Current State of the Community Bank Industry

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Speaker: Josh Siegel

This is Josh Siegel from StoneCastle. I'd like to talk to everyone today a bit about the banking system. There's obviously concern about the health of the banking system based upon the unemployment be it temporary or more permanent from many small businesses and larger businesses. I've had this discussion a few times in the last week, obviously there's questions and concerns from Washington all the way down through the industry.

Now, for sure, it's hard to predict the future, but the nice thing about banking is its generally pretty math based and a lot of things that one would have to suppose can at least be considered from some structural basis.

Let's talk about what could happen and some of the factors that mitigate what could happen. Here we are in late March. The first thing to think about is for underlying business you have had a period from January 1st through probably early March where employment, purchasing all was normal.

So, when we think about whether it's a small local business in a small town or even a larger business, most of the Q1 revenues are sound, are going to be reasonably predictable and booked. Obviously, the last few weeks of the month are going to not show as good a result.

When we get into Q2, that's obviously going to be quite detrimental to financials for Q2. It depends on your assumption of when this stay at home or don't physically go to work or don't shop as it relates to certain businesses. That's going to have a pretty significant impact on Q2 revenue. But let's focus on the Q1 for the moment.

So Q1 borrowers, borrowings from a large bank or a small bank. When we think about most smaller banks in the United States, mid and small, they tend to do first lien senior secured loans. Now, these are far less levered companies then you'd find in the leveraged

loan market, CLO's business development companies, etc. So, the effectiveness of debt and the ability to service debt is going to be less so than highly leveraged companies that are typically in the capital markets. Second thing to consider is that the only way you default on debt is to either fail to pay interest or principal when due or trip a covenant. Now covenants for most borrowers, especially outside of the capital market side, are quarterly financials and most businesses, most small businesses are not public companies, so they're not filing audience financials on a regular basis. As a result, they typically have unaudited quarter by quarter and then don't have annual most likely but had some kind of an audit. So, from a covenant standpoint, it's hard to trip a covenant, anything more than a quarter and then you have to think about the lag, as the quarter ends March 31st.

When are Q1 financials done? Is it April 15th, is it April 30th? Is it sometime in May? Hard to say, exactly. But let's just say it's 30 days, 15 to 30 days after the end of the month.

So Q1, given that the revenues for Q1 will be probably off a bit compared to what was planned for, they may not be off dramatically. So, I don't think you're going to see a massive covenantal fail to pay in the sort of Q1, which is what we're coming to the end of here. It's possible, but probably less likely.

But even if they did have less than great numbers at that point, they're not going to have reported their covenants until late-April probably. So, let's just say May 1 at that point, if they are failing to pay but also be 30 days because there's a 30-day grace period on most loans and that's the way banks book loans is you're current, then you're thirty to eighty-nine day past due, 90 plus past due and then nonaccrual. So even if you're 30 days past due that doesn't immediately make you a defaulted loan, you're put into the thirty to eighty-nine day past due bucket. A bank then has to downgrade, has to keep a little more capital against it, but it doesn't get into a liquidation scenario that quick necessarily. After 90 days, then you're 90 days plus, then it becomes a non-accrual and at some point, they may decide to charge off. But if we think about 90 days, even from March 31, now you're already into basically beginning of July.

If the Q1 financials of a lot of these borrowers isn't particularly bad, then it would be the Q2 financials that reflect the concern and what could be a significant; increase in default

rates of corporate borrowers, corporate culture in the state, etc. So if we say, OK, that will happen June 30, well, that's really July 30, right or, August 1, when the financials will come out in the 30- day grace period or non- payments go effective. So, you're already there. And then if you have 30 to eighty- nine day past due bucket, that's another two months. So that takes you from August 1st to September 1st to October 1st. So, you're almost out six months from here, which at the pace that this is going,

I think we'd all agree it's not going to end immediately not in the next few weeks likely, but does it really persist all the way through the fall? Don't know. So this, of course, assumes that there is no regulatory relief, that there is no government guarantees for certain loans. I mean, there's obviously an enormous amount of action in DC. Something will come out of that, it’s happening by the hour, so that will help. But even if we took that off the table coming into this cycle, banks under $10 billion have about 60% more capital than they did going into the financial crisis of 2008. They have about twice the loan loss reserves they had compared to 2008. In 2008 the average bank had between 80 and 85% loan to deposits. So, they had more loans relative to their deposits and full balance sheet, today it's about 65%. So, there's a lot more liquidity and basically U.S. treasuries is what fills the rest of the bucket. So, the amount of capital and reserves relative to the loan book is significantly higher.

So, the ability for banks to withstand this stress in the market is far superior to where it was back in 2008. Now, beyond that, it becomes a question of will we continue to work or a better way to put it is, is what we're experiencing in more metropolitan markets?

What we're seeing across the country and evidence to date firsthand evidence is that's not the case in many rural parts of the country that I've been able to connect with. Life is pretty much going on as normal people are out working. They're keeping some social distancing, but they're not in lockdown. They're not congregating in large numbers, but businesses are open. Things are continuing and it’s definitely the metropolitan markets that are most affected and you can call it not so much metropolitan, but population density. So, I don't know if the effect to the banking system will be uniform. It may be that more metropolitan banks are going to feel this a bit more and maybe not so much in rural markets, but it will still have to play itself out. But as a quick synopsis of the banking sector, I don't see an

immediate concern for the banking sector. There could be a long-term concern, but we'll have to see how things play out.

Banks were very heavy holding treasuries because their loan books had been smaller than they had been historically and those treasuries, of course, have increased dramatically in value. So that actually builds if they were to sell those treasuries, they booked pretty significant gains.

So that puts them in a better spot at the moment with the Fed lowering rates. The deposit rates have come down around the country, not come down massively, but they've come down. Loan rates are starting to go up. Credit spreads are up. So, banks are maintaining or even expanding that interest margins in the short term, which is probably wise because they will have to take charge offs through the cycle. So, it's hard to know how it ultimately plays out. But in the short term, dynamics and medium-term dynamics are not overly concerning, long term obviously we'll have to see.

I just wanted to share a couple of thoughts today. Thank you for listening and thank you for working with StoneCastle.

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