OPENING UP BANK STRATEGY AGAIN

April 22, 2020

As we progress into a banking environment dominated by the impacts of the coronavirus, many bank CEOs are attempting to identify and manage a vast array of threats to and opportunities for their institutions. Strategic plans created or renewed only months ago have been moved to the back burner as management focus has been on triaging the new issues presented seemingly each day.

During this treacherous time, we think a sound decision-making framework is of the utmost importance. To that end, we believe banks can adopt their own version of the White House's plan to reopen the economy by identifying key triggers for acting and preparing to implement those actions in a clear and organized fashion. Below, we attempt to identify several key areas of focus that banks should address before fully recommitting to implementation of their long-term strategic plans.

Address the Asset Side of the Balance Sheet

After shifting to an income statement focus following the financial crisis, banks now find themselves once again being valued on the strength of their balance sheets. The view of the investing public is that credit losses are bound to come with some sectors being more severely impacted than others, and most bankers would agree. Therefore, it is necessary for bank managers to stratify the bank's loan portfolio by industry and establish appropriate reserves based upon the expected impact to the various industry sectors. Perhaps even better, many community banks have the insight into individual borrower relationships to allow them to make judgments on a loan-by-loan basis, which, in turn, should enhance the bank's ability to establish reserves for future losses with a greater precision. This borrower-level insight should also inform the expected losses for each such borrower's industry.

This first step may seem obvious to many, but it requires bankers to move past two impediments to taking such decisive action, one of which is unique to this environment. First, bank managers must move past the short-term temptation to protect their income statements. While maximizing earnings in the current quarter is a worthwhile goal under most circumstances, we encourage bankers to account for any future credit losses as soon as reasonably possible.

During the financial crisis, we frequently heard the expression that the "first loss is the best loss," meaning that it is better to take losses early in a down cycle rather than later. While we can debate whether that statement is true, there is no doubt that the investing public and bank regulators believe it. In the wake of the financial crisis, we saw both public and private investors punish banks that took losses after others had returned to stronger earnings. Perhaps more importantly, bank regulators were skeptical of management teams that addressed losses in their loan portfolios later in the cycle. Therefore, we believe an important first step to returning to the pursuit of bank strategy is to establish healthy reserves against potential future credit losses and to be able to describe the level of those reserves as they relate to higher-risk segments of the loan portfolio. Publicly-traded institutions have done a good job taking on this task thus far, and we expect that trend to continue. These public banks have also given helpful cover—because the large, diversified banks have publicly declared the expected impacts on their portfolio, smaller banks have the necessary cover to build reserves without signaling to the market that they are particularly vulnerable.

The second danger that may lead to later-cycle losses relates to coronavirus-related loan accommodations. The concern is that the forbearance given by bankers through regulatory guidance and the CARES Act with regard to troubled debt restructurings may result in bankers ignoring the impact of distressed segments of their portfolios, at least for the time being. Given the potential impact on bank capital from impairing loans categorized as troubled debt restructurings, both regulators and legislators were quick to extend relief to banks to allow them to work with their borrowers at the onset of the current crisis. While helpful in giving banks the ability to provide forbearance to their borrowers without realizing an immediate capital and earnings impact, these measures will not change the ultimate credit losses associated with the current economic disruption. Therefore, we believe bankers are best-served to address through reserves any credit losses as soon as possible.

Of course, to the extent that banks need to make significant provisions in order to address credit quality issues, they should not do so without an awareness of potential impacts from disrupted earnings. In particular, if an institution has senior debt at the holding company level, management should ensure short-term losses will not result in a covenant default under the terms of those loans. Moreover, banks should test their dividend capacity at the bank level to ensure that future cash flow needs for their holding companies can be met.

In certain circumstances, near-term action may be required to ensure holding companies have sufficient cash to meet their needs if there is a short-term setback in bank earnings. Such near-term action may take the form of suspending holding company dividends and buybacks, raising equity capital, issuing subordinated debt or otherwise securing holding company debt financing, or requesting regulatory approval for dividends in excess of standard earnings limitations or other legal thresholds.

Avoid the PPP Hangover

Another significant issue in determining the appropriate time to return to a normal focus on strategic initiatives is management bandwidth. It would be impossible to have a discussion of the recent banking environment without discussing the impact of the Paycheck Protection Program. Among the cadre of issues presented for banks by the program was the intense level of senior management focus needed for what was essentially a new product launch. We found that many of our clients had little ability during the last several weeks to focus on anything outside of the implementation of that program.

While such a level of attention was likely appropriate (and necessary) to implement PPP, banks should now focus on avoiding a wholesale shift of attention to the next phase of PPP: forgiveness. Banks should build and train teams to inform and engage borrowers as further guidance is made available with respect to PPP forgiveness. Those teams would then be charged with implementing the administrative aspects of forgiveness with the goal of keeping all PPP work confined to that particular group so that the balance of bank personnel (including most of senior management) can focus on the more normalized and longer-term aspects of bank management. No true strategic implementation can take place if PPP serves as a material distraction.

Engage in Self-Evaluation

Aside from fee income generation and the ability to provide a lifeline to struggling employers, PPP also gave banks a unique opportunity to demonstrate their capabilities in dealing with rapid and intense change. While the circumstances were unique, a bank's ability to implement its PPP strategy is a great indication for how capable it is of addressing future strategic change. In our experience, there was largely a "sweet spot" in PPP implementation for banks that are large enough to have adequate experienced personnel but not so large that they had trouble communicating their strategy to a broad employee base. Banks that are heavily reliant on software to scale their products and services suffered given the lag time in establishing a scalable tech-oriented solution.

If a bank performed well in addressing PPP, management should have a great deal of confidence that the organization is prepared to handle future expansion. If a bank struggled, all is not lost, but management should embrace the likelihood that a greater amount of planning and communication is required in order to implement strategic initiatives. Bank management should have a realistic impression of their bank's ability to implement strategic change and address any needs before pursuing significant initiatives in the future.

Gather Resources as Needed

Any good strategic plan contains an evaluation of whether the bank has the resources it needs to implement the plan. For most banks, a key resource constraint is capital. Since the onset of the current disruption, the industry has touted its robust capital levels in addressing its ability to handle an economic setback. While that point is both true and helpful, banks should not be overly reliant on entering the current environment with strong capital. Instead, banks should conduct a "burn down" analysis to ensure they are comfortable that they will maintain strong capital throughout a variety of outcomes.
In conducting that analysis, banks should simultaneously consider whether they need additional capital to protect their existing franchise or, depending upon the opportunities available, to expand it. Ideally, banks would not need to raise capital during a time of depressed valuations for bank stock, but we have seen over the long term that dilution resulting from raising capital at an inopportune time can be overcome by deploying the new capital in an optimal fashion. We do not believe banks should hesitate to raise capital under most market conditions if the use of proceeds will support a sound long-term strategic objective.

Communicate with Regulators

After conducting the internal analyses described above, bank executives who are considering expansion as a part of their strategic plans should communicate the results of those analyses to regulators to ensure that they understand and agree with the outcomes. Our experience is that a great deal of credibility can be earned through this type of outreach. That credibility can pay off when banks need regulatory support to execute on their strategic plans.

For those banks that have addressed the points described above, we believe the second half of this year could be an important time to find and capture strategic opportunities. In our experience, business disruption tends to make market participants more open to change. If banks are able to position themselves to pursue an attractive opportunity, be it for new customers, new employees, or even for M&A, we believe the environment will allow for "game-changing" strategic actions. In any crisis situation, like the coronavirus pandemic, weaknesses will be exposed, and many businesses and banks will struggle. However, times of crisis also present unprecedented opportunities for strong banks with defined strategies and executable plans of action. Undoubtedly, the latter subset of banks will ultimately be the winners when we see the other side of the current economic cycle.

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