

SPONGES AND BANK PERFORMANCE

by [Steve Brown](#)

Everyone loves sponges. After all, what else can you squeeze and have liquid come gushing out? What you may not know is that sponges are filled with tiny air pockets, which is what actually holds the water. When a sponge is dipped in a bucket of water, it is these air pockets that fill up. Water is forced out when the sponge is squeezed. Running a community bank can be a lot like being a sponge. Every day, executives absorb endless amounts of information, regulation and meeting customer needs. Lately, nearly every banker we speak to seems to have been absorbed by margin pressure, funding pressure and extreme competition. Deposit customers have shifted balances from checking and money market deposits to CDs in search of better returns. This required banks to absorb higher funding costs. Meanwhile, CRE loans are being originated at 10Y fixed rates as low as 6%, squeezing asset pricing. As if that weren't enough, extreme competition has increased loan prepayments on the best quality credits, requiring banks to absorb the impact of having fewer income-generating assets. Finally, adding insult to injury, this all seems to be happening in conjunction with a slow downward shift in overall credit quality. Community bankers all over the country are telling us they need help solving these issues, their strategic meetings are getting longer and many are left wondering just how much more they can possibly absorb. Now, more than ever, community bankers are identifying their core competencies, as they try to tap into expertise while simultaneously reducing costs to enhance performance. While no one would argue that taking deposits and originating loans are core competencies, most would agree that understanding the nuances of "basis" risk is not. To stay competitive over the long-term, community bankers will have to consider outsourcing many of their non-core competencies. One example is larger IT projects. In fact, a recent Deloitte study found large national banks save roughly 40% on IT projects simply by outsourcing them to an offshore service provider. While most community banks don't take outsourcing to such an extreme, it is important to note that large banks are now quite comfortable doing so. In fact, projections indicate 75% of large national banks will increase outsourcing from about 6% of the average IT budget to 30% in the next 2Ys alone. Savings for these banks will be in the billions and outsourcing efforts beyond IT are also gaining significant traction. Call centers, human resources, simple finance and accounting functions and back office processing have all been outsourced, sharply reducing costs (consider that over the past 5Ys, Citigroup increased their revenue to expense ratio by a margin of more than 3 to 1, mostly due to outsourcing). Community bankers will need to cut costs beyond current levels to compete. The good news is that there are plenty of non-core competencies that community bankers can outsource. These days, community banks can outsource some or all human resource functions, marketing, ALM processing, internal audit, web design, interest rate risk review, bill pay, loan pricing and credit analytics, loan review, investment portfolio management, wire transfer, settlement, safekeeping, online banking, payments processing, sweep, remote capture, relationship profitability, system security testing, legal and many others are all possibilities that can make a big difference in reducing costs and enhancing specialized expertise. Outsourcing is yet another way community bankers can wring out extra savings, improve performance and compete more effectively.

BANK NEWS

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The American Bankers Association (ABA) and America's Community Bankers (ACB) announced they will merge. The combined entity will be called the American Bankers Association and will focus on industry issues and as an advocate for the banking industry.

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First Community Bancorp (\$5.3B, CA) will acquire commercial finance company Business Finance Capital Corporation (BFCC) for \$35mm in cash and stock. BFCC is an asset-based lender with \$88mm in loans as of May 31, 2007.

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National Penn Bancshares (\$5.5B, PA) will acquire Christiana Bank & Trust (\$166mm, DE) for about \$57mm in cash and stock, or 2.8x book value.

Competition

First Horizon National (the old First Tennessee), will buy a bank charter (from Centerville State Bank) in KS and begin offering products to retail and business clients. The move gives First Horizon the ability to branch within the state.

Treasury to Ease AML Burden

In an effort to make U.S. businesses, and small banks in particular, more competitive, Treasury Secretary Paulson unveiled an initiative that would ease anti-money laundering compliance burdens on financial institutions. The two-part plan would more efficiently match risk-based examinations to risk-based obligations and narrow the definition of money-services businesses.

Economic Concerns

A quarterly survey by the Small Business Research Board finds business owners in the Midwest are most concerned about soft economic conditions, while owners nationwide are worried more about taxes.

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