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More Small Banks Mull Bankruptcy as Part of Survival Plan

The day of reckoning approaches for a large swath of community banks.

Capital problems tied to trust-preferred securities and bailout debts weigh on many community banks, says Evan Tomaskovic, a partner at Carl Marks Advisory Group. He mostly works with banks that have assets between $100 million and $500 million and Tier 1 capital ratios that are hovering above 5%.

But there is hope, he says. There are other banks or investors that are interested in these banks because of their solid deposit and customer bases. Wannabe sellers may improve their odds of attracting buyers by separating banking units from their problematic holding companies in bankruptcy court, he says.

The following is an edited excerpt from a recent interview with Tomaskovic.

What are some of the biggest concerns for chief executives at community banks right now?

TOMASKOVIC: In a lot of the ones we work with, they are juggling. Their capital ratios are deteriorating. They need to work with regulators so that while they are working through whatever turnaround process they are doing, regulators are allowing them to do that in a way that doesn't affect the bank's profitability.

The worst thing that can happen for a bank is to get seized by regulators. The second worst thing is for word to get out that the bank is struggling, which can deteriorate its asset base. CEOs spend their nights sleepless, trying to keep the bank as well run as possible with regulators in check and making sure the community understands that despite some troubles it is doing well and should stick with them. It's a tough battle.

Their board members and management teams are usually entrenched people that have lived in their communities for a long time. While we all love our jobs, when you look at these community bankers they actually care a lot about what is going on in their communities. They want to make sure the community stays intact and a large part of that is keeping the bank healthy so they have a little bit of an extra burden.

Will fatigue eventually lead to some of these executives deciding to sell?

The clients we have dealt with have been really strong. They have a lot of resolve, and they really care. They could have walked away a lot earlier and they decided to stick with it. I would say they will fight in most cases.

What are the biggest challenges for banks with assets of $100 million to $500 million? Are there any advantages?

The advantage is they still likely have an attractive deposit base and they are in an area of the country that they are servicing and not many other banks are. They have good long-standing customers and a solid deposit base. That becomes very attractive to another party to invest to help turn them around.

The disadvantages are because they are small community banks, you really have a limited number of people that would be willing to make an investment in that particular area. That's simply because smaller banks require the same amount of work as a big bank would to acquire. You have to make sure you find the right parties that understand the markets that you are in.

For banks in this asset category, what is your outlook for merger-and acquisitions activity?

It depends. Many of these community banks issued trust-preferred securities and received capital through the Troubled Asset Relief Program. These were mostly put into place to give them Tier 1 capital. During the financial crisis in 2008, the banks were able to suspend payments on the Trups. That gave them a window of up to five years where they could suspend payments and work through their loss portfolios. A lot of those windows are closing now.

Evan M. Tomaskovic
Partner, Carl Marks Advisory Group

That will trigger, in my opinion, a significant amount of potential M&A activity. There will be a lot of people that will find these banks attractive and be willing to invest money in them to stabilize them. The hurdle, though, will be the regulators. They want to make sure the process is run fairly.

The reason M&A activity will still probably happen is mostly because of the 363 [section of the bankruptcy code] that is available to these banks. If you tried to get a regular bank to do a transaction with a struggling community bank, most of the time, especially the trust-preferred securities holders, are not going to take a discount on their securities. These are often held in pools of assets and there is really no one person to negotiate with. Because of that, you really can't get much done. You can then use the 363 process to get a transaction done.

A few bank holding companies have gone through bankruptcy in recent years. Will more of them?

There have been five or six done since 2010, with the first one we really watched was AmericanWest Bank, which filed in October 2010. All of the ones that have been successful, First Place, Mile High, Premier Bank in Florida and some others, basically used this same process.

This exact path is possible for some of these community banks. You want to do so in the next six to nine months because the trust-preferred windows are shutting that could cause other types of default issues. More importantly, regulators are getting more inundated with these situations. I think it's like a first-mover advantage if you can get out into the market now, especially when your capital ratios are in decent shape.

What are the regulators most concerned about with these deals?

They are most focused on ensuring the process is fair. There are a lot of constituencies that will suffer huge losses from these capital infusions or M&A transactions. The regulators want to make sure it is done properly and to make sure the deposits are protected. They don't want you out there burning up the assets of the bank for deals that will never get done. If it looks like you are out there putting the customers at risk they will be scrutinizing it and shut you down quicker.

What is the profile of someone looking to invest in a community bank right now?

It's mostly strategic so other community banks that are either nearby but not in the same footprint or trying to get into the footprint. That's one side. If they do buy a community bank, they have some cost synergies to increase the returns.

However, there are a number of financial buyers that are interested in banks. They like the space and think there is going to be a turnaround in real estate and other areas. The only caveat is that a traditional private-equity firm has limitations in how much it can own of a bank.

What is your overall outlook for distressed banks?

The next 12 months are crucial. The trust preferreds are running out and Tier 1 capital will keep deteriorating. These banks need to go out there, find some way to recapitalize. I do think if the real estate markets improve and loan portfolios improve then the returns at banks will improve. A majority of them will be cleaned up or sold and the remaining ones will have to be taken into receivership by the FDIC. From 2014 and beyond, it should be more stable for the banking sector.