The Future of Community Banks: Lessons From the Recovery of Problem Banks

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INTRODUCTION

This paper presents an update on the St. Louis Fed's research on the viability of the community bank business model. The community bank model is under stress. Competition in the financial services industry has limited the ability of community banks to rely on profits from some of their traditional lines of business, including commercial and industrial loans and consumer loans. The *FDIC Community Banking Study* (2012) finds that from 1984 to 2011, the percentage of community banks that were specialists in commercial and industrial loans declined from 11 percent to 2 percent, and the percentage that were specialists in consumer loans declined from 9 percent to 1 percent. In contrast, the percentage that specialized in commercial real estate lending rose from 2 percent in 1984 to 26 percent in 2010, before declining to 24 percent in 2011. Reduced lending opportunities and an ample supply of funds increases the risk of loosened underwriting standards and subsequent losses in stressed economic events. This was seen in the large losses experienced in commercial real estate loans during the financial crisis.

In the first phase of our research agenda, we looked at the experience of community banks that "thrived" during the recent financial crisis, deep recession and slow economic recovery.[1] We defined "thriving" as maintaining a CAMELS rating of 1 from 2006 through 2011.[2] We found that 702 community banks qualified as thriving banks, which were located in 40 states. Some of the thriving banks were located in states that experienced the most severe economic downturns during the recent recession and in states with the largest numbers of bank failures. Many of the thriving banks also had relatively large exposures to commercial real estate during the period of the study. These banks had learned how to manage the risks in commercial real estate which had been so damaging to other community banks. In our prior study of thriving banks, we used various methods of investigating the characteristics that were important for

[1] Gilbert, Meyer and Fuchs (2013).

[2] Bank safety and soundness examinations focus on six areas: capital protection (C), asset quality (A), management competence (M), earnings strength (E), liquidity risk exposure (L), and market risk sensitivity (S). Examiners assign a grade of 1 (best) through 5 (worst) to each component. In addition, they assign a composite CAMELS rating, which is also expressed on a scale of 1 through 5. Banks with composite ratings of 1 and 2 are considered to exhibit "strong" and "satisfactory" performances, respectively. Banks that fall below a rating of 2 may prompt supervisory action, which could include a board resolution, a memorandum of understanding, a written agreement, or a cease and desist order. Hence, regulators consider a drop from a rating of 2 to a rating of 3 to be a significant change. A more detailed description can be found at http://www.fedpartnership.gov/bank-life-cycle/topic-index/bank-rating-system.cfm.

helping these banks thrive during challenging times, including phone calls with the leaders of a sample of the thriving banks.

In this study, we investigate what we can learn from the experience of community banks that had relatively severe downgrades in their supervisory ratings prior to or during the financial crisis, but then reversed their condition. The community banks we identified had supervisory CAMELS ratings that were 4 or 5 at some point in time between 2006 and March 31, 2013, and subsequently improved to a CAMELS rating of 1 or 2.

We have been able to find only one study that is relevant for this phase of our research agenda. Dahl and Spivey (1995) investigate the impact on the capital ratios of undercapitalized banks of the prompt corrective actions that legislation requires of undercapitalized banks. They find that equity injections into undercapitalized banks resulted in the fastest recoveries from undercapitalization. There are important differences between the design of their study of undercapitalized banks and our study of recovered banks. Dahl and Spivey quantify recovery in terms of capital ratios derived from financial statements, whereas we focus on upgrades of CAMELS ratings. In addition, they do not examine the effect of changes in ownership or management of banks as determinants of recovery.

SUPERVISORY RATINGS OF COMMUNITY BANKS IN RECENT YEARS

In Table 1, we present the weakest CAMELS rating for the 7,274 community banks that were in operation during the years 2006 through March 31, 2013.[3] Of the total, 1,390 institutions, or approximately 19 percent, had CAMELS ratings of 4 or 5 at some time during the years 2006 through March 31, 2013. We define these institutions as the "initially adversely rated" group.

Table 2A presents CAMELS ratings information as of March 31, 2013, for the same group. The table indicates that, in many cases, a supervisory rating of CAMELS 4 or 5 has had severe adverse consequences. About one-fourth of the initially adversely rated banks failed, and

[3] In Table 1, 902 community banks had CAMELS ratings no weaker than 1 during the period 2006 through March 31, 2013. In construction of Table 1, we do not impose a constraint that each of the 902 community banks was in operation for the entire period. In Gilbert, Meyer and Fuchs (2013), we identify 702 community banks that were rated CAMELS 1 for the entire period from 2006 through 2011.

12 percent merged out of existence without going through failure. Slightly more than half of these banks were in existence as of March 31, 2013, but rated CAMELS rated 3, 4 or 5. In most cases, these banks were operating under agreements with the supervisors that placed restrictions on their freedom to make choices about their operations – restrictions that did not apply to banks rated CAMELS 1 or 2. In contrast, about 11 percent of the community banks rated CAMELS 4 or 5 at some time during the designated period had been upgraded to CAMELS 1 or 2 by March 31, 2013.

We then look at the performance of the initially adversely rated banks as of March 31, 2013, that did not fail or merge out of existence. As in Table 2A, the banks are split by CAMELS rating as of the quarter-end date.[4]

All of the performance ratios in Table 2B show the expected pattern across CAMELS classes. That is, the ratios show marked improvement as one moves from the CAMELS 5-rated banks to the 1- or 2-rated banks. For example, 5-rated banks have an average ROA of –0.81 and an average ROE of –20.55. These ratios improve monotonically with the improvement in CAMELS rating until they reach an ROA of 0.88 and an ROE of 7.50 in 1- and 2-rated banks. The other performance ratios show similar improvement.

Table 2C gives some insight into the strategic choices that led these recovered banks to outperform their troubled peers. In some cases, the balance sheet composition of the recovered banks as of March 31, 2013, may reflect charge-offs of problem loans. For instance, the ratios of commercial real estate loans to total assets may have been relatively high for some of the recovered banks prior to March 31, 2013, but lower after they charged off problem loans and received additional equity in their recovery process. Thus, the results in table 2C reflect a combination of strategic choices and a cleaning up of the balance sheets of recovered banks. In this table, it is clear that the healthier banks, on average, were:

- less "loaned up" (i.e. had lower total loans-to-total assets ratios),
- less concentrated in commercial real estate (CRE),
- much less concentrated in construction and land development (CLD) loans,

[4] The 149 2-rated banks and six 1-rated banks have been combined into a single category of 155 1- or 2-rated banks in the table to preserve the confidentiality of the underlying banks.

- less concentrated in home equity lines of credit (HELOCs),
- more concentrated in agricultural production loans and farmland-secured loans,
- more concentrated in consumer loans, and
- more reliant on core deposits.

A comparison of Tables 2B and 2C with the results in the corresponding tables in Gilbert, Meyer, and Fuchs (2013) shows that banks that managed to recover from problem status have many of the same attributes as banks that thrived throughout the financial crisis. For example, during this particular period, concentrations in agricultural loans and in farmland-secured loans are strongly correlated with both the ability to thrive throughout the crisis and to recover from financial distress. It is important to note, however, that this concentration is neither a necessary nor sufficient condition for success, given the large number of non-agricultural banks that succeeded during this period and the fact that in a future crisis, agricultural conditions may be reversed.

ANALYSIS OF PROBLEM BANKS UPGRADED TO CAMELS 1 OR 2

Of the 155 banks in Table 2A that survived to March 31, 2013, and were upgraded to CAMELS 1 or 2 by that date, 33 were purchased by bank holding companies other than their parent companies[5]at the time of their downgrades to CAMELS 4 or 5. The remaining 120 banks recovered without being purchased by other parent organizations. These 120 recovered banks were located in 35 states, with 10 or more recovered banks in the states of California, Minnesota and Texas.[6]

Table 4 indicates the distribution of the recovered banks by total assets as of the initial adverse rating date. The total assets of the recovered banks range from less than $50 million to slightly more than $10 billion, with the greatest concentration in the asset range from $300 million to $1 billion.[7]

[5] The 33 banks finding a new owner is in addition to the 161 banks that surrendered their charters through merger into other institutions.
[6] We have not investigated possible reasons for concentrations of the recovered banks in these three states.
[7] Several banks were allowed to stay in the sample if they briefly exceeded $10 billion in assets.

Table 5 indicates a wide variation among the recovered banks in the length of time from their initial downgrades to CAMELS 4 or 5 to their upgrades to 1 or 2. At the extremes of this distribution, three banks recovered within 12 months, whereas recovery took more than five years for three other banks. For about three-quarters of the recovered banks, the recovery period was longer than 24 months but not longer than 48 months.

Table 6 indicates that the recovery process for many of the banks did not involve shrinking their total assets in order to increase their ratios of capital to assets. About 60 percent of the recovered banks had reductions in their total assets during the process of recovery, but percentage declines in assets were not large among most of these banks. For instance, of the 73 banks that reduced their assets during their recovery period, only 10 banks had reductions greater than 25 percent. About 20 percent of the recovered banks had increases in their assets of 10 percent or more.

Table 7 provides information on equity injections into the recovered problem banks during their recovery process. Two of the 120 recovered banks had net equity withdrawals by shareholders during the recovery process. There were no equity injections or withdrawals at 34 of the recovered banks. Among the recovered banks with equity injections during the recovery process, equity injections as a percentage of total assets as of the quarter of the recovery ranged from very small to more than 20 percent. This evidence is too varied among recovered community banks to draw generalizations about the role of equity injections in recovery of problem community banks.

Figure 1 shows the weak relationship between equity injections and changes in assets during the recovery process. Each dot represents a recovered bank. The horizontal axis indicates the percentage change in total assets during the recovery process (from a downgrade to a CAMELS 4 or 5 to an upgrade to a CAMELS 1 or 2). The vertical axis represents equity injections as a percentage of total assets as of the upgrade quarter. As shown in the figure, the majority of recovered banks shrank during the recovery process, but the level of equity injections

varied widely.[8] The role of equity injections in community bank recoveries is the subject of ongoing study during this research program.

INSIGHTS INTO THE RECOVERY PROCESS FROM INTERVIEWS WITH LEADERS OF RECOVERED COMMUNITY BANKS

Evidence in Tables 6 and 7 indicates that the recovery process for problem community banks involves more than just reducing assets or receiving equity injections. We are attempting to learn more about the recovery process at community banks by talking to leaders of community banks that have had upgrades in their CAMELS ratings from 4 or 5 to 1 or 2. Table 8 presents a list of questions that have been discussed with a sample of recovered community banks. At this time we have talked with leaders of eight recovered community banks, and reviewed data and other relevant information on approximately one-fourth of our 120-bank sample.

A common theme among the institutions we either analyzed or spoke to directly was that, in general, a bank's recovery was accompanied by a change in management, a change in ownership, or both. At this stage in our analysis, we have not uncovered any "recovered" bank that did not experience some sort of change at either the management or ownership level. In addition, a small minority of firms were able to steer their institutions through a recovery process without the injection of new capital. However, in most instances that we've analyzed, an injection of new capital was necessary for the institution to begin dealing with its legacy problem assets and repairing its balance sheet. Operational management and relationships with regulators were also noted as important factors.

The following summarizes the common themes among the recovered banks we either analyzed or spoke to during our research.

New Management. For those recovered institutions that experienced management changes, particularly at the most senior levels of the organizations, a few key themes have already begun to emerge. For example, in most instances where management changed while

[8] Outlier banks with greater than 100 percent asset growth or equity injections of more than 10 percent of assets are not included in this figure.

ownership remained the same, a new bank president hired by the bank's owners was generally well-known in local or regional banking circles and had personal or professional connections in the geographic location in which the institution operated. In many instances, the new bank president was either near retirement or actually came out of retirement in order to guide the institution through its recovery process, suggesting that owners of a troubled banking institution might put a premium on long-tenured bankers with solid reputations in the industry. Also, the majority of new bank presidents we interviewed discussed the need to re-orient the bank around "core banking principles" and "conservative underwriting standards." Our conversations with management at these types of institutions usually focused on both the specific steps to recovery and the amount of engagement and education that needed to take place with the bank's directors. One bank president mentioned spending a significant amount of time during board meetings educating the bank's directors on their responsibilities. This president also hired an outside consultant to serve as a non-voting board member to analyze lending opportunities and to present them to the board – an arrangement the bank cites as helping its board understand the extent of its duties as well as its liabilities.

New Ownership. While new ownership of a troubled institution was usually accompanied by new management, our analysis has already uncovered a few exceptions. Most notably, management has tended to remain in place, despite a change in ownership at a troubled institution, when the new ownership team believes that the problems facing the institution were caused by the prior owners rather than the management team itself. Bank presidents that guided their institutions through both the challenges and the recovery of their banks, albeit under new ownership, generally highlighted the balance they needed to strike with the desires of their previous ownership to adjust the bank's strategy against their sense of the most effective way to run the bank. One bank president, for example, discussed the challenges of trying to instill a sense of caution in implementing a new strategy to purchase a significant amount of loan participations when the bank's ownership team had experience at other banks in which such a strategy resulted in significant returns for shareholders and wanted to replicate it.

Operational Management. Perhaps the most common theme in our research thus far is the importance of reputation management by the individuals leading the bank through recovery. From our initial interviews, reputation management appears to manifest itself in several ways:

how aggressively management chooses to follow-up on nonperforming loans, which employees it chooses to retain and which it chooses to fire, which perquisites management chooses to keep and which it chooses to eliminate, and how management manages its relationships with existing customers. In several instances, bank management had to deal with poor loan administration at their institutions. While many cited the loss of some key customers due to the subsequent implementation of more sound loan administration policies, these bank presidents also discussed how being too aggressive in the early stages of recovery could (and sometimes did) back-fire and lead to the loss of some good customers in addition to bad ones.

Operational management also appears to impact personnel decisions. In those instances thus far in our interview process where a new management team comes into the bank, it seems that existing employees are already anticipating further staff changes, which impacts morale at the institution and the reputation of the bank in its community. One newly hired bank president asked all employees for their resumes and systematically "re-hired" them while another identified the most underutilized talent at the bank and subsequently promoted those individuals to positions that reflected both their expertise and experience. Such tactics seemed to have had the effect of establishing the new management teams as mission-focused and professional. In fact, many of the newly hired bank presidents discussed that many of the bad tactical decisions that had gotten the bank into trouble were not so much mistakes as they were the natural result of an unprofessional business culture at the organization. According to one bank president, the key to managing reputation during the bank's recovery was retaining non-managerial employees who had day-to-day interactions with the bank's customers and treating employees professionally and with respect.

Relationships with Regulators. This study on recovered banks, by design, explores the interactions between banks and their regulators. At institutions where decisions by the banks' owners appeared to have contributed significantly to the initial problems at the bank, our analysis suggests that the enforcement action levied by the regulators was a necessary catalyst for action. One bank president even suggested that the bank's directors would not have made the necessary management changes nor would they have made the appropriate adjustments to the bank's loan administration policies had a public enforcement action not been implemented. This banker attributed this effect to the fact that, aside from having regulators constantly in the bank, there

was an important reputation component: in small communities, word spreads quickly when a bank gets into trouble, which impacts every bank employee and every director when he or she is out in the community.

In other instances, and with the benefit of hindsight, some bank presidents found that regulators required them to classify or charge off loans that were of bankable quality but not sufficiently documented. Essentially, some bankers believed their banks were penalized for insufficient documentation, significant out-of-market lending, or for allowing too many exceptions to policy on loans, rather than for problems with underlying loan quality. While none of these bank presidents disputed that the changes they implemented in reaction to supervisory pressure ultimately made their institutions more profitable and better able to weather future stresses, they did question the severity of the regulatory response.

None of the interviewees questioned the importance of having constant communication with the bank's state and/or federal regulators during the recovery process. One bank president, who suggested that the bank may have been at the brink of failure at various points during its recovery, cited the fact that the FDIC was always willing to work with management in identifying and implementing solutions to avoid failure as long as the solutions provided maximum protection to the FDIC's Deposit Insurance Fund. In another instance, a newly hired bank president cited that the new management team was unable to have regular and professional contact with the bank's primary federal regulator due to what the new management team perceived was a personal relationship between the local regulator and the previous management team. According to this bank president, the contentious relationship made it extremely difficult to implement an appropriate and timely recovery plan.

In some instances, regulators demanded management changes, while in others, they required the hiring of independent directors to the board of directors. Although none of the bankers we spoke to experienced a situation in which a regulator actually levied a financial penalty against any of its directors, some stated that director liability is a growing problem and that more communication between regulators and community bank directors will be necessary in the future. Specifically, some of the community bank presidents we spoke to suggested that there is a need for clearer, less subjective guidance on director liability so that banks can continue to attract good directors. Similar views were expressed by community bankers during town hall

meetings conducted by 28 state banking commissioners with more than 1,700 community bankers from April 2013 to July 2013.[9]

CONCLUSION

As in the previous paper in our on-going research agenda, our goal was to determine what we could learn about the future viability of U.S. community banks by examining the successes in the industry. To that end, we examined the attributes of banks that suffered severe financial distress but managed to recover to safe-and-sound status. Much academic research and supervisory resources have been devoted to studying banks that failed to turn around, but our goal was to determine what "best practices" may have been instrumental in staving off that failure.

We began by providing a variety of summary statistics that distinguish the performance and risk profiles of banks with varying degrees of recovery success. We supplemented this analysis with interview evidence from bankers in a subsample of community banks to obtain information that could not be gleaned from financial data or even from examination reports. Our analysis shows that the majority of recoveries followed significant changes in ownership and/or management. In some cases, a return to health could also be achieved by the existing managers as long as they put the bank back on a path of conservative underwriting principles and sound policies and procedures.

[9] The findings from these meetings are being published and released on October 3, 2013 as part of the Community Banking in the 21st Century research and policy conference co-sponsored by the Federal Reserve System and the Conference of State Bank Supervisors. A copy of this publication, Community Banking in the 21st Century: Opportunities, Challenges and Perspectives, will be available on the conference web site at http://www.stlouisfed.org/cbrc2013.

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Table 1

Lowest CAMELS Rating for Community Banks during the period from January 1, 2006 through March 31, 2013

CAMELS Rating	Number of Banks	Percent
1	902	12.4%
2	3,313	45.5
3	1,669	22.9
4	703	9.7
5	687	9.4
Total	7,274	99.9

Table 2A

Of the Banks that were Rated CAMELS 4 or 5 from 2006 through March 31, 2013 Status as of March 31, 2013

Status	Number	Percentage
Rated 5	191	13.7
Rated 4	332	23.9
Rated 3	196	14.1
Rated 2	149	10.7
Rated 1	6	0.4
Merged	161	11.6
Failed	355	25.6
Sum	1,390	100.0

Table 2B

Of the Banks that were Rated CAMELS 4 or 5 from 2006 through March 31, 2013
Status as of March 31, 2013

Performance Ratio	**5**	**4**	**3**	**1 or 2**
Number of Banks	191	332	196	155
Return on Assets (ROA)	-0.81	0.01	0.44	0.88
Return on Equity (ROE)	-20.55	0.51	3.73	7.50
Loan Losses / Total Loans	1.54	0.71	0.45	0.27
Provision Expense / Avg. Assets	0.45	0.27	0.18	0.07
Efficiency Ratio	136.86	103.08	86.29	80.13
Net Interest Margin (NIM)	3.01	3.29	3.37	3.52
Net Noninterest Margin (NNIM)	3.43	3.03	2.74	2.47

NOTE: Data are for U.S. community banks with less than $10 billion in assets. NIM means net interest margin; NNIM means net non-interest margin; ROA means return on assets; and ROE means return on equity.

Table 2C

Of the Banks that were Rated CAMELS 4 or 5 from 2006 through March 31, 2013
Status as of March 31, 2013

Strategic Ratio	**5**	**4**	**3**	**1 or 2**
Number of Banks	191	332	196	155
Total Loans / TA	63.19	63.12	63.03	61.15
Commercial RE / TL	56.23	50.11	49.79	43.42
CLD / TL	9.40	8.10	6.96	5.56
Nonfarm Nonres. / TL	42.73	37.48	38.09	33.70
Multifamily / TL	3.91	4.13	4.34	3.79
Farmland-Secured / TL	2.21	3.64	4.89	6.48
1-4 Family-Secured / TL	22.12	22.52	20.26	22.10
HELOC / TL	4.16	3.66	3.40	2.81
C&I / TL	11.12	13.82	13.06	14.81
Consumer / TL	2.42	3.62	3.46	3.90
Agricultural / TL	0.82	1.85	3.52	5.33
All Other Loans / TL	0.74	0.37	1.22	0.77
Core Deposits / Total Dep	72.88	78.45	81.08	82.94

NOTE: Data are for U.S. community banks with less than $10 billion in assets. C&I means commercial and industrial loans; CLD means construction and land development loans; HELOC means home equity lines of credit; and TL means total loans.

Table 3

Bank Failure Cases Resolved by the FDIC without Acquirers for the Failed Banks[10]

Period	Number of bank failures	No. resolved without acquirers	Percentage acquired without acquirers
Mar-2013	4	0	0.0
2012	51	6	11.8
2011	92	2	2.2
2010	157	8	5.1
2009	140	11	7.9
2008	14	0	0.0
2007	3	0	0.0

Table 4 -

Total Assets of Recovered Banks as of the Quarter of the Initial Downgrade to CAMELS 4 or 5

Asset size	Number of recovered banks
Over $10 billion[11]	2
$1 billion to $10 billion	10
$300 million to $1 billion	15
$100 million to $300 million	50
$50 million to $100 million	23
Up to $50 million	20
Total	120

[10] Includes failures of commercial banks and FDIC insured savings organizations.
[11] Several banks were allowed to stay in the sample if they briefly exceeded $10 billion in assets.

Table 5

Length of Time from the Initial Downgrade of CAMELS Rating of 4 or 5 to Upgrade to CAMELS 1 or 2

Months	Number of Banks	Percentage of Banks
1 to 12	3	2.5 %
13 to 24	18	15.0
25 to 36	57	47.5
37 to 48	30	25.0
49 to 60	9	7.5
Over 60	3	2.5
Total	120	100.0

Table 6

Percentage change in Total Assets from the Quarter of the Initial Downgrade to CAMELS 4 or 5 to the Upgrade to CAMELS 1 or 2

Range of Percentage Change	Number of banks
X > 100	3
100 > X > 50	2
50 > X > 25	5
25 > X > 10	10
10 > X > 0	27
0 > X > - 10	35
-10 > X > -25	28
-25 > X > -50	9
-50 > X	1
Total	120

Table 7

Equity Injections into Recovered Banks from the Quarter of the Initial Downgrade to CAMELS 4 or 5 to the Upgrade to 1 or 2 as Percentage of Total Assets as of the Quarter of the Upgrade

Range of Equity Injections	**Number of banks**
Withdrawals of equity	2
Zero	34
0.00 < X < 0.01	20
0.01 < X < 0.02	20
0.02 < X < 0.03	12
0.03 < X < 0.04	8
0.04 < X < 0.05	4
0.05 < X < 0.06	6
0.06 < X < 0.07	6
0.07 < X < 0.08	2
0.08 < X < 0.09	1
0.09 < X < 0.1	0
0.10 < X < 0.20	2
0.20 < X	3
Total	120

Table 8

Questions to Ask Leaders of Recovered Banks

1. What were the key factors that enabled your bank to recover from the challenges it faced during the financial crisis? Was there one key step or factor that was most significant for your institution's recovery?

2. Please describe the role of management in helping your bank recover from its challenges. Did your institution experience any management changes? If so, how were they implemented?

3. Please describe the role of your board in helping your bank recover from its challenges. Did the composition of your board change? If so, how were these changes implemented?

4. Did your bank exit business lines or reduce its emphasis in certain business areas to recover?

5. Did your bank need to grow or shrink its geographic footprint to recover?

6. Please describe the role of regulators during your bank's recovery.

7. Having gone through the experience of taking your bank through the recovery process, is there anything, upon further reflection, that you would now do differently?

8. What changes have you implemented that you believe will protect your bank from again experiencing the types of stresses it experienced during the financial crisis?

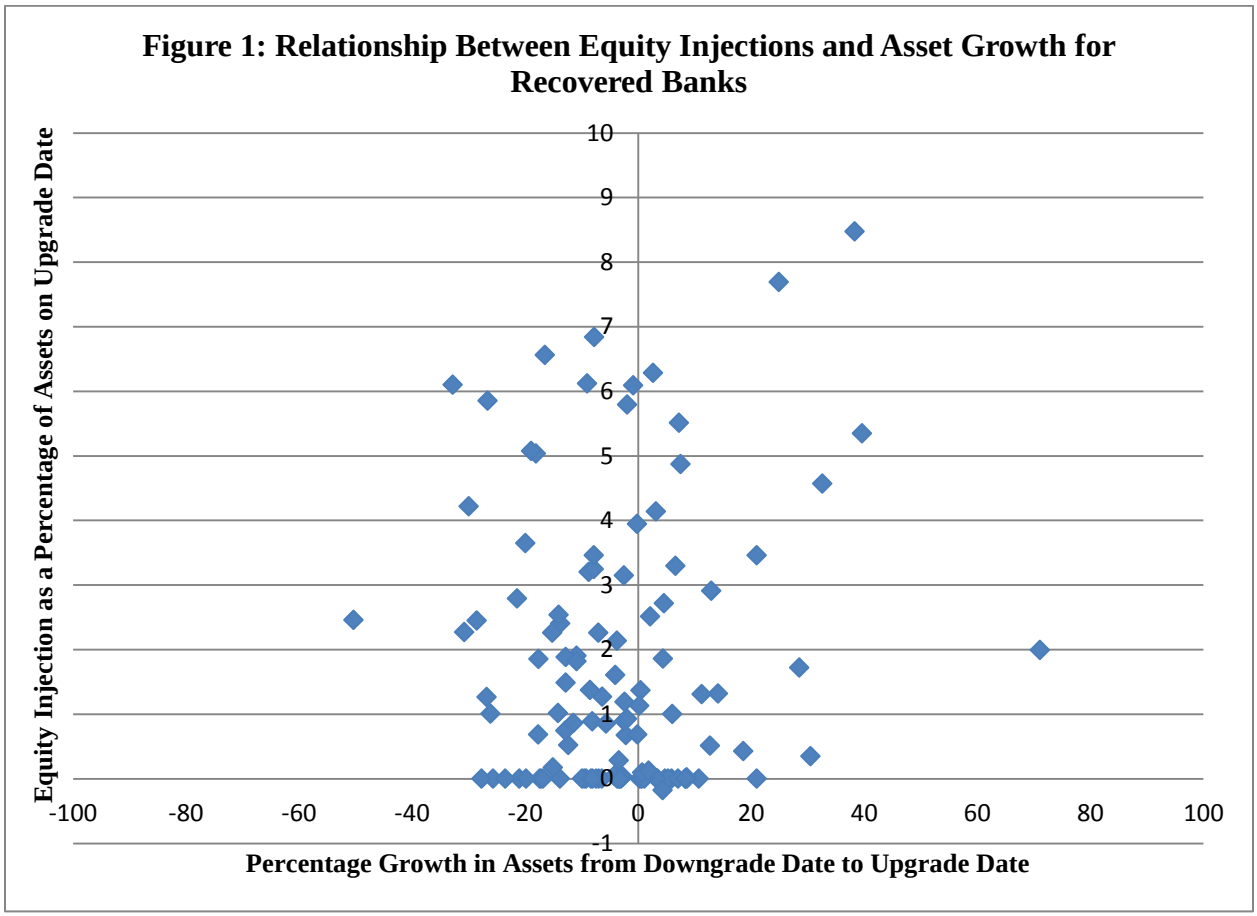
Figure 1: Relationship Between Equity Injections and Asset Growth for Recovered Banks
Equity Injection as a Percentage of Assets on Upgrade Date
10
9
8
7
6
5
4
3
2
1
0
-1
-100
-80
-60
-40
-20
0
20
40
60
80
100
Percentage Growth in Assets from Downgrade Date to Upgrade Date