

Community Banking – Getting a Grip On Reality

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Community banking is threatened in America. It doesn't have to be.

Pundits, experts, prognosticators, even lowly economists are all ready to relegate the community bank -- that uniquely American local intermediary of economic resources -- to a largely vestigial role in the world of commerce.

Financial intermediation has been assigned to the care of corporate giants whose economies of scale generate either the price leadership of a low-cost provider or the point of sale convenience of a large-scale distributor. Banking products and services, after all, are increasingly becoming commodities just like the majority of consumer products and services in our retail economy.

Are Americans destined to have their banking services provided via networks of “fast-banking” franchises? Are community banks destined to become the “mom and pop” financial stores that will be pushed into insignificance by mega-banking retailers?

Well bunky, I'm here to tell you it aint' necessarily so. As long as you listen up, smarten up, toughen up, and come out attacking!

If you expect me to sound a patriotic call to the consumer to reassess their economic choices and to promote the need for locally provided banking services in the name of “mom and apple pie” – think again!

I'm a capitalist. And an investor. Nothing will save the community bank from economic irrelevance but its own ability to deliver a sustainable competitive return on invested equity. Indeed, competitive, even superior, returns on equity can be earned in community banking if bankers will come to grips with the financial, competitive, and marketing realities facing their businesses.

Being blunt and to the point, bankers are retailers that need to:

Get a grip on their financial reality by:

- Measuring, monitoring, and most importantly, pricing their cash flows.
- Employing maximum leverage of their capital to achieve a competitive return on equity and thereby maximizing the rate of growth of the cash flowing through the income statement.

Get a grip on their competitive reality by:

- Recognizing that they are retailers producing commodities and that they need to differentiate themselves by developing and pricing various “retail options” into these products and services.
- Realizing that their business is characterized by the declining costs associated with both short-term and long-term economies of scale. Profits can only be maximized by pricing at the margin and not by any allocated average cost methodology.

Get a grip on their marketing reality by:

- Gaining, maintaining, and managing all of their points of sale. As retailers dealing in commodities, bankers must get people to use their points of sale, i.e., bricks and mortar, Internet, ATM, whatever. These represent the means to access customer cash flow, the means to sell stuff to people.

Focus on *cash flow* is the key to the financial reality facing financial institutions!

Financial institutions are typically analyzed and characterized by viewing a snapshot of their balance sheet. Of course, this approach does yield a handy general description of their area of specialization, i.e., commercial bank versus residential real estate lender versus credit union. These characterizations focus on the identity of the customer and particular collateral. But these static snapshots of institution portfolios contribute nothing to help in the efficient pricing of the cash flows that represent the essence of their businesses. Bankers would do better to view their institution as a composite of cash flows. The key to efficient pricing in a competitive market is the measurement and pricing of cash flow, not the contractual amortization term of the asset or liability.

Would you make a 30-year, fixed-rate mortgage to a 72-year old man buying a home in a restricted access seniors-only housing development? Why not? Price it like a 5-year balloon! Excuse the black humor. The point is to anticipate the prepayment and price the expected cash flow.

Bankers have to recognize that they must act like the retailers they truly are, and most importantly, like the retailers they must compete with. When the banker gains an audience with the all important customer at one of their points of sale, the banker must have a complete menu of options relating to the particular financial service or product that the customer is prepared to purchase. The bank’s interest-rate risk profile or regulatory concerns are irrelevant to the customer.

The ability of the banker to offer a complete menu of retail options at competitive prices will be enabled by the measurement and pricing of anticipated cash flows.

The dynamic measurement of cash flows and the present value of these cash flows also form the basis of effective management of interest-rate risk. The management of the interest-rate risk of the institution taken as a whole is simply not adequately addressed by any static measures of the balance sheet. An institution that grows its balance sheet, and thereby the total volume of cash

flowing from this balance sheet, will amplify the impact of interest rates on the net interest income of the institution. If, for instance, a bank produces a competitive 20% return on equity and leverages these retained earnings, the bank will grow by over 75% in only three years! The impact of even the most severe interest-rate environments will be significantly amplified. Thus in a rising rate scenario in which the long-term rates remain even only slightly over 1% above short-term rates, the bank can continue to grow its net income through the scenario. It's only when a negatively sloped yield curve characterizes the rate environment for a considerable period of time that the advantage of leverage is negated.

In any event, the measurement of pricing cash flows is critical to the management of institution-wide risk.

The increasingly commoditized market for bank products and services is characterized by narrower and narrower margins! Competitive returns on equity can only be realized by accelerating the rate at which cash flows through the balance sheet.

To achieve these competitive returns, a declining cost industry that produces commodities must learn to price at the margin!

If you don't make that next loan, how much of your expenses will you save? If you do make the loan, what will your true out-of-pocket costs be? What are the true incremental allocations for the credit risk of an "A" credit? These are the types of questions that must dominate loan pricing as institutions seek to grow loan cash flows.

The truth of a declining cost industry is that both declining long-run and short-run costs produce increases in expenses that fall short of the growth of the balance sheet.

Both the financial reality and competitive reality facing community banks places increased emphasis on the importance of the point-of-sale to the marketing of bank products and services.

Banks gain access to cash flow through their point of sale. We've already established that banks are retailers competing with other retailers to produce financial products and services.

In fact, there isn't one product or service that can be offered by a community bank that can't be offered through a non-regulated, non-depository retailing business! In further fact, since WAL*MART beat the pants off MC/VISA in the Supreme Court in 2003, the battle for the payment system's point of sale is clearly up for grabs. This payment system was the last "monopoly" of the banking system. Now the advent of the stored value card threatens this last significant differentiation.

This means that banks must find a way to add perceived value to the use of their points of sale, giving them increased ability to manage the cash flows of their customers. Banks may just have to pay competitive rates on transaction accounts that reflect their true value to an institution that has the power to leverage their capital! Banks may just have to realize that they can't build a strategic future around the premise that you can charge people for something that they think they should get for free! The competition for retail point of sale guarantees that fees attached to services for which customers can't affix perceived value would be flushed!

Pricing cash flows at the margin... leveraging capital... fully utilizing points of sale to generate increased cash flows through the balance sheet... these are the strategic tools of a declining cost industry that sells commodities.

The financial, competitive, and marketing realities facing community banks describe an environment that can lead to stagnation and irrelevance -- or to innovation and success. Choose to succeed!