Palisade
CAPITAL MANAGEMENT

DEEP DIVE SERIES

**SMALL CAP CORE EQUITY | JUNE 2020**

# SMALL-CAP BANKS

## A lens for this unprecedented economic period

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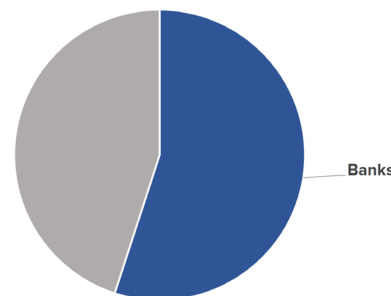
The banking industry is at the heart of the American economy, and small-cap banks are at the intersection of Wall Street and Main Street. Many of the banks in the Russell 2000® Index (the "Index") are considered community banks, which serve as depository institutions that typically focus on the needs of the local community in which they are located. As a result, small-cap banks are most directly connected to local and regional economies with both small businesses and individuals relying on their lending and depository services. Despite recent regulatory changes that have significantly modified the methodology by which banks calculate their Loan Loss Allowance (known as CECL, or Current Expected Credit Losses) and the economic impact of COVID-19, we believe small-cap banks will emerge from the current economic downturn in a strong position. Furthermore, the new regulatory changes will provide an ongoing view into how small-cap banks perceive the changing economic landscape, the potential impact of such changes to their loan portfolios, and, by extension, the health of the local economies that these banks support.

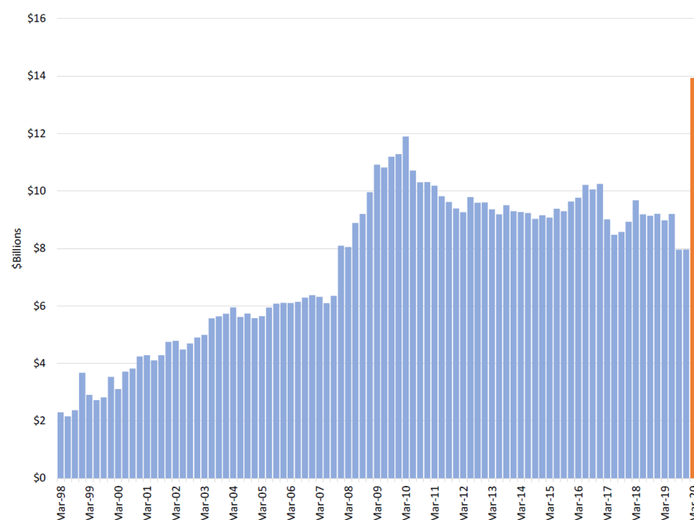



**RUSSELL 2000® INDEX BANKS INDUSTRY WEIGHTING WITHIN FINANCIALS SECTOR**

AS OF APRIL 30, 2020
SOURCE: FACTSET RESEARCH SYSTEMS, INC.

### CECL STANDARD FORCES RECALCULATION OF LOAN LOSS ALLOWANCES

In the first quarter of 2020, many small-cap banks provided a unique and insightful perspective into the U.S. economy's potential business outlook by providing unprecedented transparency into their loan portfolios. This enhanced transparency was driven by the confluence of two factors that are inextricably linked: (1) the adoption of a new FASB credit standard CECL, effective January 2020 for public filers, and (2) the impact from the rapid and unexpected COVID-19-driven shutdown of the U.S. economy.




**RUSSELL 2000® INDEX LOAN LOSS ALLOWANCES ($BILLIONS)**

AS OF MARCH 31, 2020
SOURCE: FUREY RESEARCH PARTNERS AND FACTSET

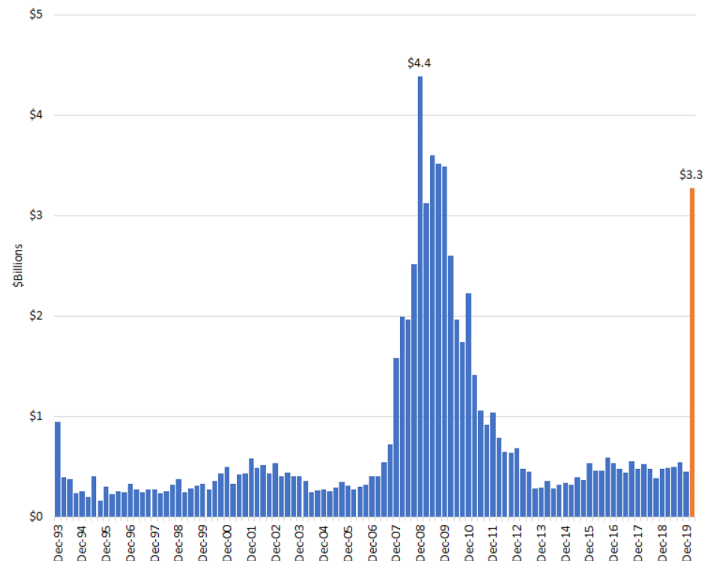
The new CECL standard significantly changed how banks account for potential losses in a loan portfolio. Previously, banks established reserves only when losses from individual loans were incurred (or probable) and could be reasonably estimated. Under the new CECL standard, banks must estimate and reserve for anticipated losses over the life of a loan by incorporating both the immediate Day 1 impact (an accounting adjustment of reserves that runs through the balance sheet and reflects life of loan losses) and an additional Day 2 impact (reflecting swings in the macroeconomic outlook that flows through the income statement). The Day 2 impact looks at inputs such as macro-level assumptions and risk factors to develop an economic outlook, and then applies various assumptions to create scenarios that inform appropriate provisioning levels. The complexities of CECL are beyond the scope of this publication, but at a high level, this shift to accounting for expected losses over the estimated life of a loan is significant as it requires banks to develop "reasonable and supportable" forecasts of how future economic conditions may impact reserve estimates and losses. Although these forecasts and related calculations are bank- and portfolio-specific, an increase in Loan Loss Allowances was expected under CECL even prior to the discovery of COVID-19.[1]

The accounting impact of CECL on small-cap banks within the Index, which required taking into account the devastation of COVID-19, was clearly seen in the industry's first quarter 2020 Loan Loss Allowances (*i.e.*, the total loss reserve held as a contra-asset account on a bank's balance sheet and netted against gross loans), which amounted to nearly $14 billion. Although this is noticeably greater than at the peak of the global financial crisis, such a comparison is misleading because during the global financial crisis Loan Loss Allowances were calculated under the prior incurred loss methodology. If CECL were in place during that crisis, Loan Loss Allowances would likely have been dramatically higher than we see today.

The CECL standards and the dramatic and swift impact of COVID-19 on the economy also led to soaring loan loss provisions for small-cap banks – the expense item driven by scenario analysis that adds to (or can subtract from) the Loan Loss Allowance. In the first quarter of 2020, loan loss provisions for banks in the Index spiked to more than $3 billion. By way of comparison, this figure was higher during the global financial crisis and peaked at $4.4 billion in the fourth quarter of 2008 – before CECL required provisioning based on "reasonable and supportable" forecasts of how future economic conditions may impact losses. One can only imagine what these figures would have been in 2008 had CECL been in place at that time.

**RUSSELL 2000® INDEX BANK LOAN LOSS PROVISIONS ($BILLIONS)**

AS OF DECEMBER 31, 2019
SOURCE: FUREY RESEARCH PARTNERS AND FACTSET




## EXAMPLES OF ASSUMPTIONS USED TO CREATE SCENARIOS

Develop reasonable and supportable forecast period of 1-2 years; revision period of 6 months

### *Apply baseline assumptions*[2]

- Recession in 2020 Q1 and Q2
- Peak unemployment rate near 9% in 2020 Q2
- Peak-to-trough real GDP of almost -6%
- Partial bounce back 2020 Q3, then slow growth
- Acceleration later in 2021
- Return to full employment by 2023

### *Many banks incorporated scenarios that considered deeper economic impacts*

- Assumes the COVID-19 crisis will persist and continue to meaningfully impact the economy[3]
- Return to full employment by 2025[2]
- Unemployment rate peaks at 16.9% in Q2 2020 / remains elevated throughout the remainder of the year[3]
- GDP growth rate of negative 18% in Q2 2020 / recovery in the 2H 2020[4]
- 50% of industries will be on lock down through Q2 2020 creating additional downward pressure on spending[3]
- No sustained economic recovery expected until Q4 2021[3]
- Federal funds rate will remain at or near 0% for foreseeable future[3]

### *Policy Assumption Considerations*[2]

- $2.2 t fiscal stimulus
- Direct payments to individuals
- Boost to UI benefits
- $500 b credit facility
- $50 b to airlines
- $100 b to hospitals
- Fed QE, lending facilities
- 4th stimulus 2020 Q4

## SMALL-CAP BANKS LIKELY TO WITHSTAND ECONOMIC DOWNTURN

Despite the higher levels of Loan Loss Allowances and provisioning prompted by CECL (and the requirement to incorporate the impact of COVID-19), most small-cap banks are still expected to be profitable in 2020. This primarily reflects banks' strong positioning prior to the COVID-19-driven downturn. Since the global financial crisis, banks have worked diligently to shore up capital, improve credit standards, and reduce operating costs.

In addition to the industry's relative health, the substantial government response to the COVID-19 crisis has resulted in a near-term increase in loan and deposit activity. The Paycheck Protection Program ("PPP") has had a meaningful impact on loan growth at many community banks that were quick to implement the required infrastructure to provide these loans. The profitability of PPP loans remains a question, but they should add to bank profits. Another factor that has driven net loans by small-cap banks to a new all-time high is the increased utilization of lines of credit as just about every company in the world focuses on liquidity.

Prior to the current healthcare crisis, community banks were operating under one of the most benign credit environments in history, while growing loans and simultaneously maintaining some of the highest and strongest capital profiles in many years. As a result, we believe these banks are well positioned to withstand the current recession spurred by the COVID-19 pandemic.

## CONCLUSION

The implementation of the new CECL standards came on the eve of the COVID-19 pandemic and the sharp recession that followed. While the ultimate duration of this crisis remains unknown, banks, large and small, entered this current recession with very strong balance sheets and excess liquidity. As a result, community banks should withstand this downcycle and exit the recession in better shape than many other industries that are being more acutely impacted by the worldwide pandemic. Despite the "one-two" punch of CECL (with its attendant increases to Loan Loss Allowances and loan loss provisioning) and the deep recession caused by the global pandemic, most small-cap banks should remain profitable in 2020. A healthy and profitable small-cap banking industry is critical to support local businesses and the communities in which they reside as the U.S. economy begins the road to recovery.

## SMALL CAP CORE EQUITY INVESTMENT TEAM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**Important Information:**

[1] *Allowance for loan and lease losses: The road ahead with the current expected credit losses (CECL) approach*, 2016. Deloitte.

[2] *COVID-19: Economic Scenarios*, March 27, 2020. Moody's Analytics, Inc.

[3] *Independent Bank Corp. Reports First Quarter Net Income of $26.8 Million*, May 18, 2020. FactSet Research Systems, Inc.

[4] *Management Comments for the First Quarter 2020*, April 23, 2020. Bank OZK.


Past performance is no guarantee of future results.

The performance and volatility of the Palisade strategies described herein will be different than those of any index.

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The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

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