THE BANK GROWTH EQUILIBRIUM EQUATION

by Steve Brown

Long-time readers of this publication know that we are skeptical about growth for growth's sake. The proper growth rate for a bank depends on 3 things (in order): ability to raise funds below market, ability to price loans above market and efficiency. The single biggest factor in determining your bank's growth speed limit is the ability to raise funds at a cost cheaper than Libor. The more this can be accomplished, the faster a bank should grow (risk controls being constant). The same can be true for loan underwriting. The better a bank is at predicting the true risk of a loan and pricing at a risk-adjusted premium, the faster a bank should grow. If a bank can do both of these things, while keeping overhead expenses in check, then it should try to grow as fast as possible. The problem is that the equation is never straightforward. For every percentage of growth achieved, the bank has most likely taken on higher cost deposits. Additionally, the bank (whether they admit it or not) has most likely increased its credit risk. Soon, because of growth, a bank gets to the point that it is funding itself at market prices and originating loans at market prices. If this is the case, it is only a matter of time before a credit or interest rate shock occurs and the bank underperforms. If a bank finds itself in an "at market situation," it must either remain lucky enough to buy time in order to fix the situation, or it must take proactive steps and decrease in size. Selling loan participations is usually our first recommendation to reduce credit risk and relieve funding pressure. Slowing loan growth by increasing pricing is our second recommendation closely followed by devoting more resources to lowering funding costs. When it comes to calculating growth, both deposits and loans need to be analyzed. While the funding side is straightforward, loans can get tricky. The definitive way to quantify loan risk is to measure whether your earnings stream is more volatile than that of the industry over a period of time. This takes into account everything including interest rate risk, credit defaults and prepayments. The more volatile the revenue stream from loans, the more risk embodied in that stream. For a new bank, the analysis is more difficult, as there is not enough of a time series of data and there is significant statistical noise from "growth." For banks less than 5Ys old, it becomes more of a subjective question. CFOs can parse items like prepayments and non-accurals, but the quality of the remaining revenue stream is subjective. Here we ask, "What is it in the underwriting process that makes your bank superior to others in the area?" Maybe your bank is a better predictor of cash flow or understands the community's appreciation better than anyone else. Unfortunately, many banks would answer that they know the borrower better. This is a problem, because while it may be true, a bank can only know so many borrowers intimately. The faster the growth, the less likely a bank will have superior information and thus, the slower it should be growing. In the alternative, banks that have a competitive advantage embedded in their infrastructure can feel comfortable picking up the pace. Banks that are honest with themselves and don't offer a competitive advantage should slow things down. We are working on a risk calculation to measures a bank's advantage in both lending and deposit gathering and equating it to growth. In the meantime, please know that the equation is non-linear, but highly correlated to the afore-mentioned factors. In summary, growth is fine until a bank's effective funding and lending revenue reach market levels under 95% of the most likely credit, liquidity and interest rate scenarios. Once that happens, equilibrium is reached and it is time to slow down.

BANK NEWS

Pull Back

The CEO of Bank of America has instructed his lobbyists to pull back from their efforts to have the 10% federal deposit cap removed. BofA controls about 9% of the country's deposits and is trailed by JPMorgan (7%), Wachovia (5%), Wells Fargo (5%) and Washington Mutual (3%).

Competition

Bank of America said it will pay bonuses of up to $1,820 to thousands of employees making less than $100k as reward for the bank's 2006 financial performance. BofA tied the bonus program to net income and its stock price. The bank will reportedly spend about $237mm on the awards.

IT Security

A new 2006 study on IT security finds 20% of Trojans horses were designed to steal bank details including account numbers, PINs, passwords and credit card numbers.

Regional Housing

A new study from DataQuick finds CA homeowner defaults jumped 145% in the 4Q of 2006, reaching the highest number for any 3 month period in 8Y. Meanwhile, foreclosures also soared, rising 595% in the 4Q, compared to the same period in 2005. Analysts point to heavy cash out refinancing, a drop in home value, higher monthly adjustable rate payments and purchasing more home than incomes can afford as primary contributing factors.

Credit

A new survey finds 97% of people do not know their credit score and 86% did not bother to check their report despite numerous offers to do so for free.

Busted

The Department of Justice arrested 19 people and charged them with fraud in connection with more than $76mm in loans guaranteed by the SBA.