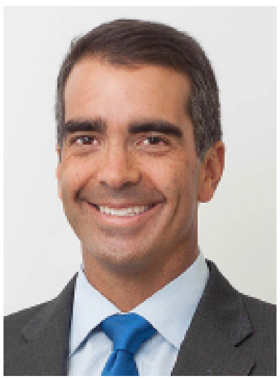
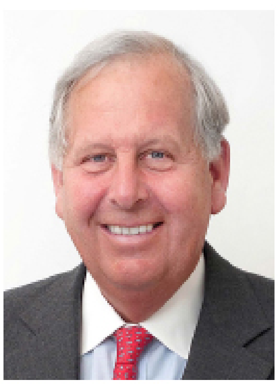
Tuesday, December 23, 2014 7:00 AM ET Exclusive

BayBoston managing principals on bank regulation, the value of deposits

By Joe Mantone and Nathan Stovall



Carlos Garcia
CEO, founder and managing partner of BayBoston
Source: BayBoston Managers LLC



Richard Durkes
Managing partner of BayBoston
Source: BayBoston Managers LLC

BayBoston Managers LLC managing partners Carlos Garcia and Richard Durkes are partnering up to invest in financial institutions, but it's not the first time the two have worked together.

Garcia, CEO of BayBoston and a veteran bank executive who spent 14 years in different roles at Banco Santander, said that for nearly 20 years he's been a client of Durkes, a former investment banker. The two said they first connected for the 1998 IPO of Banco Santander Puerto Rico when Durkes was with ABN Amro.

The relationship continued when Durkes went to Sandler O'Neill & Partners LP, and now it's moved to BayBoston, a private equity firm Garcia founded. Garcia said BayBoston is currently fundraising, but the company is also ready to invest and expects to do so by the second quarter of 2015.

While they will consider opportunities in different financial services companies, the team plans to focus on community banks. Garcia and Durkes recently spoke with SNL about growth strategies for banks, the likelihood that big bank regulation will trickle down to smaller institutions and how banks should think about their deposit bases given the prospect of rising rates.

What follows is an edited transcript of the second part of the conversation. The first part is available here.

SNL Financial: In the current rate environment, deposit premiums barely exist. But in a [Liquidity Coverage Ratio] world when rates move, there's just got to be more value than what's being recognized today.

Carlos Garcia: Historically, it always happens. In a low interest rate environment, they don't assign the right value to deposits, the backbone to the industry. Regulators have identified this. That's why loan-to-deposit ratios that were over 100% have come down. Most of the community banks have loan-to-deposit ratios that are substantially below 100%. There's a capability of being able to deploy that. Sometimes they need more time and resources to do it, and that's part of what we intend to be able to help them with.

Is a deposit franchise something that is key before you make an investment?

Garcia: That's going to be very important. We developed the seven principles for high-performing banks, and one of the principles is based on the value of that deposit franchise.

You said you're looking for strong deposit franchises and noted you have lived through past cycles. What would you advise portfolio companies to be doing with their deposit business at this point in the rate cycle?

Garcia: In general terms, to us the value of a bank is greatly measured by the value of their core deposits. Total deposits are one thing and core deposits are another thing. Community banks have to keep focusing on making sure they capture as much as they can of those core deposits in their communities. To us, that's really the long term value of that franchise. … If you look today, it's obvious that as rates go up, the value of those deposits is going to be increasing. The market is not yet really providing any real value to that. … The second part of the focus is how you balance your business in terms of asset generation. I think the biggest challenge banks currently have, is from a risk management perspective, how can we grow assets and which area should we be growing assets. Do we focus on mortgages? Some have small business lending, but have not been able to develop a C&I business. Part of what we would present to the banks is, you have to find other ways to grow consistent to your mission and with where you're operating and be able to generate other products that you're currently lacking. If you look at most of these banks and their product offering, you'll see that they're missing most of these products. They're missing most of the positive fee income generation products and some lending products.

“Community banks have to keep focusing on making sure they capture as much as they can of those core deposits in their communities. To us, that's really the long term value of that franchise.”

–– Carlos Garcia, managing partner at BayBoston Managers LLC

… And then the third one is efficiency. In order to be an efficient bank and not have an efficiency ratio over 70%, you need to have scale. The only way to dilute some current expenses is scale. There are banks that are growing in the double digits, but still that double-digit growth will take them over a decade to be able to get the scale that they need to be able to dilute the expenses they have in the current regulatory environment. We don't see in the current environment regulatory requirements being diminished. I think it's going to be to the contrary. What's happening is over time, most things that are being implemented onto the large banks continue to trickle down to the smaller banks. As you go down through the curve and those banks continue to improve, regulators are going to have more time and it's going to be hard for regulators not to ask a bank that is competing in the same market even though it's being smaller to do many of the same things.

I heard a banker compare it to being in a relationship. Like a relationship, they said that once you see something nice, you want to see it all the time. And they believe it will be like that for regulators. We've seen stress testing trickle down even if it's not mandatory. Someone else used the example of scorecarding.

Garcia: Scorecarding and just access to information. The biggest challenge for a small bank is that you're working through different platforms that you've created for your different products. Right now, if you want to be able to service your clients in a good manner, you need to have integrated data. It's really tough when you're running one deposit platform, one C&I platform, one mortgage platform, one AML platform, which is the DNA or setup of most banks. Unless you can figure out a way to merge all this data so I can treat all of you as a single customer opposed to as a mortgage customer and a deposit customer and a CD customer, it's going to be tough to provide the service they're expecting. And then from a regulatory perspective, if you're not able to aggregate this information so you can measure the risk and conduct stress testing on your capital, earnings and portfolios, it's just going to be too hard because there's just so many things you have to do manually. The manual workarounds are going to kill you. They are only going to require more people. Obviously, human error is another factor and you can't produce it as fast as regulators are asking. And that is still starting for the community banks. It's a new headwind coming for community banks and I don't think many are prepared for this.

I don't think so either.

Garcia: They're not even thinking about this at the board or management level because there are so many other things. No bank is going to be able to grow if they don't have a good anti-money laundering system.

We've seen that consistently. We've seen so many deals delayed over that. M&T Bank Corp./Hudson City Bancorp Inc. being the most famous one. They talk about the system they have now and how they can see how one customer connects to others and now that system is considered best in class and regulators just might want to see that across the board.

Garcia: Part of the disparity in value is you factor those things in. Unless you have the scale and the board and a management team thinking and preparing for this, every day is going to be tougher. If you have to react because these things are not allowing you to do to do your business, it's pretty difficult to try to do a transaction. That's part of the story and our conversations with the community banks. We don't intend to tell anybody how to run their business. That's not our model. We want to bring forward the issues you should be thinking about, help managers and shareholders think about those issues and try to see how they can implement programs that would allow them to increase their franchise value and be a better, more competitive bank and provide better customer service.