Community Banking
in the 21st Century

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

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Our objective:

- To investigate what we can learn about the viability of the community bank business model from the operation of banks that recovered from severe distress in recent years.

Our thesis:

- The community banks that can survive economic downturns in the future will likely have characteristics similar to community banks that managed to recover from the recent financial crisis and its aftermath.

Identifying Recovered Community Banks

- Banks in domestic banking organizations with total assets less than $10 billion.
- Had CAMELS rating of 4 or 5 at some point during the years 2006 through 2011.
- Upgraded to a CAMELS rating of 1 or 2 by March 31, 2013.

Two-Pronged Approach

- Quantitative analysis of the differences between banks that managed to recover and those that did not.
- Qualitative analysis of how the recovered banks managed to do so.

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	100.0

Of the CAMELS 4- or 5-rated Banks, Status as of March 2013

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

Performance Measures as of March 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

Other Financial Ratios as of March 2013

Financial 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

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	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

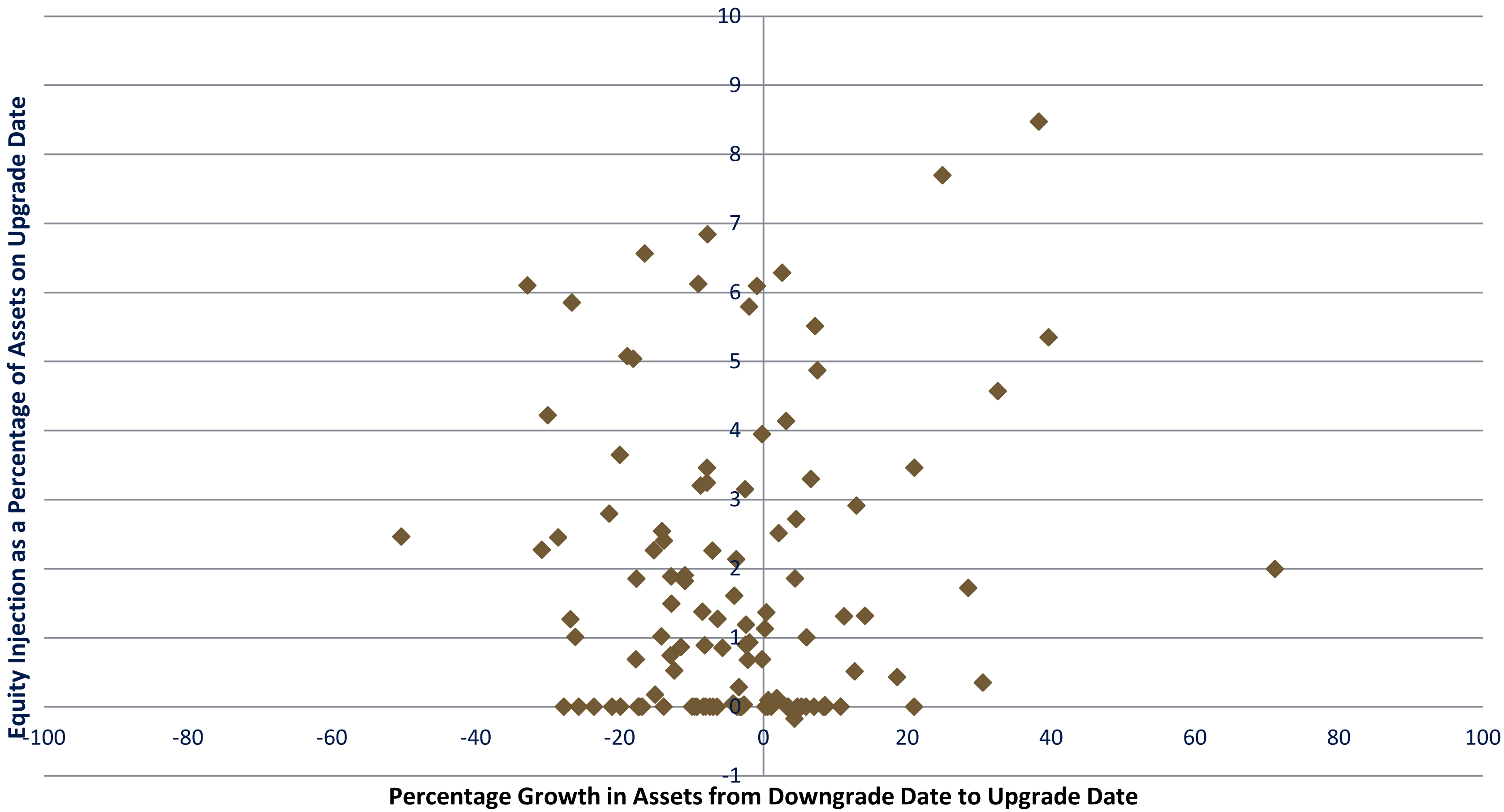
Length of Time From the Initial Downgrade to CAMELS 4 or 5 to Upgrade to 1 or 2

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

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

Relationship Between Equity Injections and Asset Growth for Recovered Banks



Interviews with Leaders of Recovered Banks

- Off-site statistical analysis can track (and even forecast) the results of management decisions, but it can only go so far.
- Exam reports from the downgrade and upgrade exams give additional insights.
- We can attain much richer insight, however, by talking directly to the leaders of the banks themselves.

Change in Management

- Recovery was usually accompanied by new management, but not always, especially if the prior management was not to blame for the financial distress.
- The new president was often well-known in local or regional banking circles.
- Often, the new leader was near retirement or came out of retirement to save the bank. (Experience matters.)
- Sometimes had to educate the bank's board of directors on its responsibilities (and liabilities).

New Ownership

- The banks often benefitted from deep-pocketed new owners, whether new stockholders or a new holding company, who had the willingness and ability to inject new capital.
- Sometimes, if the prior management team remained in place, their recent experiences made them more conservative than the new owners wanted them to be.

Operational Management

- Reputation risk was a high priority, especially in small communities where everyone knows you.
- Had to be careful about how aggressively to follow up on nonperforming loans.
- Had to decide which employees to retain and which to replace without alienating customers and the community.
- Difficult to find qualified board members who were comfortable with director liability.

Relationship with Regulators

- At least one new bank president suggested that it took an enforcement action to spur the board of directors to make necessary management and other changes.
- Some bankers suggested that regulators were too quick to force write-downs on loans based on poor documentation instead of poor performance.
- Most bankers stressed the need for close communication with regulators.

Overall Insights from Interviews with Leaders of Recovered Banks

- Recovery involves much more than just reducing assets and receiving equity injections.
- Usually (but not always) involves a change in management, in ownership, or both.
- Common theme was a return to fundamentals and to conservative underwriting principles.