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Substance over size:

How community financial institutions remain anchored while big banks get blown away

By Gabe Krajicek,
Larry Meding,
and Ryan Walker

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Most community financial institution (CFI) leaders understand that the real fallout from the recent bank failures is consumer and business confidence in the banking system. Many American deposit holders falsely believe that moving their deposits to larger institutions is now the best way to secure them.

In reality, community banks and credit unions have anchored their balance sheets to low-risk strategies while the largest banks have tried to grow their way out of myopic risk management. For these institutions to continue weathering the storms caused by Wall Street banking blunders, they need new tools and industry intelligence.

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1. The failures of Silicon Valley Bank and Signature Bank.

The failure in March 2023 of two large regional banks, Silicon Valley Bank (SVB) and Signature Bank (SB) sent shock waves through the global banking system. Due to economic fluctuations, any number of financial institutions may be struggling at a given time; usually, these wobbles can be corrected over time — consumers and companies holding money at a struggling bank can transact normally.

The bank runs that happened at SVB and SB represent a crisis of confidence. Many of the depositors were commercial entities with deposits held in excess of the FDIC threshold of $250k.* As soon as they began to doubt the solvency of these two banks and withdraw cash, a collapse was all but inevitable — a self-fulfilling prophecy.

Unfortunately, there is also a widely held mistaken belief that large institutions are more stable than locally owned CFIs. Due to the complexity of the banking ecosystem, it is equally probable for a large institution to be more fragile than a smaller one. This phenomenon helped create the label "too big to fail" in the financial crisis of 2007/08 due to government bailouts of extremely large banks that became insolvent.

The only way to correct the mistaken narrative that "bigger is safer" for depositors is to shine a light on the numbers. To this end, Kasasa has partnered with the Thomas Ho Company, Ltd (THC) to reveal the true nature of stability at community financial institutions and what those institutions can do to reinforce their position despite wavering consumer confidence in the banking system.

** https://www.nytimes.com/2023/03/19/business/economy/fed-silicon-valley-bank.html*

Thomas Ho Company
Financial Engineering

About the Thomas Ho Company

Thomas Ho is a leading financial engineering firm with a long history of providing interest rate risk modeling and balance sheet management services for CFIs. Their extensive database of bank balance sheet information offers valuable insight for the comparison between balance sheets at large and small institutions.

About Kasasa

Kasasa is a financial technology and marketing provider committed to driving results for community banks and credit unions to help them recapture market share. Since 2003, their branded retail products, world-class marketing, and expert consulting services have helped their clients attract, engage, and retain more consumers. Today, their combined network of community financial institutions represents the 4th largest branch banking network in the country. For more information, please visit [Kasasa.com]() or visit them on [LinkedIn]().

2. What really happened?

SVB and SB were outliers in terms of size and fragility, as they relied heavily on large, uninsured deposits, which can be highly volatile in times of doubt.

More than 90% of SVB and SB's deposits were uninsured by the FDIC. Deposits that exceed $250k are not covered by FDIC or NCUA insurance, so when depositors doubt the soundness of an institution, they pull their money out as quickly as possible. Typically, a bank could sell securities from its investment portfolio to raise liquidity. While SVB and SB had outsized investment portfolios relative to assets, they were both heavily invested in longer-duration bonds that declined sharply in value as the Federal Reserve raised rates over the past year.* Neither bank had adequate capital to absorb the losses from selling their under-valued securities — creating a perfect storm that sank both institutions.

As reported by the New York Times,* the Federal Reserve was aware of problems with SVB's balance sheet more than a year before the bank collapsed, but the bank failed to remedy the issues in a timely fashion. Although, by some measures, SB had a less risky balance sheet than SVB, the crisis of confidence was contagious enough to cause a run by their depositors as well. In both cases, the FDIC has guaranteed all deposits regardless of the amount — only shareholders at the bank will suffer losses.

However, the damage to depositor confidence is done. Consumers and companies are asking hard questions about the institutions holding their money. Many of these people are moving their money to what they perceive as "safer" institutions. Unfortunately, size is a poor measure of safety. The public will need ongoing reassurance of this fact, and community financial institutions will need to demonstrate their strength and solvency in clear terms.

** https://www.nytimes.com/2023/03/19/business/economy/fed-silicon-valley-bank.html*

3. How community financial institutions operate differently.

In the banking sector, there were 9,574 FDIC or NCUA-insured financial institutions operating as of Q4'22. 8,157 of those institutions, or 85%, reported total assets at or below $1bn. The majority of these institutions are prudently managed, profitable, have stable and diversified sources of funding, strong capital positions, and pose minimal systemic risk. Their deposit bases primarily consist of individual balances less than $250k, so there isn't the urgency for account holders to pull money out based on rumors of potential trouble. This paper is primarily concerned with comparing metrics for community banks (not credit unions) against SVB and SB. Although community banks and credit unions share many similarities, their business models and structure differ.

Community banks also maintain smaller investment portfolios as a % of assets, generally in the 20% range or below, as opposed to 58% for SVB and 29% for SB. Since these banks don't rely on their investment portfolios to drive earnings, they're managed more conservatively with an average duration of ~3-5 years compared to ~7-10 years for SVB and SB — longer duration reflects larger interest rate risk, i.e. price sensitivity as interest rates fluctuate. Lastly, community banks are heavily involved in secured mortgage lending, with modest loan-to-value ratios that provide additional protection.

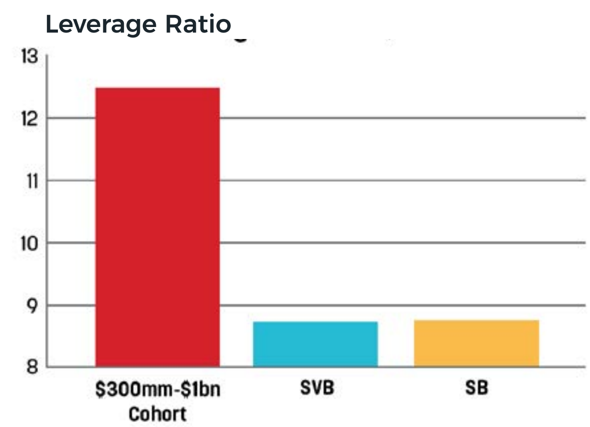
Table A – Comparing key financial metrics.

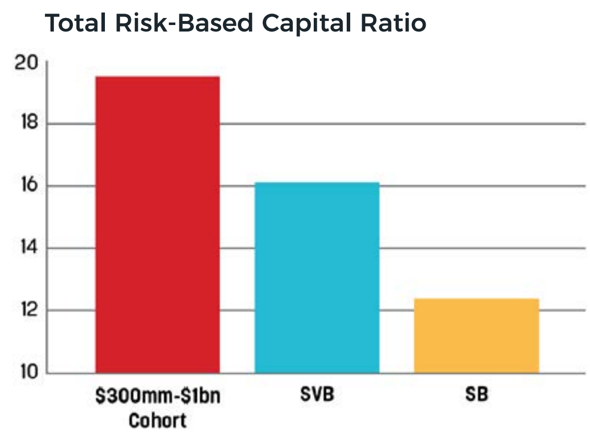
The following table highlights a few key financial metrics for community banks in the $300mm to $1bn range compared to similar metrics for SVB and SB.

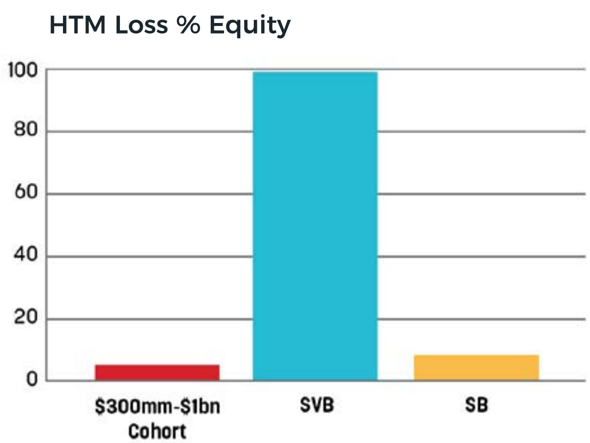
From the Q4'22 Uniform Bank Performance Report

PER Q4 '22 UPBR	$300MM-$1BN COHORT	SVB	SB
Leverage ratio	12.47	8.76	8.79
Total risk-based capital ratio	19.63	16.05	12.32
HTM* loss % equity	6.08	**98.08**	**9.51**
Non-core funding deposits	5.69	9.34	9.99
Insured deposits % total deposits	76.46	**6.10**	**10.3**
Investments % avg assets	16.77	57.60	29.06
NIM	3.12	2.20	2.20
ROA	0.64	0.94	1.14
ROE	5.90	13.43	16.82

**Held-to-maturity*







What do the numbers tell us?
Community banks operate on a more conservative business model and tend to follow more prudent banking policies compared to SVB and SB. Capital, which serves as a buffer to protect borrowers and depositors, is very strong for community banks, with a leverage ratio and total capital ratio of 12.47% and 19.63%, respectively. The leverage ratio is defined as Tier 1 Capital / Avg Assets. The regulatory minimum is 9%, but 10% or higher is generally considered to be the floor. As you can see, community banks were well above this threshold, while SVB and SB fell below. Total Risk-Based Capital is a slightly broader measure of capital adequacy. The regulatory minimum is 10%; community banks have a healthy buffer above this threshold as well.

Profitability metrics typically capture the headlines since investors use these as a key factor in equity valuation. These can be deceptive measures when judging safety and soundness. They don't capture the risk associated with the returns. SVB and SB's metrics were mostly in line with banks of similar size and with some even higher than the community bank cohort. The true fragility of SVB and SB is revealed by the percentage of insured deposits and HTM losses as a percentage of equity.

As discussed earlier, deposits exceeding $250k are not covered by FDIC insurance and are at risk if a bank fails. Depositors holding such high amounts of cash understand their risk and are likely to withdraw the money as soon as doubts arise. The second metric shows the mark-to-market loss for securities classified as held-to-maturity (HTM). HTM is used for securities expected to be held until maturity, so institutions don't have to report the loss in current earnings — the loss is only meaningful if the security is sold at current market value. If the security is held to maturity, its value is predetermined and carries no loss.

SVB had to sell their securities at current market value to shore up their liquidity and were forced to realize the loss. Subsequently, that loss wiped out a big chunk of their capital reserves.

Community banks are in a much better position. They also hold a much higher percentage of insured deposits (also called core deposits), meaning that in even in a catastrophic bank failure, the FDIC will guarantee nearly all account holder funds.

The true fragility of SVB and SB is revealed by the percentage of insured deposits and HTM losses as a percentage of equity.

4. The improved stability of Kasasa institutions.

The value of sticky core deposits is greater than ever. CFIs, including credit unions, must be able to project an image of stability that is backed by hard numbers. Institutions that have partnered with Kasasa have demonstrated a noticeable improvement in their ability to retain diverse sources of core funding. When institutions see runoff in their low-cost demand deposits, they must replace that liquidity with high-cost certificates of deposit. That replacement creates increased interest rate risk for the institution, which can increase balance sheet instability as well. Over the last two quarters (Q3-Q4'22) the banking sector has grappled with a tremendous movement of deposits from non-timed instruments, like checking, savings, and money market accounts, into more confidence-sensitive funding like brokered deposits.

In Q4 2022, Kasasa partner institutions saw 65% less core deposit bleed and 31% less reliance on high-rate CDs to backfill the hole.

Table B – Deposit growth at KFIs

Q3-Q4 2022	ALL FDIC AND NCUA INSTITUTIONS	KASASA PARTNER INSTITUTIONS LEVERAGING CONSULTATION
Total deposit change (%)	-0.54%	+0.78%
Non-timed deposits	-3.44%	-1.20%
Timed deposits	+2.90%	+1.99%

The chart above highlights that institutions offering Kasasa have been successful at gathering deposits while most of the banking industry has hemorrhaged them. The Kasasa suite of deposit products allows financial institutions to attract lots of retail account holders with balances below the FDIC and NCUA coverage cap. Without these low-cost core deposits, CFIs must rely on expensive funding sources such as wholesale deposits or securities (a contributor to SVB's demise).

5. True strength is sustainable.

It's no surprise to CFI leaders that their balance sheets are better managed than the goliath institutions of Wall Street. The current environment does pose a dual challenge: 1) through no fault of their own, CFIs must re-prove their safety and soundness to the public; 2) CFIs must also take meaningful steps to shore up their balance sheets with the highest quality, lowest cost deposits available.

Neither challenge is new to anyone who helmed a CFI through the financial crisis of 2007/08. They represent the need to recommit to the idea that the strongest institutions are those that grow sustainably and with the account holder's best interests at heart.

6. IncomeRisk: An innovative approach to managing balance sheet risk.

Due to the data we've seen, a large number of FIs have misjudged their interest rate risk because they're using tools that don't accurately assess risk in the current environment.

Kasasa has partnered with THC to take a deep dive into the performance of our deposit products and the key drivers of Net-Interest Margin (NIM) at CFIs. This methodology is available in a new tool called **IncomeRisk**. It's an elegant way to update your ALCO process, diagnose the true threats to your balance sheet, and assess remediation of those risks.

THC's groundbreaking research in this area highlights the importance of maintaining a strong core deposit base and how such a base can contribute to profitability. IncomeRisk links risk and return into a cohesive management tool that can easily be monitored over time and in comparison to other institutions. It also links to THC's Optimization Modelling to identify value-added strategies for maximizing risk-adjusted returns.

We believe this new approach solves a glaring weakness of the current asset-liability-committee (ALCO) process, i.e., the conflicting signals from the EVE and EAR reports. As you may already be aware, EVE is a point-in-time snapshot of risk, whereas EAR is a forward projection of earnings. In a rising rate environment, EVE is declining while EAR is increasing. Reconciling these two metrics is very challenging when they seem to contradict each other. IncomeRisk provides a way to harmonize the data and creates a roadmap for responsible balance sheet management.

To learn more about how IncomeRisk could benefit your institution, please visit www.kasasa.com/contact-us for a customized demonstration.