

**Bank**Director.

# Breakout 5: One Year Later: The Bond Market's View of Community Banks

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*KBRA*

#A0BA24



# **ONE YEAR LATER: THE BOND MARKET'S VIEW OF COMMUNITY BANKS**

Acquire or Be Acquired Conference

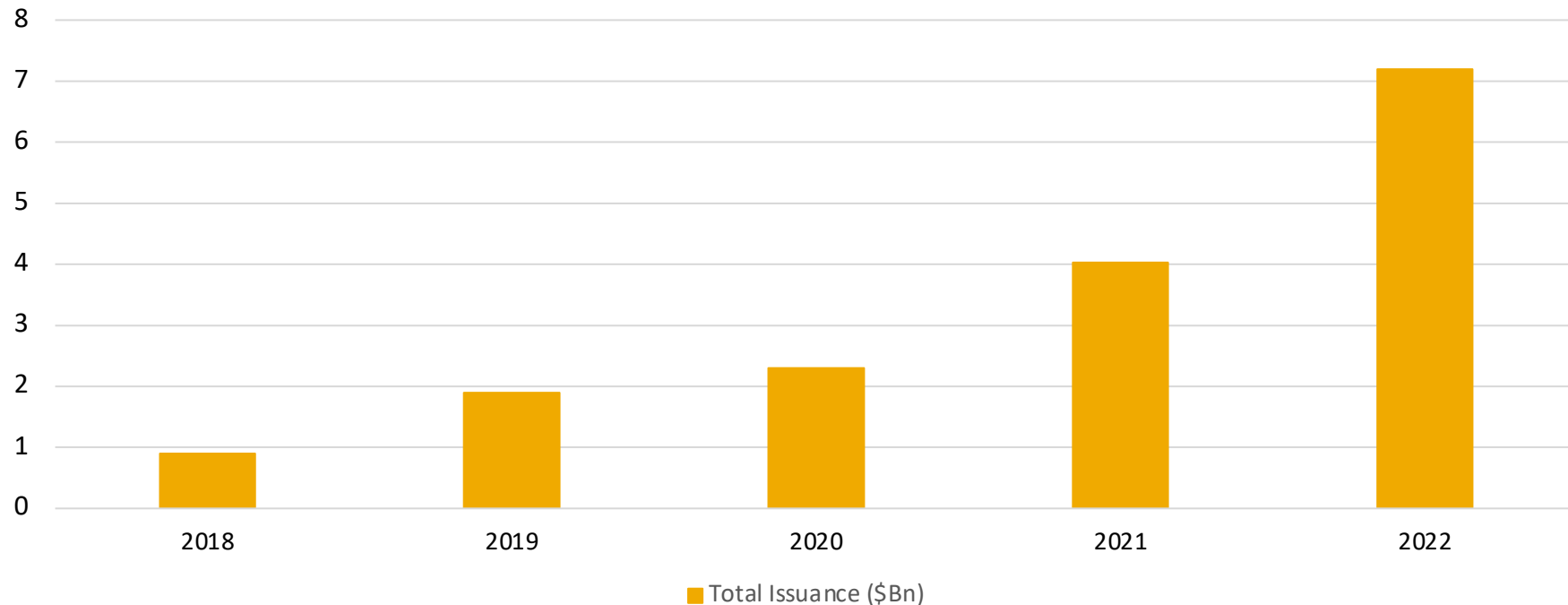
Van Hesser, Chief Strategist

January 2024

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# A New Market: Access to Cost Effective Debt Markets

## Community Bank Total Bond Issuance (\$ bn), 2018-2022

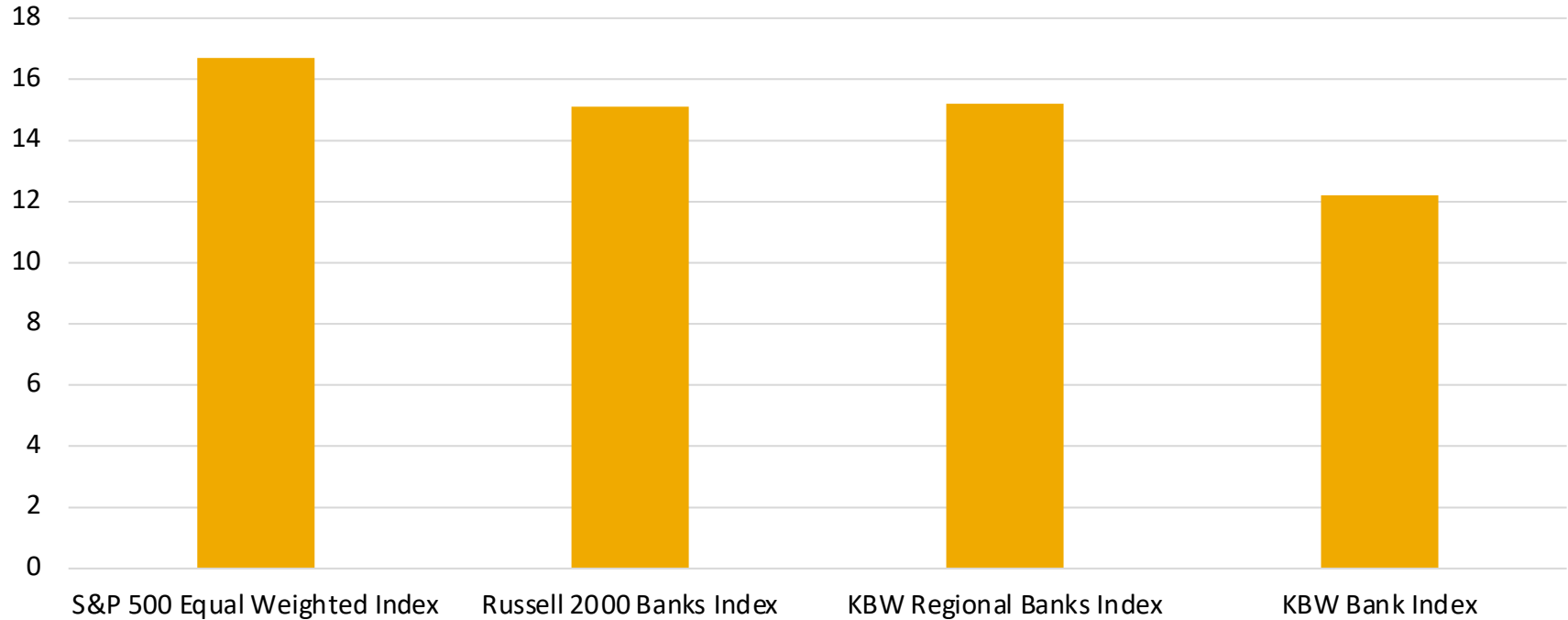


Source: Keefe Bruyette, & Woods



# Equity Markets Approve

## Average Forward P/E Multiples, 2012-2019



# Community Banks *Can* Be Well Regarded By Investors

- Comparable cost structure to larger banks
- Consolidation story
- Sufficient risk diversification
- Credible value proposition
- Regulatory oversight

# “The March Events”

## Perspective

- 3 banks fail out of 4,700
- Highly idiosyncratic

## But...

### ...An Unsettling Wake-Up Call

- Technological Disruption
  - Deposit stickiness and cheapness in an era of smartphones + social media
- Strategic Stasis
  - “Most stand-alone loans don’t return their cost of capital” – Christopher Gorman, CEO of KeyCorp
- Regulatory Defects
  - Ineffective supervision
  - Dated deposit insurance scheme

# Community Banks: Conventional Wisdom

Competitively Disadvantaged	High Risk
<ul style="list-style-type: none"><li>▪ Inefficient</li><li>▪ Simple product set</li><li>▪ Incapable of keeping up on marketing, technology fronts</li></ul>	<ul style="list-style-type: none"><li>▪ Adverse selection</li><li>▪ Concentrated risks</li></ul>



**Size Bias**

# A Reimagined Take

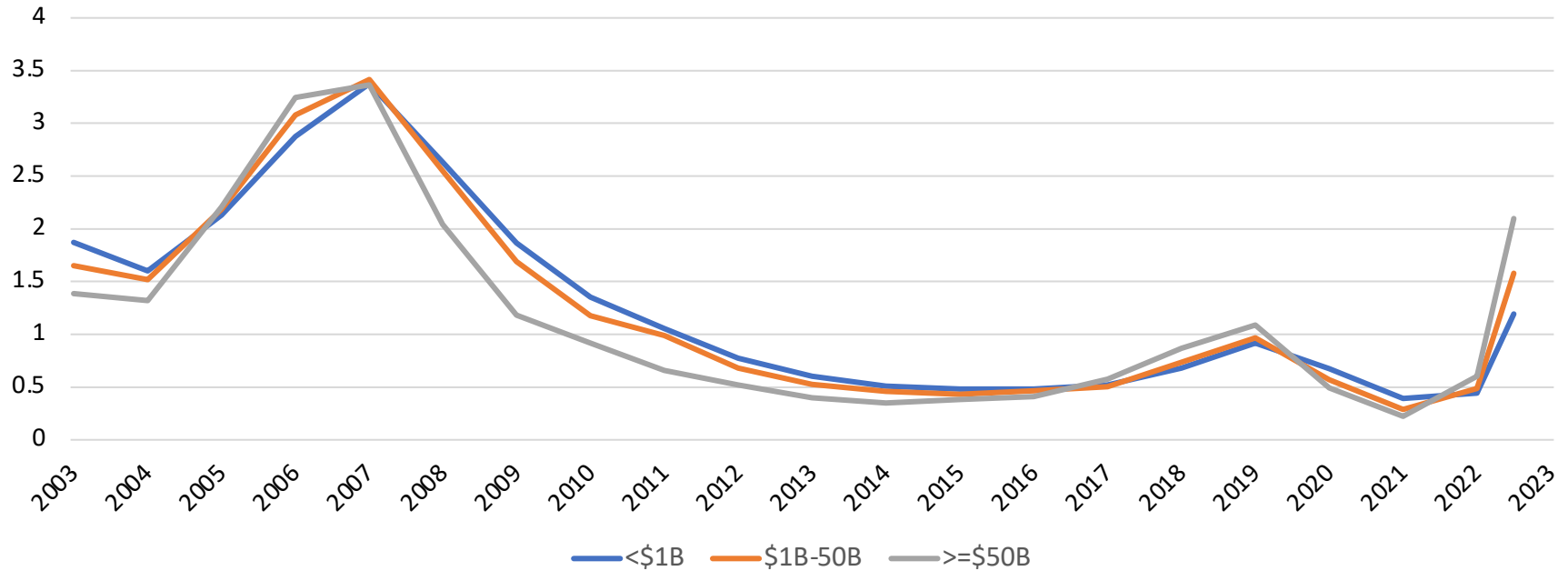
## Let's test conventional thinking...

- “Community Banks are Competitively Disadvantaged...”
- Let's look at cost structure
  - Raw material—cost of funds
  - Overhead—non-interest expense
- “Community Banks are High Risk”
- Let's look at loan loss experience
- Let's examine risk-adjusted profitability



# Deposit Insurance Drives Comparable Cost Structure

## Average Cost of Liabilities (2003-2023)



Source: KBRA Financial Intelligence

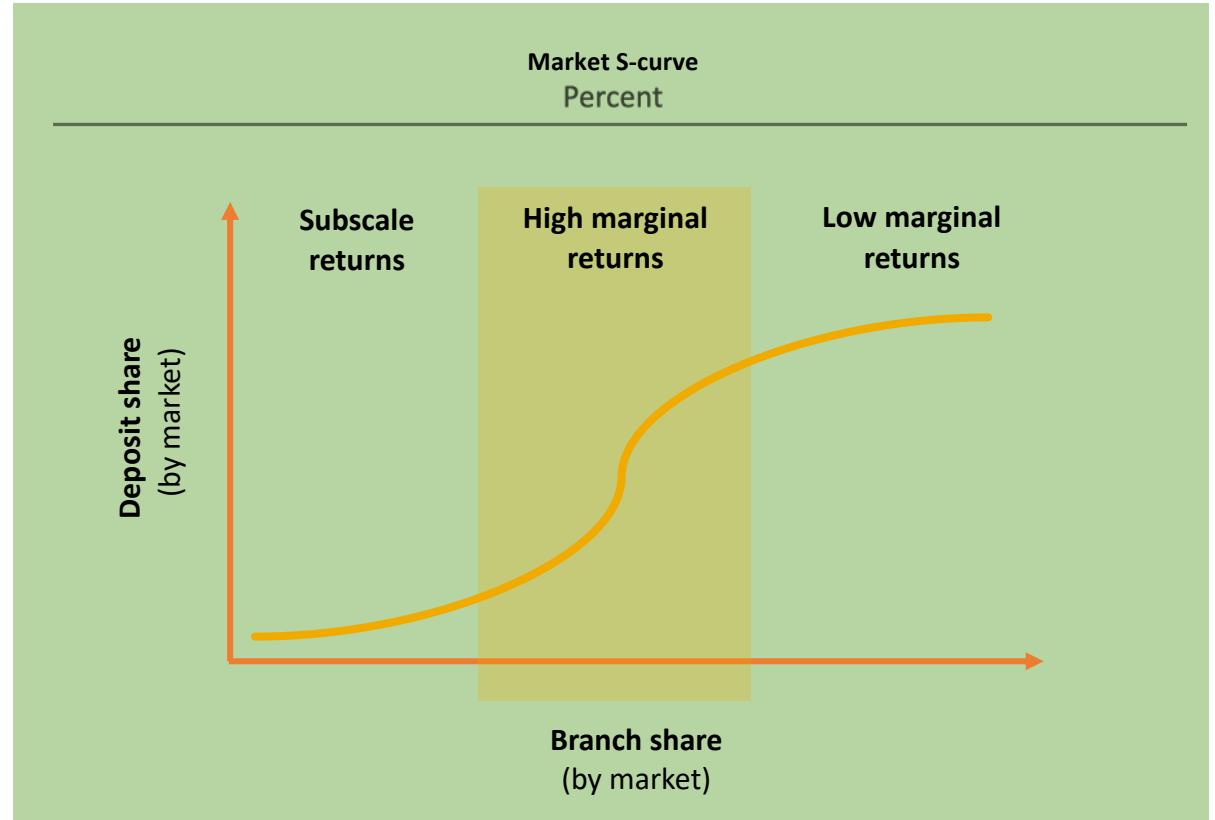


# Banking is a Scale Business, But Which Scale?

## Local scale matters most

“Although many people associate economies of scale with large regional and national banks...community banks generally realize most of the benefits of scale by the time they reach \$600 million in assets.”

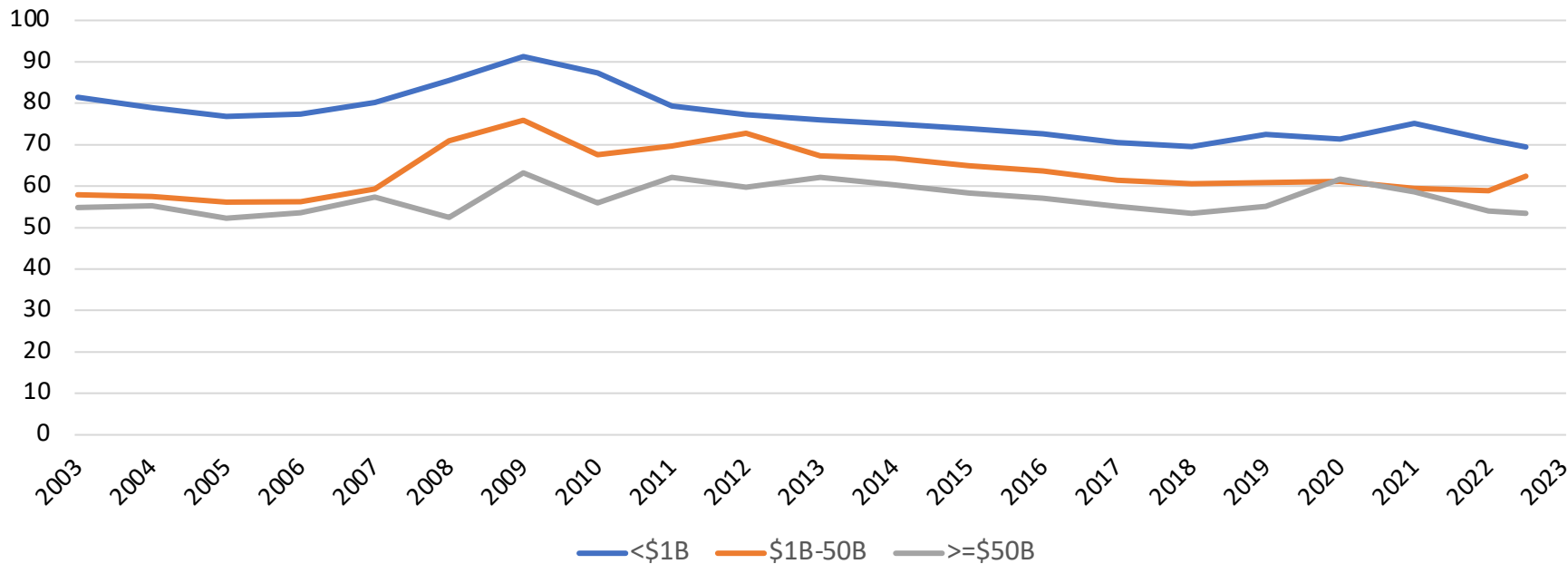
- FDIC Community Banking Study, December 2020



Source: KBRA

# Comparable Efficiency Speaks to Simplicity of Model

## Average Efficiency Ratio (2003-2023)

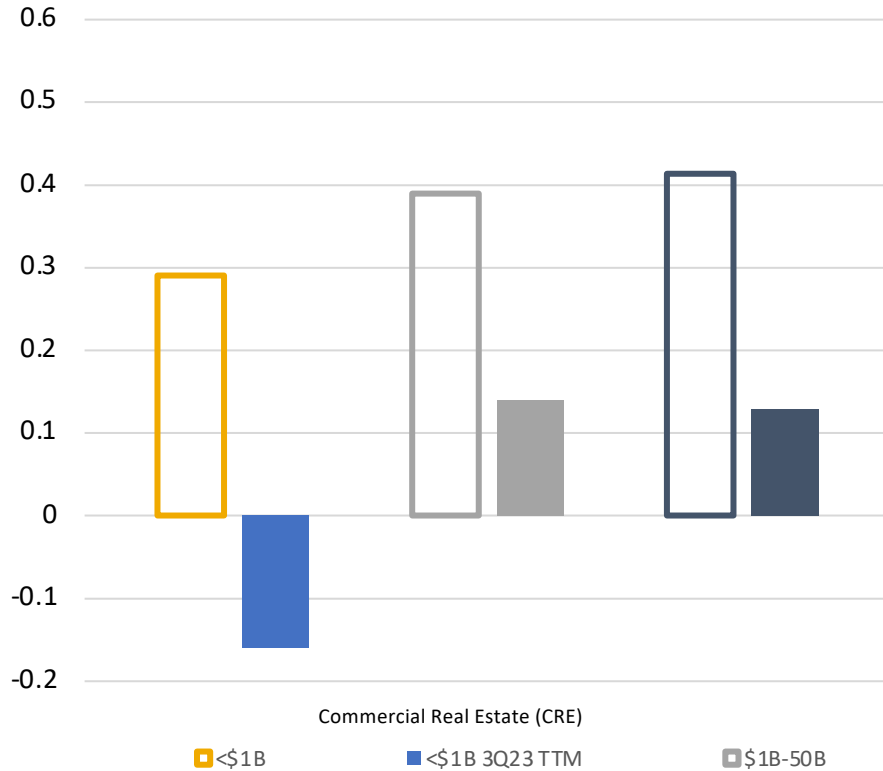


Source: KBRA Financial Intelligence

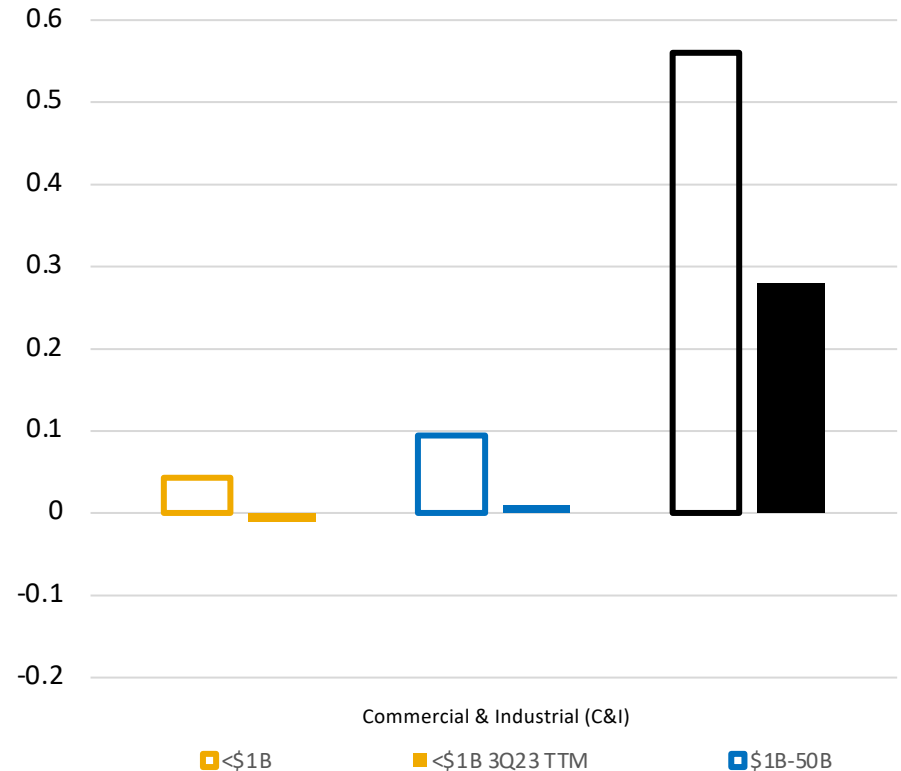


# No Need to Reach for Earnings via the Loan Book

CRE NCO's, Today vs. 20-Yr Avg



C&I NCO's, Today vs. 20-Yr Avg

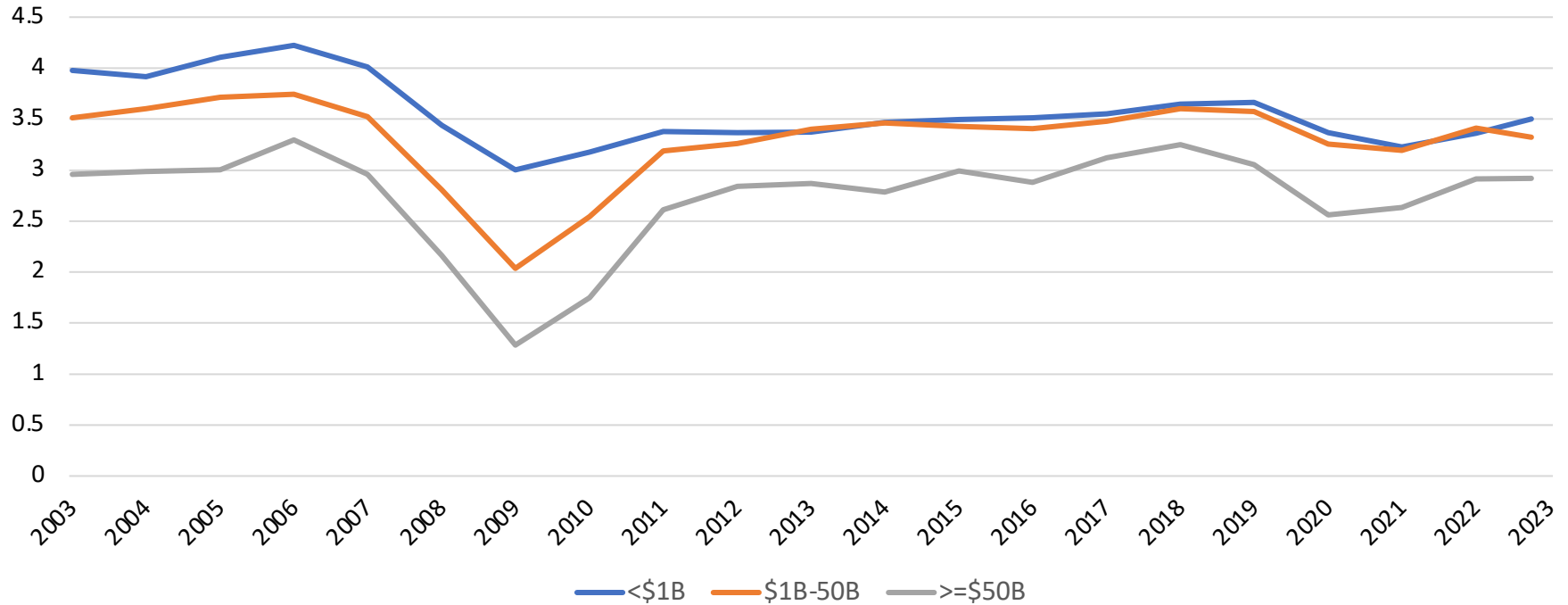


Source: KBRA Financial Intelligence



# The Model Makes Sense

## Average Risk Adjusted Margin (2003-2023)

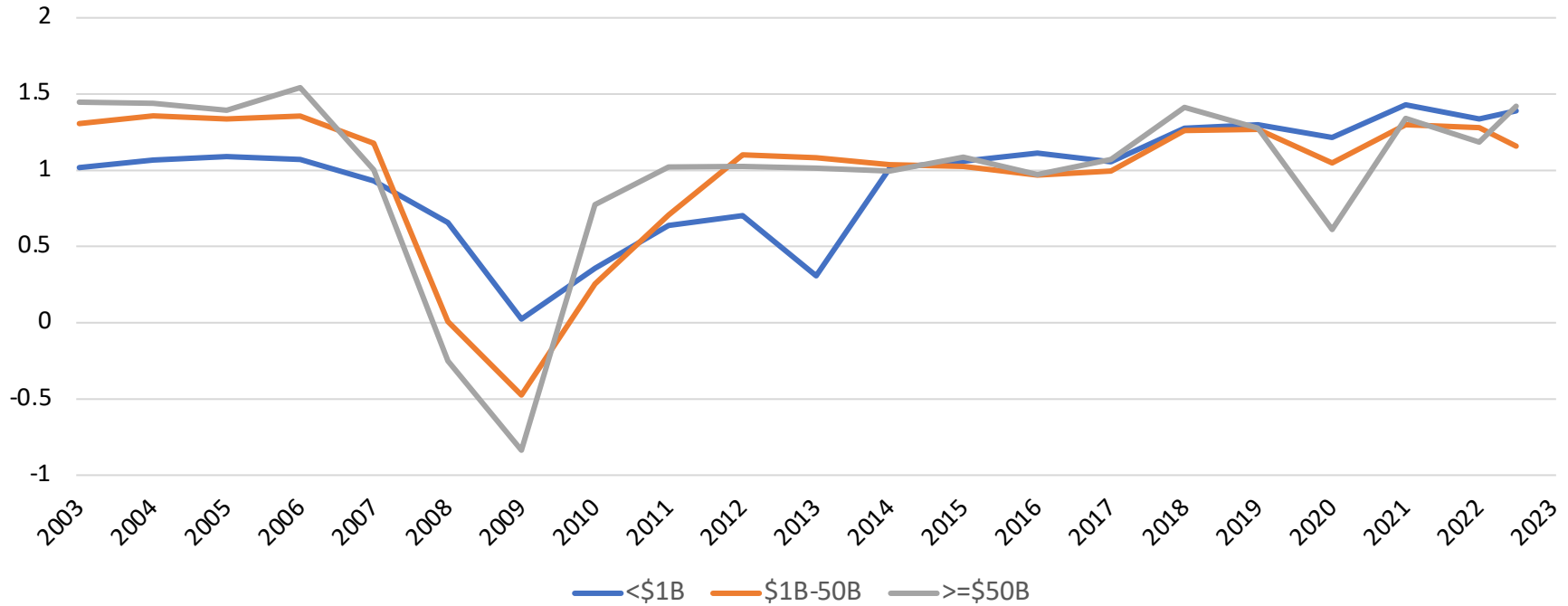


Source: KBRA Financial Intelligence



# Proof is in the Pudding

## Average Return on Assets (2003-2023)



Source: KBRA Financial Intelligence



# Community Banking's Credible Value Proposition

- Local market knowledge
- Local relationships, community involvement
- Superior responsiveness

# An Important Cog In The Wheel

*“... Midsized and community banks...are essential to the American economic system. They fill a critical role in small communities, offering local knowledge and local relationships that some large banks simply can’t provide—or can’t provide cost-effectively.”*

Jamie Dimon, CEO J.P. Morgan Chase

Source: JP Morgan Chase & Co.



# The World's Best Financial System?

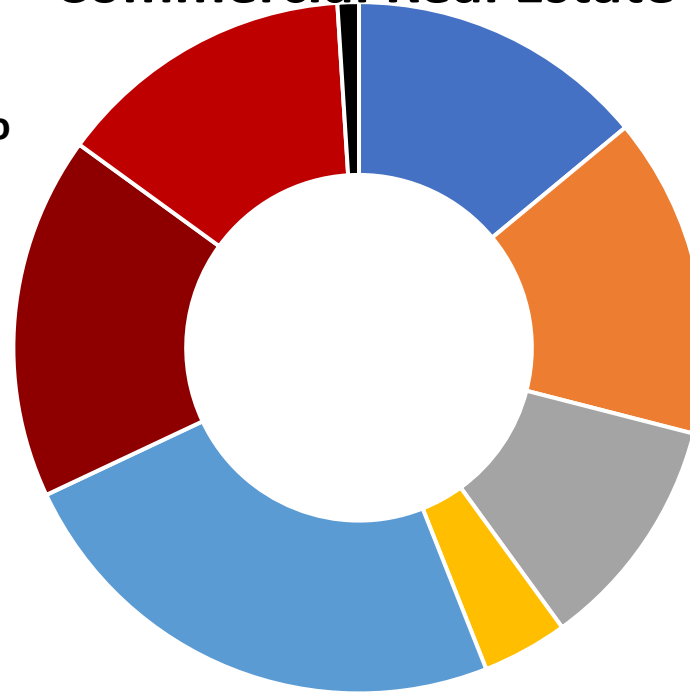
	Nonbanks		Banks		
	Public Debt & Equity	Private Debt & Equity	Universal	Regional	Community
Targeted Commercial Customer	Mid-sized to Very Large	Full Quality Spectrum Small to Large	High Quality Small to Very Large	Higher Quality Small to Large	Higher Quality Small
Operating Leverage	N/A	Low	High	High	High
Regulatory Oversight	High	Low	High	High	High

# Guilty Until Proven Innocent

\$4.1 Trillion Total, As of Sept. 30, 2023

## Commercial Real Estate Lenders

- Agency and GSE, Portfolio and MBS  
24% (\$986 bn)
- Insurance Companies  
17% (\$702 bn)
- CMBS, CDO, other MBS  
14% (\$593 bn)
- Others  
1% (\$31 bn)



- Top 25 Banks  
15% (\$596 bn)
- Regional Banks  
(\$10 bn to \$160 bn assets)  
11% (\$485 bn)
- Community Banks  
(\$1 bn to \$10 bn assets)  
4% (\$145 bn)
- Small Banks

Source: Mortgage Bankers Association, KBRA Financial Intelligence

# Commercial Real Estate Exposure: An Earnings Drag

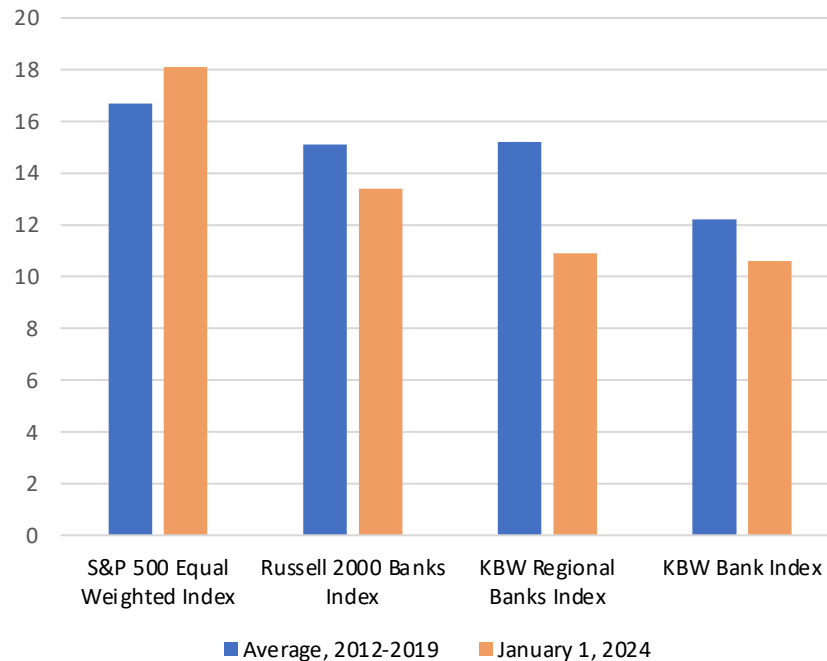
- Community Bank CRE exposure is, in general, less risky than that of larger banks
  - Minimal large market office exposure
  - In-market, economically durable properties
  - Long-standing relationship lending
  - Less speculative development
- Losses will bleed out over time

# “I Guess March Was Idiosyncratic After All”

## Bank Stock Performance



## Forward P/E Multiples

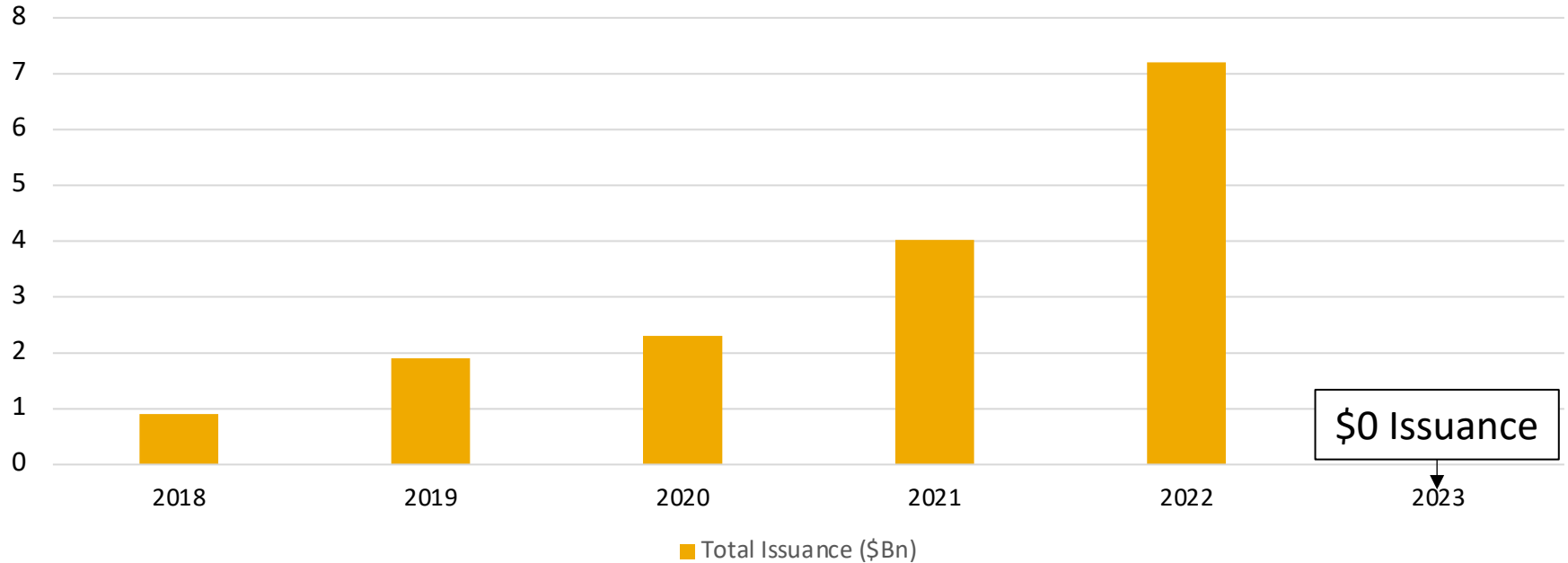


Source: S&P Global, KBW, London Stock Exchange Group, Bloomberg



# Bond Investors Awaiting Visibility

## Community Bank Total Bond Issuance (\$ bn), 2018-2022



Source: Keefe Bruyette, & Woods



# The Way Forward

## Regulation

- More capital is not the answer
  - Banking is highly levered and reliant on effective regulatory oversight for confidence
  - Makes bank credit more expensive and less accessible, pushing more lending into the less regulated private markets
- Overhaul deposit insurance scheme
  - Provide targeted coverage of commercial operational deposits
- Incorporate interest rate environment volatility in stress test
- Upgrade supervision function

## Banks

- Improve disclosure of liquidity concentration management
- Explore fair market accounting disclosure
- Improve customer profitability analytics
- Improve commercial real estate disclosure

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Chief Strategist

**Van Hesser** is a Senior Managing Director and Chief Strategist at KBRA, where he is responsible for commenting on market and economic developments and their impact on credit markets. He is also a member of the firm's Executive Committee. Van is the creator and host of KBRA's weekly podcast, 3 Things in Credit. Previously, he led the company's Financial Institutions and Corporates credit rating groups, where he leveraged over 30 years of experience as an institutional investor, sell-side research analyst, investment banker, and regulator. During his professional career, Van was named to Institutional Investor Magazine's All-America Fixed Income Research Team rankings 10 times across three categories and has marketed his investment views extensively across the U.S., Europe, and Asia. He has also served as an expert witness in important industry litigation.

Prior to joining KBRA, Van was a managing director in the Financial Institutions Group at Wells Fargo Principal Investments. Previously, he worked at HSBC Securities for 10 years, serving as managing director and global head of Credit Research and head of U.S. Fixed Income Research. He also served on HSBC's six-person Global Research Management Committee. In addition to his managerial responsibilities, Van served as a senior corporate bond research analyst covering U.S. banks, brokers, and specialty finance companies.

Van also held senior sell-side corporate bond research roles covering financial institutions at Credit Suisse First Boston and Goldman Sachs, as well as a corporate finance position in Salomon Brothers' Financial Institutions Group. He started his career as a bank examiner at the Federal Reserve Bank of New York.

Van earned a B.S., cum laude, from Fordham University and an MBA from Yale University.



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