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It's Hard for Banks to Tell It Like It Is

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After Call Reports are filed and earnings are released in January, the attention of boards and management at many publicly-held community banks and bank holding companies turns to preparation of 10-K filings and Annual Reports to shareholders, with Proxy Statements next on the horizon.

The current mantra in the market seems to be that the economics of banking are looking better. However, it is a challenge for some banks to admit some past regulatory missteps and discuss frankly with their constituencies certain challenges they face in returning to solid earnings and quarterly dividends. For example, directors are reluctant to admit that they may need to improve as fiduciary caretakers and may have relied on a management team that needs to be strengthened. And it would win no points for bankers to observe in hindsight that they were allowed, if not encouraged, by monetary policies, regulator passivity and pressure from competitors to make loans with poor underwriting attention. Blaming borrowers for being overconfident or loan brokers and investment bankers for fanning the lending and securitization frenzy also will not play well with bank shareholders or regulators.

Few bankers would acknowledge that they may have accepted TARP funds primarily because it was an implied government endorsement of the bank's health and prospects for weathering the recession storm. Banks were rushing to exit lending markets as the tsunami of enforcement actions approached. They had little interest in lending more as the economy deteriorated. Many banks that now seek to raise new capital and pay off TARP are not receiving the support of their primary federal regulators because they have enforcement orders and the regulators believe they should keep Treasury's investment capital while they work on their supervisory and earnings shortcomings. Also, paying back TARP, which would eliminate the TARP program restrictions on executive compensation, has an overtone of management self-interest. Likewise, asserting the competitive challenge of retaining quality management as a result of other regulatory limits and guidelines for executive compensation may not be well received. It is also awkward that a key selling point for participating in the new $30 billion Small Business Lending Fund established pursuant to the enactment of the Small Business Jobs Act of 2010 is that this new Treasury Tier 1 capital investment for community banks with assets under $10 billion can replace existing TARP and would not come with executive compensation restrictions.

Banks may be reluctant to discuss certain provisions of the new Dodd-Frank Act and other regulatory initiatives, such as disclosures that address the burden and costs of compliance with required say-on-pay shareholder votes on executive compensation and other corporate governance provisions. Limits on debit card exchange fees, the costs of now paying interest on business checking accounts and the new best practice of limiting customer overdraft fees will mean a reduction in revenue sources which banks may prefer not to emphasize in their disclosures. Core deposit customers are likely to be asked to absorb these revenue losses through changes such as the elimination of free checking or increased charges for other account services. Such revelations will likely bring some customer pushback.

Earnings and dividends at community banks will be stunted for many more quarters because the removal of enforcement orders generally requires 1 or

2 full examination cycles. In the meantime, these orders usually demand more capital and generally preclude significant expansion, M&A or bidding on failed banks until they are removed. Many banks have sought new capital from private equity sources, but usually face massive dilution of existing shareholders to entice such investments and extensive time delays while potential investors run the regulatory application gauntlet. The significant projected increase in capital requirements upon the full implementation of Dodd-Frank and Basle III also makes it unlikely that shareholders will see, at least in the near term, a return to the ROE performance they had come to routinely expect from banks.

It is difficult for community banks to share all these challenges with shareholders and still be upbeat as to the bank's improving prospects. However, full, balanced and focused disclosure to shareholders is advised. The Risk Factors and Supervision and Regulation text in 10-Ks should not read like operating manuals for compliance officers and examiners. These sections should instead be tailored to explain how new legislation and regulatory and economic developments will or will not directly impact the bank. It is also generally advisable to proactively share with shareholders the efforts of the board and management to comply with enforcement orders and the results to date rather than limit such disclosure for fear of depositor angst or stock price declines.

It is no secret that many who took the most egregious actions and risks are no longer in the banking industry. That means it is left to the boards of directors and senior executives who remain committed to banking to repair banking's damaged reputation and recover any lost confidence of customers and shareholders. One way to start is to describe the regulatory environment like it is.