

Meeting the Competitive Challenge: A Manifesto for Insured Depositories

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

It's aggravating to realize that the tools to survive even thrive, in a competitive banking environment lie well within the grasp of both stock and mutually-owned community financial institutions. While big bankers eat their children, community institutions can feast on the crumbs falling off the table. But, in order to seize their competitive advantage, community institutions must be prepared to:

- Manage the increased portfolio risks that are required to offset the narrowing interest margins that are being precipitated by the increasing securitization of assets throughout the economy.
- Fight to control the point of sale that is required to expand the sources of non-interest income generated by selling stuff to their customers.
- Outsource part or all of the production of financial services in order to capture the economies of scale that are necessary to bring advanced technology and delivery systems to their customers.
- Achieve the rates of growth that are necessary to produce competitive returns on their equity.

These competitive imperatives are not the result of consulting my economic "crystal ball". Most of you remember that I'm an "ex-economist." I'm cured. I joined Economists Anonymous years ago. Whenever I get the urge to make

forecasts, Tom Farin talks me out of it...usually. You don't need to hire professional planning gurus and pay them to paste your own ideas all over your walls in an effort to prioritize a search for your navel. All you need to do is review and analyze the basic profitability equation that explains and predicts the competitive pressures facing all businesses: $ROE = ROA \times LEVERAGE$.

Profitability Is the Competitive Pacemaker

We all operate within a capitalist system that is geared to rewarding the owners of capital with a competitive return on their investment. Don't turn me off mutual thrifts, savings banks and credit unions. You're part of the same economic system, governed by the same laws of supply and demand. The simple fact that you are cooperatively owned only defines how you divide the pie, not how you bake it. You'll see that the rate at which your stock brethren have to generate profits also defines the pace of competition in the market place. The pace of product development, packaging and pricing, in fact the very aggressiveness of the battle for customers is determined by the need to deliver a competitive return to investors. This is a competitive reality we all face, regardless of our particular form of ownership.

Managers, listen up. If you can't produce a competitive return on their equity, investors sell your butt. Or perhaps less drastically, investors try to coerce management into finding ways to pro-

duce a competitive return on their investment. If that doesn't work, they may search for new managers. If that doesn't work, they sell your butt.

For most financial institutions, I can even tell you how fast you're going to have to generate earnings. Over the long-term, investors in insured financial intermediaries have demanded a 12% to 15% return on their investment. That's right, if you want to stay in business you need to produce a consistent 12% to 15% ROE. You can call it ROE, earnings per share or just plain old growth in net income. But investors want to see a 12% to 15% growth in earnings, year in and year out.

That's not to say some investors won't demand a greater return than this 12% to 15%. After all, it only represents the average rate of return historically required for investors in financial equities. But, it is to say that you can't exist in the long run if you produce a rate of return that is consistently less than 12% to 15%. What if you are a closely held stock institution whose investors temporarily seem to require a lower rate of return? Well, what happens when the major stockholder dies? The heirs wind up selling to new investors. Or what happens when some key investors no longer derive a significant portion of their return in the form of salary? More new investors. Or what happens when the major investors simply want to cash out? You see, there's no escape. Eventually you must produce a competitive return on equity.

While you mutuals, including credit unions, may not be in any danger of being sold if you don't produce a competitive return on equity, you'll simply become irrelevant. What we'll see after some further discussion of our profitability equation is that for most institutions achieving a competitive return becomes synonymous with growing the institution. In the long run if you don't grow by your ROE net of dividends, you'll just get squeezed into an insignificant position within the market.

Fighting the Pressure on ROA

So, now that we recognize the need to produce a consistent 12% to 15% annual return on equity, how do we do it? Only by either increasing ROA by 12% to 15% each and every year and/or by growing the institution by 12% to 15% each and every year. First let's look at the goal of annually increasing the institution's ROA by 12% to 15%.

Good luck! I'm not talking about the growth in ROA required to get some sub-par performing institutions up to 1.0% or above. I'm talking about an annual rate of improvement in the ROA of an efficiently managed institution. How would you like to have to take your ROA from, say 1.2% to 1.4%, then to 1.65%, then to...well you get the idea. No way. It's just not a realistic financial objective. In fact I'll argue that most financial institutions will have the devil's own time just keeping their ROAs from declining.

If we break down ROA into three general components: interest margin, non-interest income and operating expenses, we'll be able to see the challenge at hand.

Interest Margins—Under Downward Pressure...FOREVER!

Oh, oh. Another prediction. Interest margins, the bread and butter of depository earnings, are under downward pressure...forever. Am I using another one of my crystal balls? No. I'm just

recounting the evidence of the accelerating level of asset securitization that's been characterizing our capital markets over the past decade. Mortgages, consumer loans, commercial loans, you name it and it's being pasteurized, homogenized and securitized. We're making mortgage-backed securities out of mortgages and all types of asset-backed securities, and leasing paper out of consumer and commercial loans.

What do you do when you securitize an asset's cash flow? You squeeze the risk out of the cash flow. And what do you do when you squeeze risk out? You also squeeze the yield out of the cash flow. So if you buy the securitized asset, you're going to earn less yield than if you owned the non-securitized loan. Even if you decide to hold a nonconforming loan in your portfolio, one that's a little less likely to be securitized, you'll still see some lessening of the yield on that loan because even the nonconforming loans will be priced relative to the securitizable loans.

Securitization translates into less yield on earning assets for most financial institutions.

And, of course, the cost of your household deposit liabilities also reflects the competition you face from the mutual fund industry, which is just another form of asset securitization.

The result of the unrelenting trend of increased securitization: squeezed margins...forever.

While interest margins will still vary based on the cyclical nature of interest rates and the particular asset/liability mix of a financial institution, there will still be that downward pressure on spreads.

Fighting to Maintain Margins The strategic implication of the squeeze on interest margins will be to force institutions to find ways to put some increased yield on their assets and cut the costs of their funding. The only way to earn more yield on portfolio assets will be to take on, price, and manage more risk. There,

I said it. No equivocation. More yield requires increased levels of either credit risk or interest rate risk. I didn't say increased levels of unmanaged or mismanaged risk. Though I'm sure some institutions will attempt to do both. But that's why we have regulators. No, I'm talking about increasing the levels of managed risk.

Institutions, which choose to take interest rate risk, will need more sophisticated tools to measure and monitor that risk. Mortgage portfolio lenders will require more accurate means to estimate the option risks associated with their loans and their deposits. From estimates of prepayment speeds on loans to estimates of the rate sensitivity of deposits, unless you document your ability to manage interest rate risk, regulators will simply err on the side of caution and prevent you from taking the risks necessary to earn a competitive return.

The more interesting question will be how community financial institutions choose to put increased credit risk into their portfolios. You see, the large national and regional bank holding companies have already recognized that the household sector represents the greatest potential for profit. Large commercial borrowers have alternatives. They can go directly to the capital markets. Furthermore, they're a tough sale, battling the lender for every basis point. Ahh, but households, they represent a point of sale worth fighting for. The large banks have recognized that

100% equity lines of credit give them an open-ended option on the extension on consumer indebtedness. They've also recognized that the basis for underwriting the equity line goes beyond collateral and extends to cash flow and net worth-based, risk-weighted underwriting systems. They've recognized that households buy all kinds of products and services that can be marketed in all kinds of profitable ways. Will the community

financial institution make the necessary changes in underwriting criteria to compete for the household?

Managing Margins through Efficient Pricing

Community financial institutions will have to adopt predatory pricing tactics. Individual institutions must price retail products relative to their own investment alternatives and with respect to their own surplus equity. They'll need to adopt risk-based credit scoring systems that permit them to price and thereby get paid for their additional risks. They should adopt the relationship pricing tactics of other successful retailers to capture households. All these areas represent pricing tactics that can be used to forestall eroding asset yields.

In order to squeeze the most yield out of earnings assets, excess liquidity will have to be reduced. That means that the borrowing power afforded by access to the Federal Home Loan Bank System will have to be used to create the basis for liability-based liquidity policies. No longer can institutions afford to depend solely on liquid assets to provide the funding for loans.

In fact, this question of borrowing from wholesale sources gets us into the whole issue of the efficient pricing of retail liabilities. A whole slew of marketing tactics will be called for to segregate the more rate-sensitive from the less rate-sensitive customer. Funding mixes between wholesale and retail sources must be determined by analyzing the marginal cost of funding alternatives. Management information systems, which simply compare the average costs of funding alternatives, give the wrong signals and sacrifice too much income at the margin. You can't grow your institution profitably by paying more for old money.

All of these margin management strategies notwithstanding, institutions

will be doing well to halt the erosion of interest margins. They must seek other sources of income.

Searching For Non-interest Income

Winning the battle for the point of sale will be crucial to institutions trying to maximize their opportunities to increase non-interest income. Retailers make money by selling stuff to people. Community financial institutions are retailers. You fill in the next sentence.

Often we think of increasing the fees on existing loan and deposit products as the primary source for future increases in non-interest income. Don't count on it! The consumer backlash on fee income of this sort is already a source for political rhetoric and, more importantly, competitive response.

The perceived value of basic banking services is already built into existing customer expectations. How dare you charge me more for something that I've come to believe is a basic economic right. The idea is to get paid for being a gateway for the sale of more types of consumer products and services. Intermediaries get paid to facilitate transactions. So facilitate them.

What products and services should you sell? Heck, I don't know for sure. And don't rely on your directors or anecdotal evidence from management or consultants for the answer either. Go ask your customers what their priorities are. Sure they're fickle. Sure they can be swayed by clever marketing tactics and they follow fads. That's the point of fashioning a customer-driven strategic plan. Identify those customer groups that are responsible for the most important components of your balance sheet and income statement. Then identify and serve their priorities. But how can you capture the benefits of being their financial service gateway if you don't establish yourself as their point of sale? You can't.

Here's an example from my generation, the "pre-retirement" generation. I get tired of being referred to as a disloyal, coupon-clipping, totally rate-sensitive old so and so. Can't you understand that I'm scared about providing for my retirement? I'm focused on security. And I know two things for certain. I won't be able to depend on the government "safety-net" for this security and I sure won't depend on my children to take care of me. Their idea of care would be to stick me in a wheelchair in the basement and let me drool away my golden years. No. I look for investments. Mutual funds. Equities. Your 5% or 6% CD just won't cut it. If you want to capture my point of sale, you must serve as a gateway for a menu of investment alternatives. Sure, your CD may be one of the options, but not unless you capture the point of sale for the other options as well.

Look, when it's all said and done, I'll just be happy if my institution's increased revenues from non-interest sources offsets the downward pressure on interest margins over the long run.

Now, what about operating expenses. Can I gain my 12% to 15% increase in ROA by achieving operating efficiencies as I grow?

Exploding the Myth of the Advantage of Size

There are no economies of scale in the production of financial services that can't be captured by outsourcing to third party providers. Anything that a big bank can offer to a customer a small bank can also offer. Oh sure you can amortize the fixed costs of an existing delivery system over a greater volume of production. There are few barriers to the provision of financial services because of the size of the institution. Ain't technology wonderful?

Can small financial institutions play on the same household financial services field as the big boys? What's going to

happen when the “Internet” becomes the delivery system of choice? Won’t that spell the doom of the small community institution? Ask Tom Farin. He’ll tell you that the community institution may even have a competitive advantage in this area.

In general, large institutions just don’t operate at significant cost advantages to smaller institutions. Now don’t confuse this phenomenon with the cost-cutting bloodbaths attendant to the merger of institutions. That is an attempt to avoid the “diseconomies” of scale.

Wow! What a lecture on ROA. All to discover that I won’t be able to count on a consistent annual increase in ROA to feed the required increase in earnings necessary to maintain a competitive ROE.

The Answer is Leverage

Big bank holding companies grow their companies by their ROE, net of dividends, year in and year out. It’s how they maintain a competitive ROE. They do it. By hook or by crook, they grow their companies by the growth rate of internal capital. They don’t do it by raising rates; they do it by buying your butt. That’s why I say bankers eat their children. They need to support their required rates of return on equity. They also do it by supporting their growth by supplementing retail deposits with wholesale funding...lots of wholesale funding.

Community institutions, you too will learn to grow by your ROE, net of dividends. You too will learn to use wholesale funding. That is, you will if you want to survive and to remain a relevant player in the financial services markets within the community you serve. Let me explain.

The engine of capitalism is leverage. Getting capital to support as much earning assets as possible is the path to profit for the investor. This is true in any business enterprise, but it’s the very foundation of profit for the financial intermediary. For crying out loud, it’s why we invented a banking system based on fractional reserves and deposit insurance. We intended to maximize the amount of economic growth that a limited supply of capital could support.

Maintaining any capital in excess of that required for the safe and sound operation of the financial institution is a sin. Oh there’s room for some debate between and among regulators and investors as to the level of capital relative to the risk of a particular institution. But seldom have I seen that debate result in a level of tangible capital in excess of 6% to 8% of assets in a well-run institution.

Now that I’ve probably aggravated most of my readers at “well-capitalized” institutions, let me explain the reason for my passion on this subject. Community banks are falling prey to larger institutions

not because they aren’t producing competitive ROAs, but because of noncompetitive ROEs which are a result of low leverage ratios.

Community institutions just aren’t growing fast enough to use their capital efficiently. The irony of this situation is that community institutions may, because of the relatively smaller size of their balance sheets, have an easier time growing at a rate sufficient to produce a competitive ROE. But doing so requires that you be innovative, clever, and willing to take on risk. Lots of crumbs are falling off the big bank tables.

Too many of you turn up your nose at the opportunities they create saying, “that’s not right for me,” “that’s too risky for me,” or “my regulator told me I’d get sick if I ate that.”

There is no reason why community institutions can’t achieve the competitive levels of profitability required to remain independent. If you want to sell out, then do it at a fair price that is based on a higher rate of earnings. But, it sure is a shame to see community franchises either sold or shrinking into irrelevance based on the failure to implement achievable business strategies.