LOOKING UP EFFICIENCY

by Steve Brown

Look up efficient in the Merriam-Webster Online Dictionary and you will find the definition "productive of desired effects without waste." Inefficient, on the other hand, is defined as "not producing the effect intended or desired." Historically, banks have flourished because of inefficiencies in the allocation of credit. A CEO with influence in his community, combined with a solid core of loan officers could almost be guaranteed success. Banks were able to extract higher interest rates out of customers precisely because borrowers were inefficient. Customers, limited by geography, were confined to a select number of loan offerings from a limited number of banks. While high quality real estate secured credit with a 50% LTV should have been priced at Prime minus 2%, banks were able to originate loans well above that level. The banking world has changed and those days are gone. Greater competition from banks and finance companies, expanded reach and information access through the internet, and an industry desire to grow aggressively have driven competition to new heights. Lending products have become more homogenous, easier to shop and easier to process. As such, the market for loans has become significantly more efficient and margins have been squeezed. Through competition and market pricing, banks are forced to allocate resources so that the most efficient delivery is achieved. Banks are facing customers armed with more information, greater sophistication, less fear, more access to analytical tools and more competitors interested in obtaining their business. Compounding this effect, large banks have experienced stagnant lending growth to large companies (as they are flush with cash), the mortgage sector has softened dramatically (another sector large banks lend into), conduit activity has mushroomed (commercial mortgage securitization is moving down market). As if that weren't enough pressure on lending, credit unions are just beginning to enter the fray (only about 1% of credit unions make business loans currently, a number expected rise to 10% by the end of 2007). Banks that think of themselves primarily as lenders, instead of portfolio managers of assets, liabilities and customer relationships, will find themselves struggling with words to explain performance deterioration. Customers with the highest credit quality are already being priced at Libor+125bp. One doesn't need a dictionary to know that difficult is defined as "hard to do, make, or carry out." The good news is that independent banks are making great strides to expand risk management practices, control funding costs and better identify more efficient uses for limited resources. By more effectively pricing loans and deposits, to the best customers, bankers are finding ways to take on less risk while holding the line on profitability. Independent bankers that put in a little extra work will be perÂ·fectÂ·ly poÂ·siÂ·tioned.

BANK NEWS

Big Bank Earnings

All banks listed below indicated NIM contracted primarily due to a depositor shift to higher yielding accounts. National City reported a 15% increase in net income, 22% increase in fee income, NIM of 3.73% and an 18% increase in non-performing assets. JPMorgan Chase said profit increased 30% as investment banking fees soared 44%, provisions fell and grew small business loans by $2.5B. Wells Fargo reported record 3Q income, NIM of 4.79% and an 18% jump in small business loans. US Bank reported record income (as revenue increased from units that charge fees for business services and money management) and NIM of 3.56%. SunTrust said profit rose 4.9% on lending and the sale of a trustee business. NIM fell to 3.56% and small business lending skyrocketed 20%. Wachovia reported profit climbed 13% on gains in business and consumer lending. NIM fell to 3.03%, small business loans swelled 14% and service fees rose 15%.

3Q Trends

While it is too early to tell, as we monitor 3Q releases, we are seeing a slight decrease in credit, largely stemming from the consumer side. For example, Wells Fargo reports a 53% increase in credit losses from last quarter. A current trend is to reallocate resources to lower margined, but higher quality loan product. Banks that have recently done this include Wachovia, M&T, Nat City and Key Corp. True to projections, loan growth has slowed, margins have decreased and core deposit growth is almost non-existent.

Home Equity

The final HELOC home equity numbers are in for July and it is confirmed that 2nd lien delinquencies shot up 22.5% to 7.23%, or the most since 1998. Higher floating rates and the consumer's inability to refinance the 1st mortgage at lower rates are the two main causes for deteriorating performance. Charge offs rose almost 32% and stand at 98bp.