Does a Zombie Bank Know It's a Zombie?
by Charles B. Wendel

In recent years most of us have seen movies in which zombies stagger about, lurching toward their next human victim. Probably they don't think of themselves as half-dead-or-more zombies but rather "people" just going about their business. The same may be the case for the increasing number of zombie banks.

Zombie banks are also kind of alive, although each year they become less so as more business moves to bigger bank and non-bank competitors and traditional customers go elsewhere or, as Hamlet said, they depart "this mortal coil."

A *CNBC* story this week highlights an inciteful Klaros Group report that looked at both CRE exposure and the impact of interest rates on bank performance, focusing on banks where CRE comprised over 300% of capital and banks where unrealized losses put capital levels below 4%.

"After hiking rates 11 times through July, the Federal Reserve has yet to start cutting its benchmark. As a result, hundreds of billions of dollars of unrealized losses on low-interest bonds and loans remain buried on banks' balance sheets. That, combined with potential losses on commercial real estate, leaves swaths of the industry vulnerable. Of about 4,000 U.S. banks analyzed by consulting firm Klaros Group, 282 institutions have both high levels of commercial real estate exposure and large unrealized losses from the rate surge — a potentially toxic combo that may force these lenders to raise fresh capital or engage in mergers."

Klaros broke out its analysis further: 265 of these banks hold less than $10B in assets while another 16 are in the $10-100B category. As the report notes, those 16 hold more assets than the 265 community banks combined.

Other comments from the article are worth noting:

- Brian Graham, the head of Klaros, said that these injured banks need to raise capital most likely from private capital sources or merge with stronger banks.
- He added that banks could choose to wait as bonds mature and roll off their balance sheets, resulting in years of mediocre earnings below their competitors, while as the article states putting "them at risk of being swamped by rising loan losses."
- Quoting a Fitch analysis, the article reported that in 2023, 67 lenders had low levels of liquidity — meaning the cash or securities that can be quickly sold when needed — up from nine in 2021.
- "And regulators have added more companies to their "Problem Bank List" of companies with the worst financial or operational ratings in the past year. There are 52 lenders with a combined $66.3 billion in assets on that list, 13 more than a year earlier, according to the Federal Deposit Insurance Corporation."

Given all the above, it may be a surprise that a Mercer Capital report found that, "There were fewer than 100 bank acquisitions announced last year… The total deal value of $4.6 billion was the lowest since 1990."

What can a Zombie Bank do? No bank CEO is likely to proclaim his bank's Zombieness nor are a bank's advisors likely to be direct in informing their clients of their semi-deadness. And even with one-third of regional bank CEOs beyond 65 in age, M&A numbers are low.

Here's my take on the reality:

- The number of Zombies exceeds 265 and may approach 1,000. One list of banks by asset size at year end 2023 totals 4,612 bank. Almost 3600 of those banks have assets below $1Billion. Many may not be suffering from interest rate and CRE woes, but they have other issues.

  For example, one under $1B bank reported the following for full year 2023 versus the prior year: lower net income, lower NIM, lower ROAA, lower ROE , and higher leverage. That bank and others like it that maybe on their way to the Zombie neighborhood. Almost every bank with assets below $1B might be a zombie or on its way to becoming one. Factors like regulatory and IT costs and difficulty in attracting and retaining great all point in one direction.

- Some smaller banks can thrive, but they probably need a niche or specialty to do so. Too many are relying on a neighborhood focus that, despite good customer service, may not be sustainable. All banks need a sustainable customer differentiator.
- Many small bank CEOs and their Boards are either in a state of denial or simply don't know what to do and hope the problem disappears (it won't).
- While larger banks' M&A will be slow to occur due to regulatory issues, with smaller banks at least two problems may exist. First, small bank management may be continuing to overvalue itself. Second, larger banks see limited value in acquiring a smaller bank that "doesn't move the needle" but could require as much work as a larger bank deal.
- Smaller banks could consolidate, but even zombie bank leaders may have big egos and two weak banks do not make a strong one. While Private Equity firms could play a role in stabilizing banks, they are both very selective and slow to pull the deal trigger. They will not be interested in most of the banks.

So, what to do? The first step is for these banks to recognize an urgent problem exists and that, whether or not they are under a regulatory microscope currently, they probably will be soon. Then, rather than punting their problem, they need to build a team around addressing it. And management needs to be honest enough to consider solutions they might not like, such as sale or consolidation. One thing they need to avoid is becoming distracted by "shiny new toys" such as AI.

Focus needs to be on more immediate issues all tied to survival or sale.

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