LET THE MARKET MANAGE OR MANAGE THE MARKET?

by Steve Brown

If there is one thing that saps the ROE of an independent bank, it is the origination of loans below $500,000. While good for diversification, small loans have nearly the same acquisition and maintenance cost as their larger brethren. It takes the same time to court the customer, same time to process credit and the same effort in documentation. A study we conducted last year revealed that the average independent bank loan officer spent almost 60% of their time with activities related to the pure administration of customers. Given that the average acquisition cost is approximately $15k per loan, banks need to drive more than $75k from the relationship in order to cover credit risk, relationship administration and overhead. A review of our relationship profitability database shows that 46% of these relationships fall below a 15% risk adjusted ROE and some are even negative. Since smaller loans are the bread and butter of many independent banks, lenders are left with the following tactics: 1) Increase pricing Â– Depending on the structure, pricing on small loans may need to be increased in order to compensate for the higher relative acquisition cost. Admittedly, increasing pricing by 20% or more is usually the least available option. 2) Streamline underwriting Â– In order to lower processing costs, banks that want to make smaller loans more profitable need to be prepared to reduce paperwork, simplify the loan approval process and utilize more credit scoring. Banks that do these things can cut direct and indirect expenses from an average of $15k, down to about $8k per loan. 3) More profitable structuring Â– Small loans need to have longer effective durations and less optionality than larger loans, in order to maintain the same profitability. Further, these loans need to be part of a deeper relationship. This means greater use of floors, prepayment penalties and covenants that increase (or decrease) pricing based on credit performance over time. In addition, banks should consider requiring mandatory deposits and longer maturities the smaller the loan. By using a pricing model similar to ours, banks can quantitatively see how these multiple factors can interact to create value. 4) Live with it Â– If banks are not willing to change pricing, underwriting procedures or structure, but still want to originate smaller loans, then they should understand the risk-adjusted ROE will suffer. For banks that are either forced to originate smaller loans, or choose to do so, it is important to make sure this is a conscience decision. For banks that find "small loans are all that they can originate," we challenge these banks to change their origination process to make the organization more profitable. Loans below $500k do not need to be a drag on profitability. In fact, if done right, banks can achieve risk adjusted returns of 20% or better with a bit more focus. As we say about all bank operations, management of resources and capital must be at the discretion of management, not the market.

BANK NEWS

M&A

The merger between Barclays and ABN AMRO would create the 5th largest bank in the world if it ends up being consummated. Such a large combination has analysts speculating the move could accelerate a trend of consolidation among larger global banks. Analysts say First Horizon, WAMU, Comerica, Zions, National City and BB&T could be targets, while Citigroup, JPMorgan, BBVA, BNP Paribas and Royal Bank of Scotland could be interested in acquiring.

M&A

The insurance subsidiary of Wescom Credit Union will acquire regional insurance agency Grentner & Litzinger Insurance. Grentner is a P&C insurance company and is the 3rd such acquisition for Wescom.

Cuts

Wells Fargo said it will eliminate 500 jobs in its subprime mortgage lending area. Cuts will occur in AZ, CA and SC.

Competition

In an effort to attract new customers, Bank of America is testing a "no-fee" mortgage program in WA. The program offers customers the ability to switch to a lower rate mortgage once per year without a fee, waives appraisal, credit report and other fees and offers customers $250 if they are approved for a mortgage but take out a loan with a competitor.

Refunds

As of the first week of March, 35.6 million taxpayers had electronically deposited $101.5B in tax refunds to checking or savings accounts via direct deposit. This is an increase of 8.7% over the same period last year.

Credit Cards

The latest GAO study finds total credit card debt grew to $802B from $237B over the past 15Y. Meanwhile, the average credit card debt is about $9k per household and only 40% of cardholders pay off their balance each month.

Mobile Banking

According to recent studies, 70% of US workers will use mobile banking services by 2009.

Exec Turnover

Last year, 22% of CFO's at large companies quit their jobs, according to a study. Pressure related to SOX and increased board oversight were cited as some of the biggest reasons.