# Devilish Details

by Steve Brown

In the movie "The Omen," the sign of the devil was 666. Since the remake is scheduled for release today (given the date), we though we would have a little more fun, try to keep things light and provide devilish insight into the banking industry's most recent numbers. Note that all analysis is based on 3/31/06 FDIC Call reports. First, for banks keeping score, the biggest banks in the country are running 14% higher LTD ratios. On average, big banks have LTD ratios of 94.6%, while independents average about 82.9%. As upcoming data will show, this results in quite a financial advantage for the larger banks. Given that NIM remains a popular way of viewing bank performance, it is interesting to note that independent banks beat larger banks by a whopping 17% (i.e. 4.14% vs. 3.52%). Interestingly, banks in excess of $10B in assets have been leveraging non-interest income more and as such, have strategically driven their NIM down 18% in the past 5 years (from about 4.00% to 3.28%). While many readers will no doubt smile at that spread tightening, note that it has not severely impacted their ROA or ROE. In fact, large banks pump out ROA that is 18% higher than independents (1.34% vs. 1.11%) and an ROE that is close to 22% higher. In addition, given an efficiency ratio 16% lower than independents (55.8% vs. 64.5%), large banks remain highly competitive. Changing tacks, the data also indicates just how heavy commercial lending competition has been running. One needs to look no further than the number of banks the FDIC classifies as commercial lenders. Over the past 5 years, the number of banks in this category has soared 17% and remains the fastest growing. In all, nearly 50% of banks in the U.S. (4,631 banks) are now categorized as commercial lenders. As luck and hard work would have it, independent banks have been able to offset some of these issues. In addition to other items too numerous to mention, independent banks have been able to maintain a 21% cost advantage in funding (2.25% vs. 2.86%) and a much wider NIM (as already indicated above). Banks are better at protecting their tax position, as evidenced by more than 1 in 4 banks nationwide that has elected Sub-S status. This is a 15 percentage point increase over the past 2 years. Finally, taking a step backward and looking at the entire banking industry, we find 60% of banks use FHLB advances and 99.3% of banks remain well-capitalized. As far as areas for improvement go, we suggest banks continue to focus on Learning Hedging: Over the past 4Q, fixed rate lending has exceeded adjustable by a ratio of 3 to 1, which partially explains why swaps have exploded. In fact, 1 in 10 banks (882 banks) has now used swaps, a whopping 52 percentage point increase from just 2 years ago, when only about 1 in about 15 banks did so. In all, there are now over $92T in swaps outstanding. Boosting NII: While admittedly tough for independent banks, the collapsing NIM position of large banks should serve as a warning so efforts to expand this must continue in earnest. Categories big banks leveraged that are available for independent banks include service charges on deposit accounts, gains on asset sales (sell loans to book gains), servicing fees (retain servicing on loans sold) and fiduciary income. In total, large banks had 45% more non-interest income as a percent of net revenue than independent banks. Monitoring Quality: While the biggest 1Q charge-offs came in credit cards (53%) and other consumer (23%), independent banking categories of C&I and CRE also began to show stress (11% and 10%, respectively), so diligence must continue. As the data points out, the devil is in the details.

## BANK NEWS

**Acquisition**

Sterling Financial Corp. ($7.6B, WA) will acquire FirstBank NW ($842mm, WA) in a deal valued at nearly $170mm or 2.16x book.

**Acquisition**

Southcoast Financial ($476mm, SC) will acquire Charles Towne Mortgage Corp. for an undisclosed sum.

**Acquisition**

The insurance subsidiary of BNC National Bank ($726mm, AZ) will acquire regional employee benefit insurance provider T.M Richards, in a transaction valued at approximately $2MM.

**Lending**

Independent banks have an average 14% of their loan portfolio in construction and 26% in CRE, levels about 250% more than larger bank competitors.

**Yields**

For bankers expecting long term yields to spike above current levels, it is interesting to note that of the major countries, only Australia has a higher 10Y yield than the U.S. As long as central banks don't have the option to invest in another country with a higher yield than our 10Y Treasury, supply and demand dictate money will continue to flow into the U.S. and yields will remain stuck. The country closest to us is Britain, with a 10Y yield of 4.50%.

**GDP**

Given that global growth drives so much of future rate expectations, it is interesting to note that of the major OECD countries; only Sweden and Ireland are expected to have stronger GDP growth than the U.S. Meanwhile, France, Germany and Italy continue to languish below the 2% level.

**Darn Sox**

A new study finds board of director changes at major companies have nearly doubled in the past 6M (from 477 in late 2005 to more than 890 in April of 2006). Disclosure risks were cited as the primary cause by departing directors.

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