UNDERNEATH A CALM EFFICIENCY RATIO

by Steve Brown

A few months ago, a banker wrote in asking us to take some time to explain the Efficiency Ratio ("ER"). Like a single drip of rainwater that falls from the sky, however, discussing ER can often lead to unexpected ripples in an otherwise serene banking pool. At its most basic level, ER measures bank productivity by measuring the cost to generate a dollar of revenue. As with most ratios, it serves a purpose, but it can also lead to confusion. ER is calculated by taking noninterest expense (i.e. salaries, technology, buildings, supplies and administrative expenses) minus amortization expense of intangible assets divided by the sum of net interest income (interest revenue less interest expenses) and noninterest income. In short, the ratio is designed to measure noninterest expenses as a proportion of revenue. The thought goes that banks (like all other companies), must effectively control costs to ensure long-term survival. Therefore, the higher the ER, the more the bank is spending to support its income, while the lower the ER, the greater the operating efficiency. As of the 3Q of 2006, the banking industry as a whole had an ER of 56.1%. Consider what happens when the data point is broken into more pieces, however. By doing that, one finds the ER for banks with assets below $100mm was 70.1%, banks with assets from $100mm to $1B was 61.7% and banks greater than $1B was 55.2%. In short, the larger the bank the lower the ER will generally be. The calculation seems simple enough, but that simplicity can lead to problems. To begin, the ratio requires context, since banks operate under different business models. While it is interesting to have an industry rule-of-thumb that showers admiration on those banks operating at or below 50% (and conversely points the finger at banks operating above 70%), this is misplaced. Other factors must be considered. Business mix matters. For instance, independent banks that utilize a high-touch service model will usually have a higher ER. However, if the service model also brings in lower cost deposits and a higher NIM, does it matter? Alternatively, a bank focused on tight cost controls might be operating at a low ER yet have the same NIM as the bank in the prior example. Size matters. As banks grow, they also tend to have more sources of income from business areas outside of traditional banking activities. The larger the bank, the more these become available and the lower its ER can become. Branching matters. Banks with more branches seem better able to generate greater relative revenue and therefore, usually have a better ER. Revenue matters. As a long-term strategy, bankers will agree that cutting costs seldom leads to greatness. In fact, depending on the expense base, the ER is inversely proportional to net revenue. Therefore, banks that increase revenue can achieve a better ER than those who cut costs. Risk matters. A lower ER begs the question whether there is enough infrastructure in place to adequately support growth. It is also important to note that in and of itself, ER does not capture the risk of the revenue either. A bank generating lots of revenue doing speculative land deals may have a great ER, but may also be teetering on significant trouble. To summarize, since there aren't that many significant changes our mature industry can do to lower its ER, banks will have to work both the numerator and the denominator of the ratio. Reducing time spent on wasted customer leads, speeding up account processing, increasing fee income, redefining the role of frontline sales, redesigning processes and shortening the time it takes to make decisions can all help the ER. In closing, banks should not lose sight of the fact that there is a wide range of ER's among banks and that ER does not take into account many key elements of a business strategy. Using ER is fine, as long as it is kept in context and bankers keep in mind where the ripples originally emanated.

BANK NEWS

Wells Fargo

Net income set a record for the Company and rose 11% to $8.5B for 2006. The increase comes from greater growth in small business lending (one of their most profitable lines on a risk-adjusted basis), cost cutting at its mortgage operation and wider net interest margins (9bp increase).

Wachovia

The bank announced plans to strengthen its West Coast presence by focusing more on commercial lending. Concrete plans include significantly increasing the number of commercial lenders in Oakland, Downtown San Francisco and Phoenix. In addition, the Bank's plans call for the opening of 30 branches in Southern CA and 40 in Northern CA.

Pressure

HR firm Challenger, Gray & Christmas said U.S. companies in 2006 fired their CEOs at the fastest pace since 1999. A weak economy, performance pressure, retirement, options backdating and increased compliance were all cited as reasons for the surge. Through November, more than 1,347 executives have been let go.

Consumer

Given that consumer spending supports some 70% of the economy, it is interesting to note that credit card late payments increased in 3Q to 4.57% (about 4% more than the 2Q). Analysts said the cumulative effect of 17 FOMC rate hikes and weak home values most likely led to the increase.

Customers

Studies find 19% of small companies plan to ramp up hiring in 2007, the highest level in 3Y.