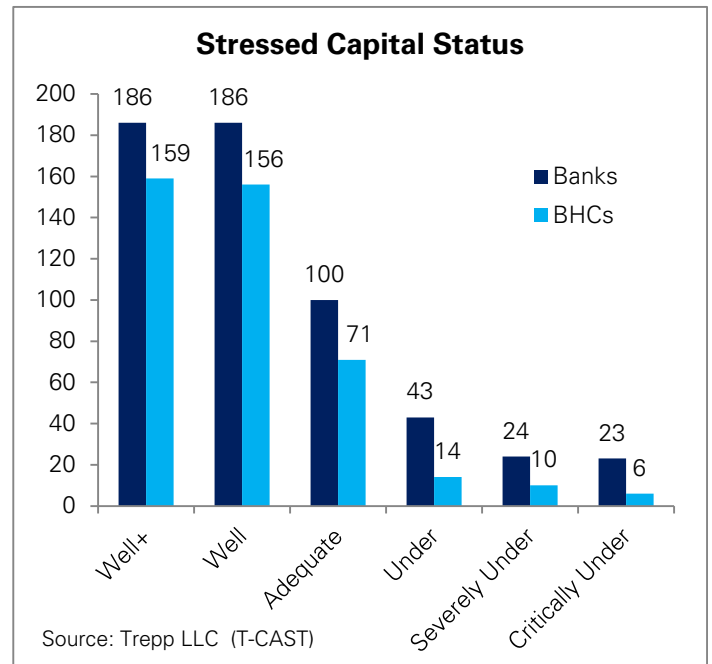
As of Q2 2014, nearly all the banks and bank holding companies in the \$1 to \$10 billion size range would be deemed “well capitalized” based on their reported regulatory capital ratios. Of the 988 banks² and bank holding companies Trepp analyzed,³ only 10 were less than well capitalized. One might be tempted to conclude that the 978 well capitalized banks and bank holding companies would all qualify for investment grade status.

When looking at stressed capital ratios, however, greater differences emerge. The stressed capital ratios simulate how the banks’ and holding companies’ capital ratios would be impacted by an “adverse” or “severely adverse” economic scenario, including moderate and deep recession economic conditions.

- Approximately 35 percent of the institutions (186 banks and 159 bank holding companies) would be what Trepp calls “well capitalized-plus,” meaning they would maintain capital ratios well in excess of the thresholds to be called well capitalized.
- Another 35 percent (186 banks and 156 holding companies) would be well capitalized, though not quite reaching the “well capitalized-plus” designation.
- Nearly 30 percent would fall below the “well capitalized” thresholds.
 - Seventeen percent (100 banks and 71 holding companies) would fall into the “adequately capitalized” category.
 - Twelve percent (90 banks and 30 bank holding companies) would fall into different categories of “under-capitalized.”

² Here the term “bank” refers to both banks and thrifts. Since Q1 2012, thrifts have been reporting quarterly condition statements (Call Reports) on the same basis as commercial and savings banks.

³ This analysis includes both banks/thrifts and holding companies. Most of the banks/thrifts in the group belong to one of the holding companies. It is more common for the bank holding company to raise additional debt, although it is typical for both to receive debt ratings from ratings agencies.



There is a clear, significant opportunity for community banks to tap into debt markets to fund growth. As banks, investors, and rating agencies move further into this area, Trepp believes stressed capital projections will play a key role in the establishment of greater transparency in the market.

Looking at only as-reported capital ratios is not sufficient, as the analysis above would indicate. Given that nearly 30% of the currently well capitalized banks would fall below the well capitalized threshold in a stress scenario, market participants will want to include stress test results in their analysis of risks and opportunities in the market. Even banks that would rank at the upper end of the spectrum—in the well capitalized and “well-plus” categories—will value stress test results, as a better credit rating will enhance their capacity to raise debt and to do so at appropriate risk spreads. As for banks that would fall below the well-capitalized category, investors and rating agencies will want to be assured that qualitative factors, such as strategy and management quality, are in place to mitigate downside risks. ■

Appendix

Trepp used the thresholds outlined in the table below to categorize the stressed capital ratios. Note that “Well Capitalized-Plus” is a category created by Trepp. The other categories have been delineated by bank regulators, although there are no published standards for stressed capital, as compared to reported (actual) capital ratios.

Stressed Capital Ratio Categories			
Capitalization Category	Capital Ratio		
	Tier 1 Leverage	Tier 1 Risk Based	Total Risk Based
Well - Plus	$\geq 8\%$	$\geq 10\%$	$\geq 12\%$
Well	5 to 8%	6 to 10%	10 to 12%
Adequate	4 to 5%	4 to 6%	8 to 10%
Under	3 to 4%	3 to 6%	6 to 8%
Significantly Under	2 to 3%	$< 3\%$	$< 6\%$
Critically Under	$< 2\%$	—	—

Source: Trepp LLC

For inquiries about the data analysis conducted in this research, contact press@trepp.com.

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