$19.97 | Issue No. 28

EXTRAORDINARY BANKER

THE 5 STEP
Blueprint for Winning Low-Cost Deposits

BANK VALUATION
Concepts to Influence How You Lead

AVOID THESE
Three Risky Deposit Strategies

CONGRATULATING **CHRIS FLOYD**
& THE FIRST NATIONAL BANK OF SYRACUSE TEAM

2019 **BANK** OF THE **YEAR**
WINNER

Full 2019 Banky™ Awards Winner's List Inside

ARE YOU READY FOR THE NEXT RECESSION?

By Joshua Siegel & Jim Brennan, StoneCastle Partners, LLC

It has been more than a decade since the country's last recession, and while one can never be certain of the exact timing, history indicates that we are a bit overdue. Since the last recession (December 2007 to June 2009), community banks have been living in the Dodd-Frank world of increased regulation, and regulation, like business, has cycles. During periods of increased bank regulation, community bank strategies become more restricted and commoditized. Conversely, in periods of decreased bank regulation—which already began with the passing of S.2155—the Economic Growth, Regulatory Relief & Consumer Protection Act in 2018—community banks can pursue more deliberate and differentiated strategies.

This increased latitude in driving strategy puts the onus firmly on management *to make calculated decisions that are in the best interests of the bank* and don't put them too far over their skis.

This increased latitude in driving strategy puts the onus firmly on management to make calculated decisions that are in the best interests of the bank and don't put them too far over their skis. We can look back at 2006, a year before the last recession and prior to Dodd-Frank; more specifically, we can look at community banks with assets of $200-500 million. Not surprisingly, failed banks in this cohort had greater exposure to construction and land development (C&LD) loans, experienced rapid growth, and maintained higher loan yields by a wide margin compared to banks that remained whole.

MEDIAN %	FAILED	DIDN'T
C&LD Loans	32.76%	10.03%
2001-2006 Asset CAGR	18.61%	4.99%
2006 Loan Yield	8.45%	7.55%

Source: FDIC.gov

Those Who Fail to Learn from History are Condemned to Repeat It

A key question to ask in every regulatory cycle is: "And now what?" Regulations are relaxing, and latitude is being restored to make independent decisions that are not mandated by the government. Is this reduction of regulation always a good thing? It is if you are prepared. Instead of being told what to do, you now have more choices to consider, and it is incumbent upon management and your board to fully vet and understand the implications of each decision. Challenge each other's assumptions, examine the causes of past failures, and identify deficiencies that could have easily been cured. Failure to do so could have dire results, including failure of your bank. As longtime investors in community banks, we have seen this exact scenario repeated numerous times.

For example, should a community bank now pursue an aggressive lending campaign and raise additional capital to grow? It depends. What is happening in its local market? Is unemployment in the area going down? Are more people moving in? If so, what are their average ages and education levels? Is a company building a new plant or closing one in the area? The answers could mean hundreds or thousands of new jobs and customers, or lending could slow and defaults could rise.

Preparing for All Scenarios

Capital solves two primary issues: funding growth and withstanding periods of stress and credit losses. If your bank doesn't raise enough capital to fund growth, you can quickly miss out on upswings in the area and lose local market share to competitors that thoughtfully raised capital to position their banks to better appeal to new clientele and future bank needs.

Alternatively, we have seen many banks fail because they underestimated the amount of capital needed to absorb losses. They argue, rather shortsightedly, that they don't want to suffer the dilution of raising more capital, which is typically the first phase on the path to the ultimate dilution—failure—because 100 percent of nothing is still nothing.

We believe that a proven solution for smartly raising capital is the use of subordinated debt at the holding company and preferred stock (if available). While both carry a cost per annum, it is typically nominal compared to common equity and does not cause any dilution. Also, unlike dilutive common equity that cannot be redeemed, your bank can "undo" issuing subordinated debt or preferred stock since both have a call date to redeem the capital at 100 percent of face value.

There's no such thing as too much capital during a recession, *which is also the most difficult time to obtain it.*

Challenge each other. Discuss the uses of capital and how to deploy it for growth or use as dry powder in a market downturn. It has been just over a decade since the end of the last recession, so now is the time to discuss how your bank will be prepared. There's no such thing as too much capital during a recession, which is also the most difficult time to obtain it. Subordinated debt currently remains available to community banks as an economically efficient way to address capital needs, including the pending changes from CECL.

Be prepared for the next recession. Give the past a closer look and consider the following:

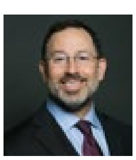
1) Be extremely mindful when growing your construction loan book.
2) Keep growth rates in check. If you decide to outgrow your peers, consider:
- **a.** If you want to grow faster than local GDP, you need to take loans away from other banks by taking higher risks or accepting lower yields, both of which create risks for your bank.
- **b.** M&A is often a safer growth strategy than significant organic growth, especially out-of-footprint expansion.
- **c.** It's always better to compromise on loan pricing than lending criteria.
- **d.** Don't stretch the amount or quality of capital to get there—during a recession, the more capital, the better.

3) Be cautious of chasing new lending strategies to increase loan yields. Marketplace lending and renewed interest in SBA lending can be an option, but consider all the risks attached to these programs, and ask yourself if you are truly being compensated for the added risk.

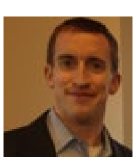
History tells us there will be another recession, and it may not be that far away. Listen to what it is saying.

■

Connect with the Authors:



Joshua Siegel
StoneCastle Partners, LLC
347-887-0303
JSiegel@StoneCastle.com



Jim Brennan
StoneCastle Partners, LLC
347-887-0326
JBrennan@StoneCastle.com

About StoneCastle Partners

Founded in 2003, StoneCastle Partners is one of America's largest asset management firms dedicated to the U.S. banking sector and a recognized cash management leader for institutional investors. With over $20 billion in assets under management and advisement, StoneCastle Partners and its subsidiaries offer solutions that help address the needs of community banks as well as the investment community.

Notes & Disclosures

The information contained in this article is for informational purposes and should not be construed as investment advice or an offer, solicitation, or recommendation to purchase any security. The views are as of the date of this article and are subject to change.