

Community Banks: Has the Pendulum Swung Too Far on Capital?



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Community banks may be sitting on more capital than they actually need, undermining long-term growth and profitability. At first blush, maintaining high capital ratios appears to be a sound first line of defense against a repeat of the 2008 financial crisis. Upon closer scrutiny, however, Trepp’s analysis of banks suggests that the pendulum may have swung too far in that direction. By focusing solely on current capital ratios, many banks will have unproductive “excess” capital, while others may be lulled into a false sense of security because they are not as well capitalized as they think. Community bankers should focus on evaluating stressed capital by using the same approach that larger banks have recently implemented to comply with regulatory mandates under the Dodd-Frank Act. An emphasis on stressed capital would enable community banks to right-size their capital bases and boost profitability for long-term strategic growth.

Why the Focus on Capital?

Five years ago, the universal concern for banks of all sizes was their capital ratios. Given the uncertainty over the quality of bank loans, the lack of liquidity in the financial markets, and the belief that the appraised values of the collateral underlying loans were grossly inflated, regulators and investors were fixated on bank capital. For the larger institutions, this gave rise to complex projections known as ‘stress tests’ to determine whether the banks would remain adequately capitalized under three regulator-defined economic scenarios.

Now, liquidity has returned to the market; banks have retained half a decade worth of earnings driven by a favorable interest rate environment; and after the huge decline in asset values in 2008 and 2009 (particularly in commercial and residential real estate),

prices have come close to their pre-recession highs in many markets.

Despite the improvement in the economy, bank asset growth—loan growth in particular—has been lacking. During the five years since the end of the 2007-2009 recession, bank assets have grown by 14.2%, which is somewhat below the 16.8% rate in the five years after the 1990-1991 recession and significantly below the 50.7% growth rate after the 2001 recession. The 6.3% cumulative loan growth in the current recovery is well also below the 14.3% rate after the 1990-1991 recession and the 51.9% growth rate after the 2001 recession.

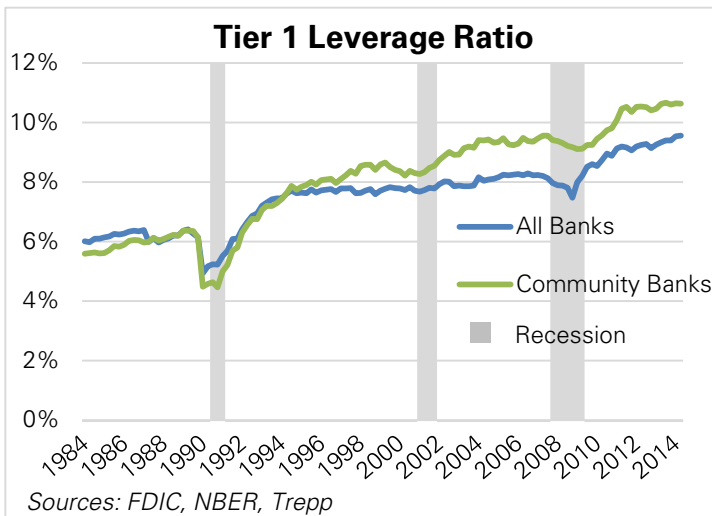
Bank Asset Growth, First Five Years After Recession		
Cumulative Growth Rate		
Recession	Total Assets	Loans Outstanding
1990 - 1991	16.8%	14.3%
2001	50.7%	51.9%
2007 - 2009	14.2%	6.3%

Sources: FDIC, NBER, Trepp

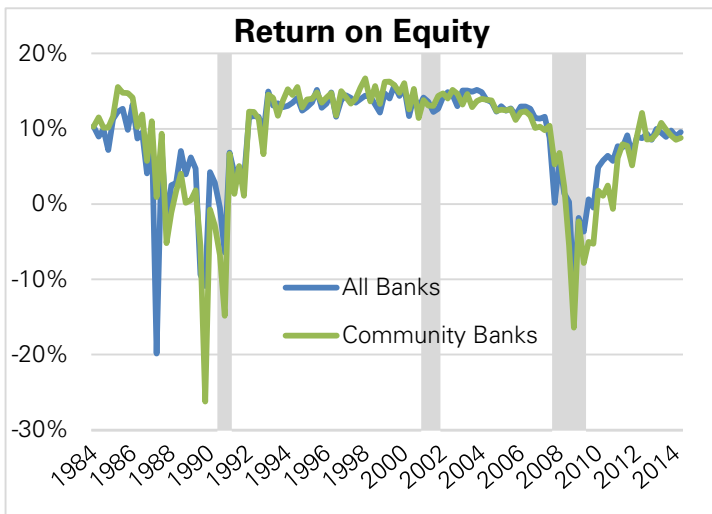
Higher Capital, Lower Returns

The cautious approach to asset growth in the current recovery is largely a result of the desire to boost capital ratios. The average Tier 1 Leverage Ratio for all banks has risen from a pre-crisis average of 8.1% to 9.6% as of Q2 2014, and it appears to be heading higher. For community banks with total assets between \$1 billion and \$10 billion, the Tier 1 Leverage Ratio has risen from an average of 9.3% pre-crisis to 10.6% as of Q2 2014.

Return on equity (ROE) has been affected by anemic asset growth and the increased focus on capital ratios. Bank ROE has rebounded from the losses during the recession and financial crisis, but has since leveled off in the 9% to 10% range. Pre-crisis ROE levels were in 12% to 15% range during the 1993 to 2006 period.



The increase in capital ratios has had a direct negative impact on ROE by increasing the denominator in the calculation of this ratio. A lack of loan growth has also had a negative impact on ROE, as the higher risk weights on loans have dampened banks' enthusiasm to make fresh loans. However, loans are generally the most significant source of interest income, especially for community banks. So the focus on capital and capital ratios has undercut increases in banks' earnings.



Boosting equity is a defense mechanism that it is understandable in the wake of the financial crisis. Increased capital can be used to address past

perceived shortcomings and prepare banks for potential adverse conditions in the future. Without specific ideas of how a downturn could affect a bank, a "higher-is-better" approach to capital and capital ratios is likely to prevail. *If bank management and the board lack a clear idea of the potential losses the bank could experience in a downturn, they will have a hard time setting appropriate targets for the bank's capital ratios.*

There are two main drawbacks to the equity-boosting approach. First, management may still underestimate the risks the bank faces, and therefore have inadequate capital and controls in place to deal with adversity. Second, management may carry excess capital in an attempt to hedge risk, leading to sub-optimal lending volumes and ultimately sub-par ROE.

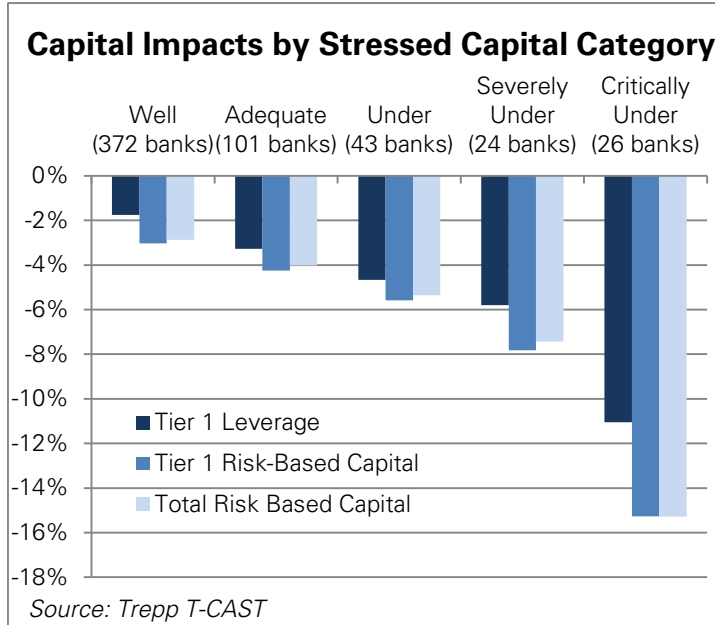
Using Stressed Capital as a Guide

The same approaches that large banks are employing to comply with the Dodd-Frank mandates for stress testing can be used by community banks. Rather than just target higher capital ratios, community banks can use their stressed capital as a guide to how much capital they should maintain.

Under Dodd-Frank, banks with \$10 billion or more in assets are required to produce scenario-driven forecasts of the balance sheet, earnings, and capital and submit the results to regulators once a year. While there is no current stress testing requirement for banks with less than \$10 billion in assets, the same techniques can be used to forecast banks' minimum capital levels under a severely adverse scenario as a means to quantifying how much capital the bank should maintain.

Using Trepp's Capital Adequacy Stress Test (T-CAST) model, which produces multi-year projections of the balance sheet, earnings, capital and capital ratios under multiple scenarios, Trepp examined 566 community banks to determine how they would perform in the regulators' adverse or severely adverse scenario with respect to their capitalization levels. The analysis was conducted using Q2 2014 reported capital ratios.

Stress Test Results for Community Banks



Nearly all of the banks, 562 or 99.3%, are currently “well capitalized.” Under the adverse or severely adverse scenario, the bulk of the banks (372 or 66%) would suffer relatively minor effects on their capital ratios and would remain well capitalized. The median change in the Tier 1 Leverage ratio was -1.8% and the median change in the Tier 1 Risk-Based and Total Risk-Based ratios were -3.0% and -2.9%, respectively.

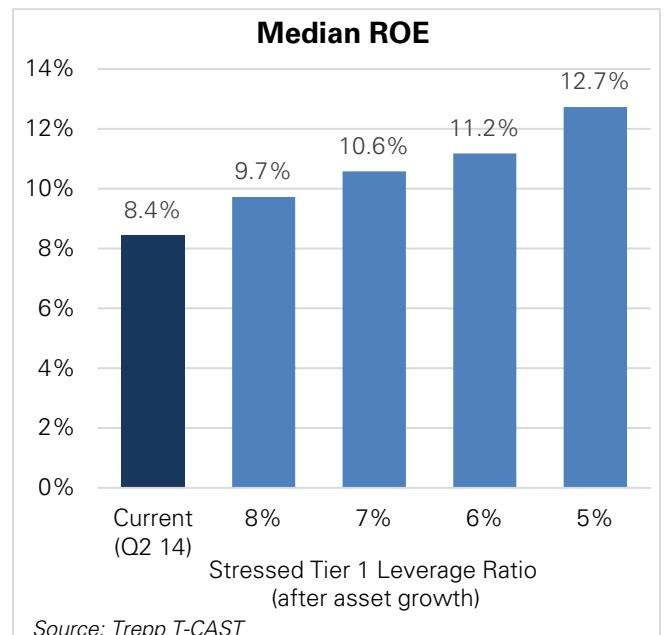
Another relatively large group of banks (101 or 18%) would get knocked down to the “adequately capitalized” category. The median Tier 1 Leverage ratio would decline -3.3% and the Tier 1 Risk-Based and Total Risk-Based ratio would decline -4.3% and -4.0%, respectively.

A third sizeable group of banks (93 or 16%) would fall to “under-capitalized” or below, with more significant negative effects on their capital ratios. These changes ranged from a median 5% to 7% decline in capital ratios for banks that would become “under-capitalized,” to double-digit declines for banks that would fall to “critically under-capitalized.”

Targeting Capital Levels

The banks that would remain at least adequately capitalized in a stress scenario (473 of the 566 we tested) may have excess capital that could be deployed in a more productive manner for the bank. One use of excess capital could be a one-time dividend to shareholders. More interesting uses could involve expanding a bank’s asset base, such as through increased loan originations, or through bank or loan portfolio acquisitions.

To simulate the effect of growing the balance sheet for these banks, Trepp estimated the impact on ROE, assuming that institutions in this group could target varying levels of stressed Tier 1 Leverage ratios. As indicated in the chart below, community banks could boost their ROE by right-sizing their capital base. In this simulation, banks would increase assets, including interest-earning assets like loans, while still maintaining stressed capital above minimum thresholds. The increased net income would boost ROE to a median 9.7% if banks maintained stressed Tier 1 Leverage ratios of 8%. For decreased stressed Tier 1 Leverage ratios (and increased asset bases), the effect on net income and ROE would be more pronounced. If stressed Tier 1 Leverage was allowed to fall to 5%, the median increase in net income



would be \$7.8 million, bringing the median ROE to 12.7%.

Not all banks will want to allow stressed capital ratios to fall to the minimum thresholds, but rather will want to maintain some cushion as a safety margin. However, this analysis suggests that even modest shifts toward a more leveraged capital base can boost earnings and ROE.

Benefits of a Comprehensive View of Capital

For most banks below the \$10 billion threshold, the approach to capital planning has generally been to maintain or boost current capital ratios. Since banks below the \$10 billion threshold are not mandated to run a stress test, there is no mechanism in place that forces banks of that size to demonstrate to their boards and regulators that it is time to loosen the purse strings a little. But perhaps the time is now for community banks to consider this exercise to improve the management and capital planning process. A more comprehensive view of capital needs may allow banks to come to regulatory reviews with more ammunition for redeploying capital and more evidence that the bank will be well capitalized even under the most adverse economic scenarios. ■

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Appendix

To estimate forecasted ROE, Trepp made the following assumptions:

1. Stressed Tier 1 Capital was the lower of the Tier 1 Capital from the Adverse and the Severely Adverse scenarios.
2. Total assets would grow to combine with the Stressed Tier 1 Capital and produce the targeted stressed Tier 1 Leverage ratio. For example, if Stressed Tier 1 Capital is \$10 and the targeted stressed Tier 1 Leverage ratio is 8%, then total assets would be \$800 in order to satisfy the Tier 1 Leverage ratio of $\$10 / \$800 = 8\%$.
3. Earning assets grow at the same rate as total assets.
4. Net interest margin remains constant, so projected net interest income will grow proportionally with earning assets and total assets.
5. The only growth in projected total revenues is from net interest income. Noninterest income remains constant.
6. The efficiency ratio remains constant, so noninterest expenses will rise with total revenue.
7. The ratio of pre-provision net revenue to net income remains constant.
8. The net effect of these assumptions tends to result in a slight negative impact on return on assets (ROA), indicating that these assumptions are relatively conservative.

About Trepp

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