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BIG IDEAS FOR 2016

New Ways to Raise Capital for Your Bank

By Dave Lindorff
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Raising capital has been tough for community banks ever since the financial crisis, especially the smallest ones.

But a few investment firms have developed structured products that offer community banks a chance to band together to raise needed Tier 1 capital at relatively low cost.

These products — called collateralized debt obligations — also avoid some of the issues that caused regulators to frown on such financing in the past.

StoneCastle Financial Corp. in New York completed one such deal in October, raising about $205 million for a group of 35 community and regional banks in 24 states. EJF Capital in Arlington, Va., did a similar deal around the same time on behalf of 23 banks, mostly in California and Texas.

Michel Iannaccone, a managing director at Finpro, says he expects to see more.

"From the bank side, there are very few sources of capital available," Iannaccone says. "And from the investor side, there is clearly interest — though how long it'll last will depend on how the economy and the market does."

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Josh Siegel, StoneCastle's chairman and chief executive, also predicts more to come. His company is eager to do another deal just as soon as it can line up enough banks.

StoneCastle is targeting tiny, privately held banks that otherwise would not have access to the capital markets.

Its pioneering deal was used to fund 10-year subordinate loans to the banks. Though the loans count as Tier 2 capital, if a bank holding company uses the proceeds to purchase stock in its underlying depositary institution, the depository can treat the new capital as Tier 1 common equity, Siegel says.

Four large institutional investors snapped up the deal. "The hardest part is rounding up the banks to do an issue," Siegel says. "Selling it was the easy part."

The investors did not include any banks, which StoneCastle barred from participating as buyers to avoid any concern from regulators.

Otherwise, Siegel says, regulators might see too much of a resemblance to a common pre-crisis source of funding that wreaked havoc.

Back then, community banks were able to issue trust-preferred securities, a longer-term, debt-equity hybrid that counted as Tier 1 capital, and there was a ready market to buy the bonds backed by this debt. But many trust-preferred CDOs ended up being bought by banks themselves, which only compounded their problems during the financial crisis. Trust-preferreds no longer count as Tier 1 capital and, under the Dodd-Frank Act, can no longer be securitized, so that market has evaporated.

Though issuing common or preferred stock is an option for community banks, it's not so easy or attractive these days, Siegel says.

"This issue we just did ends up costing the banks about 4.5% after costs and, if you compare that to other options, it's 'Wow!' Remember, the average community bank has a return on equity of 9%, so to finance your capital at half that rate is really attractive," he says.

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