FORGET THE COMPETITION

by Steve Brown

Next to the phrase "we have always done it this way," the phrase "that is what our competitors do" should also be banned from the language of banking. The later is a phrase we hear a tremendous amount when it comes to loan and deposit pricing. The rational that your bank should match the competitor's price is dangerous and should be tempered. Risk is absolute. That is to say that it is not related to what your competitors do. To illustrate the point, consider the risk in sky diving. The moment you step off that perfectly good airplane, you take on a certain elevated level of risk. It doesn't matter if you do it alone or if you do it with 100 of your competitors, the risk is still the same. If anything, the risk is greater by following the crowd. The more people jumping out of an airplane, the greater the risk of equipment failure or an accident involving 2 parties getting tangled or colliding into one another. The analogy is apt for banking as the more lenders chasing construction transactions, the higher the risk of a lending accident. The risk of following the crowd is even worse in lending, as price is affected, further skewing your risk/return profile. The risk of default of any given loan is public knowledge (on our pricing model or many of our presentations for example) and it is the same risk no mater how many loans are made. On the deposit side, it is even more important as gathering deposits is not a zero sum game. If your geographical area prices their money market accounts lower, then everyone wins. Pricing to competition leads to an irrational spiral that only hurts the industry. The larger your market share is in a given market, the more you are hurting the industry by matching a competitor's price. One bank kept raising rates to match their competition, until they realized that the competition was doing the same. By bringing rates down, the competition followed and everyone was better off. Price for loans, deposits and services should be set according to the value of the total relationship and the position of your bank. Since no two banks have the same funding structure, cost of capital, view of credit risk and overhead, pricing will (and should) vary from institution to institution. Further, each customer's relationship varies in value. Because of these differences, using another bank's price for a product is like jumping out of a plane and blindly using someone else's chute Â– you won't know until it is too late if the chute is the right size and structure. Banks need to have confidence that they understand the credit risk and relationship value and then set the price at or above the point of indifference. Why would you want a relationship priced to a negative or low return? Giving these relationships to your competition is a double win for you and most banks should be doing more of that. Instead of worrying and spending resources on fighting your competition, spend the effort to get (and utilize) a strong loan pricing and customer profitability model. We cannot think of a better strategic imperative. With margins dropping below 2.90% at many institutions, banks are going to have to have more confidence that they are pricing the relationship accordingly. Getting the tools, training and process in place now to understand these dynamics will enhance your execution and make your bank so strong that it will not matter what the competition does. The average skydiver spends 32 hours per year in training and $3k in new equipment. Considering that the risk of a major accident in skydiving is more than 33 times less of the risk of a commercial loan going into default, shouldn't bankers at least match the training and equipment to get pricing and profitability correct?

BANK NEWS

Acquisition

Sky Financial ($15.8B, OH) will acquire Wells River Bancorp and its wholly owned subsidiary, Perpetual Savings Bank ($74.7mm, OH). Terms of the transaction were not disclosed.

Acquisition

IberiaBank ($2.8B, LA) will acquire Pulaski Investment Corp. (AK) in a transaction valued at nearly $130mm.

Residential Construction

Luxury homebuilder Toll Brothers said that the 3Q sales were down and would continue to fall as the housing market slows. The company announced that sales are headed lower in the Mid-Atlantic, Midwest and California markets, while markets in the Northeast, Southeast, and Southwest are headed up.

Accounting Review

FNMA said a recent accounting review will reveal all previous errors. The mortgage giant said that it would miss a regulatory deadline for filing its financial statements for the 2Q '06. The anticipated correction of earnings is estimated at about $10.8B.

Loan Competition

Wachovia revealed plans to provide loans and other services to low to moderate income Californians. The bank is making $70B available for mortgages, $15B for small business loans, $60B for moderate income consumer loans, and $4B for multifamily housing.