RISK VS RETURN

by Steve Brown

On Tuesday we established that large banks have a net interest margin (NIM) about 150bp lower than independent banks. Yesterday, we highlighted that despite a lower NIM, large banks have a return on equity (ROE) that is about 150bp higher than independent banks. Today, we continue this series by discussing critical items independent banks can incorporate to become more competitive with larger banks. Since lending is such a big contributor to both components, we focus our discussion on a few critical elements to consider. For comparison purposes, we selected a potential loan on an office building as a starting point. This $3mm sized loan had a 25 year amortization and a maturity of 7 years. It carried a 1% up-front fee and a fixed rate to the client of 7.25%. The potential loan also had a primary guarantor with a FICO of 725, LTV of 75% and a DSCR of 1.25. After running this loan through our loan pricing model (LPM), we find this loan should return a 7.74% average book yield over its life, an ROA of 1.41% and a risk-adjusted ROE of 35.3%. With this as our starting point, we begin to vary one component at a time to measure its impact on performance. First, we reduced the loan size from an initial balance of $3mm to $500k. Experience shows many independent banks will price loans based on spread alone (or NIM), without considering the overall loan size. To measure the impact of such a strategy, we re-compute using LPM and find the results to be quite startling. This simple change of reducing loan size has pushed the risk-adjusted ROE from 35.3% to a mere 2.5%. In this case, our fixed origination cost of $22k for this loan (direct and indirect) has slammed down the risk-adjusted ROE like a bag of cement dropped from the window of an office building. Takeaway Â– make larger loans, or price smaller ones at higher rates to achieve risk adjusted return hurdles. Next, we review the impact from debt service. By adjusting the DSCR from 1.25 to 1.45, we would expect risk-adjusted return to increase and that is exactly what occurs. By reducing the risk on this loan, given a higher quality borrower, the ROE jumps nearly 21% (from 35.3% to 42.6%). Takeaway Â– the higher the debt coverage, the lower the rate needed to produce the same risk-adjusted ROE. Since these loans are higher quality, they will have a higher probability of delivering the bank an uninterrupted stream of earnings than loans with lower DSCRs. Third, we examine the asset class. Again, we hold everything else constant to our base case, shifting only the lending class (from office to senior housing). The model picks up both historical and projected losses for each category and applies them to the loan. In this case, offices have lower expected losses than senior housing (by a factor of 6), which is why the risk-adjusted ROE falls significantly to 0.9%. Takeaway Â– a bank that originates senior housing loans should be charging more for them than they do for office loans, because these loans are more likely to see losses in the future. To maintain long-term profitability and return hurdles, a wider spread, better DSCR, or other factors will need to be incorporated to reach equilibrium. Finally, we extended the term of the loan from a 7 to a 15 year maturity. While many independent bankers are wary of making longer term loans, they are extremely beneficial for the customer's credit profile, as DSCR improves over time (i.e. higher interest rates do not impact fixed rate borrowers). Since the bank gets to clip the coupon for a longer period of time, return is enhanced and as such, the risk-adjusted ROE increases from 35.3% in our example to 39.6%. Takeaway Â– making longer term loans can improve the borrower risk profile and boost return. Tomorrow we conclude this 4 part series by examining how this type of analysis can be incorporated to boost overall return and performance.

BANK NEWS

Acquisition

Community Banks ($2.4B, PA) will acquire East Prospect State Bank ($57.5mm, PA) for about $21.5mm, or 1.53x book.

High Priced Talent

Hall of Fame quarterback Joe Montana was named Vice Chairman of Modern Bank ($202mm, NY) and will focus on recruiting professional athletes and entertaining clients. The 4x Super Bowler will focus on building the private client business for households with $5mm or more investable assets.

Competition

Wachovia is working to shift all customer communication (retail and corporate) to email and has rolled out a new online communication system to do just that. Our independent bank clients should take note and ask existing and new customers if e-mail is their preferred delivery channel.

Gift Card Penetration

U.S. Bank announced that it issued its 10 millionth Visa Gift Card in July and expects to issue its 15 millionth in mid-December. The bank has been one of the more successful marketers of the product.