

Retail Strategies for the New Millennium: Face Up, Fess Up, and Overcome

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A noted economist has said, "The long-run inevitability of continuing bank consolidation is the pure unadulterated result of competition in a declining cost industry that produces commodities."

Another noted economist has said, "In the long-run... we're all dead!"

Well, yours truly is an *ex*-economist, and I say, "Bull-bleep! As long as I can leverage capital at 15 to 1, watch me make a buck in community banking!"

Coping with the Reality of Narrowing Interest Margins

Face up...to the fact that margins are narrowing – forever!

Fess up...to an inefficient risk-measurement and risk-management process!

Overcome...by committing to measuring and managing risk in order to meet the market's demand for well-priced retail products!

On the Asset Side

Why are interest margins narrowing on the asset side of the balance sheet? The answer: Securitization, securitization, securitization! Capital markets are on a march toward ever-increasing efficiency.

Beware of management tactics that seek to evade the inevitability of narrowing margins:

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- We'll get back to a positively sloped yield curve eventually!?
 - We're restructuring our portfolio mix to include higher yielding assets...with little additional risk!?
 - When the market crashes, people will come running back to our safe, insured CDs so we'll have plenty of money to lend to a depressed economy!?
 - We're not going to make loans at a current margin less than our average margin...we'll just have to take time off from increasing earnings while the yield curve is so flat!?

Don't delude yourself. Nobody will escape the trend of narrowing margins!

Is there a way out? Absolutely! Measure, manage, and price risk in order to create well-priced retail products that meet the needs of the consumer. Examine your need to portfolio increased risk by creating nonconforming loans with well-priced consumer options.

Let's take a look at the risks we're paid to manage...

- *Credit risk*: Note the movement from solely collateral-based lending decision to a cash-flow-based, risk- and cost-adjusted underwriting process.
- *Interest-rate risk*: Project the future results on earnings and market values from alternative management strategies under a variety of interest-rate environments.
- *Liquidity risk*: Develop a total sources and uses of funding approach to liquidity management which includes the impact of wholesale funds and retail pricing tactics.

On the Liability Side

Why are interest margins narrowing on the liability side of the balance sheet? The answer: Mutual funds, mutual funds, mutual funds!

Your liability is your customer's asset, and securitization is playing a dominating role in the competition for intermediate retail funds. What happens when economics and demographics come face to face with retirement?

Is there a way out? Absolutely! Recognize and manage the implications of funding your institution with transactions and liquidity balances:

- The battle for checking gets "down and dirty" with "no-fault" checking and "early payday" checking. Give the consumer earlier and easier access to their funds. I don't care who the "float" technically belongs to.... You can't lose the "float" on checking accounts that you don't have!

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- Price your CDs so that you offer the best *rate*, not the best *rates*. You can't afford to pay rate-sensitive rates to non-rate sensitive customers.
 - Start competing "head to head" with Money Market Funds for liquidity balances. Make sure that Investment subsidiaries and affiliates clear into your own aggressively priced checking accounts. Maybe the time is ripe to offer unlimited checking at money market rates!

Striving for Fees: The Race to Replace Narrowing Interest Margins with Sources of Non-interest Income

Face up...How do you build a strategic plan around charging people a fee for something that they should get for free?!

Fess up...Everybody's doing it. So what's the problem? After all, 80% of my profits come from 20% of my customers; everybody must pay their own freight or get flushed! Customer profitability is king!

Overcome...If 80% of your customers are unprofitable, then shame on you! Recognize that you are a retailer managing points of sale. Sell stuff...some stuff...any stuff! Just make sure that your customer perceives the value of what you're selling!

What to sell:

- Bank products...of course!
- Financial services...sure!
- Anything your point of sale permits!
- Enter the Internet and e-commerce!

Seize Your Competitive Advantage

Face up...Big banks are feeding their "ROE Beast" with your "A" credits. Predatory pricing with CD specials, de novo branching, M&A strategies and much wholesale funding allow big banks to minimize their funding costs.

Fess up...Real credit scoring and differentiated pricing scares the !@#\$ out of you. Besides, you feel you're small and not sophisticated enough to implement complicated pricing strategies...and community banking is all about fairness and charging everyone the same fair rate.

Overcome...by following Dr. Tom's retail rules.

Dr. Tom's Retail Rules:

1. Nobody but nobody sells to your "A" credits but you!
 - Create or buy an option on all the future credit extension of "A" credits using home equity. Become the lender of first resort, making sure no other lender can file a lien on top of you. Manage the risk of home equity loans.
 - Recapture the point of sale: Refinance all secured consumer installment debt. Make the customer an offer they can't refuse.
 - Adopt a retail focus –Get your "share of wallet".
2. Gain, maintain, and manage the point of sale!
 - Sell stuff to people!
3. Minimize the cost of funding your bank at the margin!
 - Pay the best *rate*, not the best *rates*.
 - Start an all-out war for checking with direct deposit.
 - Recognize the long-term permanence of wholesale funding on your balance sheet.