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NYCB blues … could events at the bank hit smaller institutions?

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- **We don't believe the problems exposed by the 2023 banking crisis have been properly addressed, with the New York Community Bancorp stock rout highlighting this**
- **A failure to regulate smaller banks or address liquidity buffers, coupled with continued quantitative tightening, has left the system vulnerable**
- **There is a split between larger more cautious institutions and smaller ones which will struggle to cope should conditions deteriorate further**

Within our global team of fundamental research analysts, eight are dedicated to covering financial institutions across equities and fixed income. This financials team gets together regularly to debate the big issues, and the events at New York Community Bancorp (NYCB) got us talking about both this specific company and the broader potential implications.

As a group, we feel that problems exposed by the 2023 banking crisis haven't been properly addressed. The US Federal Reserve (Fed) stepped in with a temporary liquidity program – the Bank Term Funding Program (BTFP) – in March 2023 and told the large and medium-sized banks to hold more capital. However, nothing was done to regulate smaller banks or to directly address liquidity buffers. As a result, we believe the banking system is vulnerable to aftershocks as central banks continue quantitative tightening (QT) – a monetary policy tool to reduce the amount of money in the economy.[1]

[1] The mention of any specific shares or bonds should not be taken as a recommendation to deal

What's happening at NYCB?

NYCB is historically a New York City metro commercial real estate (CRE) lender. In late 2015, the OCC, a primary bank regulator, issued a statement telling banks with high concentrations of CRE that they would be subject to higher standards and oversight.[2] This came after an industry-wide period of rapid growth in the asset class, whereby regulators witnessed a loosening of terms and conditions due to heightened competition among lenders. NYCB's CRE concentration was twice the regulator's acceptable level. The company attempted to address the problem by diversifying through acquisition. The purchase of Flagstar Bank in 2022 and the Signature Bank assets from the Federal Deposit Insurance Corporation (FDIC) in 2023 increased commercial and industrial (C&I) lending, diluting the CRE concentration. The acquisitions effectively doubled the size of the bank to $116 billion at the end of 2023.[3]

Moving above the $100 billion asset threshold, however, created another problem for management to tackle. NYCB is now a "Category IV" institution in the eyes of the Fed, which brings with it enhanced capital and liquidity requirements.[4] Conversations between banks and their primary regulators are almost always private, but it is not a leap to assume that the Fed asked NYCB to improve its capital and liquidity position to be more in line with other Category IV banks. Management responded by communicating an increase in NYCB's cash position and its reserve for future credit losses in the CRE loan book. The costly liquidity increase dragged the net interest margin down, leading to a decline in the future profitability profile of the bank by around 40%, while the increased provisioning resulted in the bank posting a loss for the quarter. In addition, the bank cut its quarterly distribution by 70% to preserve capital, sending shares tumbling.[5]

What now?

Ironically, NYBC is a much safer bank than it was three months ago. However, management is planning more action to shore up the balance sheet. The loan-to-deposit ratio is too high at more than 100%.[6] It could look to sell some of the C&I loans it just bought – portfolios of equipment finance and dealer floorplan lending may be options – but it can't sell CRE loans at this point in the cycle. Why? Mainly because the loans would be sold at lower values than presently carried on the balance sheet, which would have negative implications for capital levels.

What about a buyer?

We think the chance of a buyer is close to zero. Much of NYCB's loans are backed by rent-regulated buildings in New York.[7] These assets are unattractive. Borrowers are experiencing stress because they can't raise rents to improve cashflows. In addition, the accounting rules force a purchaser to mark to market the entire acquired loan portfolio, which would force an equity injection. We don't think that attempting an equity raise is a good option either – it could destabilise rather than improve matters. All of this leaves them in a tricky situation.

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[2] The Office of the Comptroller of the Currency (OCC) Real Estate Lending: Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending, December 2015

[3] New York Community Bancorp, company report 2023

[4] Federal Reserve, Requirements for Domestic and Foreign Banking Organizations, October 2020

[5] Bloomberg, February 2024

[6] New York Community Bancorp, company report 2023

[7] New York Community Bancorp, company report 2023

How did we get here again?

The responsibility, in our view, lies with management, regulators, and politicians. Let's take each in turn:

Management NYBC was running a huge concentration in CRE with weak liquidity and capital positions, while doubling the size of the bank over a two-year period with back-to-back acquisitions. It is extremely difficult to maintain disciplined risk management when this happens. History provides us with countless examples, but the Irish banks in the early 2000s spring to mind – and that didn't end well.

Regulators We think regulators bear considerable responsibility for creating this situation. The Federal Deposit Insurance Corporation (FDIC) sold the large portfolio of loans from the Signature bank failure to NYCB. This sale moved NYCB into a higher set of rules for which the company was not prepared. The sale forced the bank to take drastic actions to satisfy the new rules, triggering the crisis. Did the FDIC anticipate this chain of events and went ahead with the sale anyway, or were they surprised as well?

Politics Small banks (those below $100 billion of assets) are held to a very weak regulatory standard compared to their bigger peers. These banks tend to operate more locally and their communities rely on them as an alternative to the larger national operators. This geographic concentration denies the small bank economic diversity. However, with the risk of operating locally comes an important ally – the local politician. Seemingly every new, more strenuous set of regulations comes with a carve out for these small banks. Their representative points out the community needs them to make loans when the big banks turn them down. And, the argument goes, the cost of compliance will burden the small bank as they will need complex risk management systems. All of which is perhaps true, but this means the riskiest, most concentrated banks are being run to a low standard with poor risk management systems. The politicians want their local bank to play by an easier rule set, and when that local bank gets too big – like NYCB did – their weaknesses are exposed, with dire consequences.

Let's put some numbers around that …

The big four US banks have a buffer to minimum "gold plated" capital requirements of more than 200bps on average. For Europe's big banks it's 400bps over somewhat less onerous requirements. If we apply the same rules to the small and mid-sized US banks we cover, the number is less than 50bps, with several falling below the required minimum. Similarly, the big four US banks are running cash balances equivalent to 20% of deposits on average; most smaller US banks are around 10% with some holding 5% or less!

What about the read across to Europe?

Credit Suisse was the domino knocked over by problems at Silicon Valley Bank. Could NYCB's issues spread to Europe? Quite possibly. The large European banks, like their big US peers, are well capitalised with low exposure to CRE. However, a handful of regional German lenders are more exposed to US office lending than many US banks. If we take provisioning to large US bank levels overnight – as NYCB did – it would leave these banks close to minimum capital levels. We expect some uncomfortable months ahead.

Can't we just let capitalism do its thing and let the small banks fail?

One argument against regulating smaller banks is that they are small enough to fail without causing problems at the system level. The trouble with this is that if several small banks get into liquidity problems at the same time, credit starts to tighten and it all begins to get a bit systemic.

(Small bank lending is important to the US economy: around two thirds of all bank CRE loans sit with small banks.[8])

What's more, we are headed into an uncertain time for bank liquidity as QT continues. Quantitative easing (QE) pumped around $10 trillion into the US, UK and eurozone systems over a decade, an amount equivalent to 25% of banking sector deposits.[9] Central banks are now a year or so into withdrawing that liquidity. The process has gone smoothly to date and the US is furthest ahead, but we are watching what will happen this year.

A word on QT

This is fiddly, but bear with us. It's all down to two items on the liability side of the Fed's balance sheet: reserves from banks (the banking sector's cash balances), and reverse repo (from money market funds). The Fed's balance sheet has declined by about $1.5 trillion since it started QT.[10] Reverse repo has fallen materially – money market funds have shifted into treasury bills to pick up yield – but bank reserves have gone up as the big banks hoard cash. We could soon reach a point where reverse repo reaches a floor and bank reserves (cash) start falling.

There is a level of reserves required for the financial system to operate smoothly. In 2019, when money market rates spiked to around 9%, reserves in the system were around $1.6 trillion. Now, the banking sector and economy are bigger and liquidity rules tougher so the current system requires more cash. The level at which the system starts to run short is probably well over $2 trillion. At the current rate of QT we could get there this year and the banks with lower cash levels will be most vulnerable.[11]

To conclude

The speed limit might be 60, but in potentially icy conditions society expects drivers to slow down and proceed with caution to prevent accidents, regardless of the size of vehicle! We are seeing that at large banks with great capital and high cash balances. Many smaller banks, however, still have the foot to the floor in top gear. We think the market will reward careful drivers this year.

[8] SNL, Fed Flow of Funds, Autonomous. April 2023

[9] National central banks

[10] Federal Reserve, February 2024

[11] Federal Reserve, Fed Balance Sheet Normalization and the Minimum Level of Ample Reserves, February 2023

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