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Mega-Banks Faring Better Than Small Banks; Loan Demand Weak

By: Mike Allen
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While the latest government report on bank earnings makes it appear the industry is in clover, there's a clear difference between how mega-banks and community banks are faring, local bankers say.

Last month, commercial banks reported aggregate net profits of $35.3 billion for the third quarter, up from $23.8 billion for the third quarter of 2010. It was the ninth straight quarter when profits exceeded those in the prior year's quarter, according to a report from the Federal Deposit Insurance Corp.

But the same report shows the largest share of the profits came from the nation's largest banks, not from the far more numerous smaller community banks. Lenders with assets greater than $10 billion, which make up only 1.4 percent of the total of about 7,400 institutions, generated $29.8 billion, or 84 percent, of the total profit.

Dan Yates, chief executive of **Regents Bank**, with about $350 million in assets, said the biggest banks derive a big part of their profits through fee income, and aren't as dependent on loans as their smaller brethren.

And because the commercial real estate markets still have risk and the margins for taking that risk remain low, many lenders are more cautious before extending credit, he said.

Good for Borrowers, Not Banks

"There's an overcapacity that's happening nationally," Yates said. "There are more banks looking (to make) loans, and that's driving down rates. It's good for borrowers, but not good for bank earnings."

In the third quarter, Regents' loan balance declined to $208 million, down 8 percent from $226 million in the third quarter of 2010.

Yates said virtually all community banks are facing the same problem. They have plenty of cash, but demand for credit is at an all-time low. And with interest rates getting squeezed, profit margins don't justify the risk.

"We expect loan growth to remain tepid throughout our industry while the economy struggles to rebound," he said.

Alan Lane, chief executive of Silvergate Bank in La Jolla, with about $360 million in assets, agreed that all banks are having a tougher time generating revenue and profits.

What's Next?

He noted that the main reason why banks produced higher profits in the past quarter was most did not put aside as much money into reserves for real and potential loan losses.

“Once those reverses (on loan loss allowances) are done, then what do banks do next? It’s not a sustainable dynamic,” Lane said. “Unless loan demand comes back and banks find other ways to create revenue other than cutting expenses … it will be tough for them to beat the prior quarter’s profits.”

In September, Regents Bank’s board decided the bank would have a better shot at winning business by becoming part of a larger entity. It announced the sale of the bank to Los Angeles-based Grandpoint Capital, a holding company for two banks that has about $900 million in total assets.

That deal, which Yates said was for above book value of Regents’ stock, should close by the fourth week in January.

Like many other lenders, Regents has got control of its problem loans. As of Sept. 30, it reported only $1.8 million in nonaccrual loans, or 0.5 percent of its total assets, minuscule by any measure. At the end of 2009, Regents held $8 million in problem loans, about 4 percent of its assets.

With the problems so few, the bank didn’t put any money into its loan loss reserves. Most banks also cut back substantially on those allocations.

Reduced provisions usually translate to increased profits.

Reduced Profits
But for smaller banks like Regents, fewer loans and more loan payoffs mean reduced profits. It had net income of $430,000 in the third quarter compared with $830,000 in the like quarter of 2010. For the nine months, Regents had net income of $1.2 million compared with a net loss of $68,000.

Some banks don’t make it. The FDIC reported that there were 26 failures in the third quarter, nearly all of them small community banks, and no mega-banks. In the first nine months of 2011, there were 74 bank failures, down from 127 for the like period of 2010.

Yates sees fewer bank failures, but an increased number of mergers and acquisitions. Bank boards will look to sell as they realize how difficult growing and making money has become in this economy.

Undoubtedly, the industry will continue to contract, he said. As of Sept. 30, there were 7,436 insured financial institutions. But of that figure, 6,769 of the banks were below $1 billion in assets.

“The (number of remaining banks) that I’ve heard is that the industry will be somewhere between 2,000 to 5,000 banks over the next two to five years,” Yates said.