PART 3 OF 3 Â– BANKING SPECIALIZATION

by Steve Brown

BANKING SPECIALIZATION:

Late last week we discussed the commoditization of the industry and how large national banks have been targeting small business owners with increased emphasis. We also suggested banks review their performance, identify core competencies and target the correct customers. We close off this series by sharing some concrete changes we have seen banks implement that allowed them to differentiate within their respective markets and comparing strengths and weaknesses to large national banks. 1) A number of community banks that we deal with have focused their attention on a small number of industries. One of our customers targets hospitality loans (hiring lenders and underwriters familiar with that industry). Within the hospitality industry, for owner/operated cash stabilized properties, the market demands longer-term loans. Management was comfortable with a 10Y loan product, even with a 25Y amortization schedule, but they were still losing deals with longer maturities. Management rethought its strategy and loan committee concluded that since the 15Y fully amortizing loan was roughly the same weighted average maturity as the 10Y product; they should also be comfortable originating these structures. The bank also found out that borrower perception of these alternatives is very different. Within this bank's geographic location, only national banks were offering a competing 15Y and 20Y product, so having this tool provided an opportunity to capture more customers. This bank would not have come to this conclusion if it viewed only its community bank peers as competitors during its strategic competitive analysis. 2) Another client conducted a study and wrote an internal paper on the value of personal recourse on secured loans. With legal input and empirical evidence, the bank's management team concluded that the value of personal guaranties to the bank was low compared to the perceived cost of the guaranty to the borrower. The bank decided to permit certain loans to be offered without recourse to sponsors or, alternatively, build in guaranty "burn-offs" for stabilizing projects. Again, within this bank's geographic region, only national banks offered a competing product. As in the previous example, this bank would not have come to this conclusion if it only viewed other community banks as its competition. 3) Many of our clients are also chasing C&I credits, as they respond to CRE concentration issues and increased regulatory scrutiny. Yet, few can state how these loans are profitable. Given higher default rates, many banks do not track the inherent risk or accurately quantify it. Overhead can also be higher on these loans. Finally, few banks are positioned to handle the complex underwriting required on these credits (i.e. analyzing business strategy and cash flows). Many of our community bank customers have found success by emphasizing specialized industries and investing the resources to educate their lenders to understand those industries. Some examples of successful specialization include: industrial production, recycling, professional services (including surgeons, lawyers and dentists) and mini-storage. The banks can then position themselves as industry knowledge experts, advising on leases, mergers, cash management, HR and lending. These customer banks also realized that these businesses (what was previously termed as owner-occupied CRE credits) are truly C&I loans, with the additional benefit of real estate security. One reason C&I loans are profitable is that the correlation between the business (the cash flow and primary source of repayment) and the collateral (the security interest in the real estate and secondary source of repayment) is very low. The above examples serve to highlight products, services and strategic direction that banks can take to increase profitability. Note that in none of the above examples did banks define their industry as "community banking." Instead, innovation was derived through a broader view of the competitive landscape. Future success requires community banks to acknowledge they have more competitors than each other and not wait to take action.

BANK NEWS

M&A

In the first investment of a U.S. bank by a Mainland Chinese bank, China Minsheng Banking will acquire 9.9% of UCBH Holdings (CA) for an undisclosed sum. The deal gives Minsheng an option to buy up to 20% of UCBH.

Subprime

A new report from the Financial Times estimates Bank of America and JPMorgan will announce combined losses of $3B related to subprime. If that is true, the total loss for the world's top banks related to subprime would be $20B.

OCC On Loans

Comptroller John Dugan was adamant that banks should strengthen their underwriting standards particularly loans sold to other banks. Dugan implied that banks tend to have lower underwriting standards when they sell loans to 3rd parties.

Targeted Competition

Capital One announced a new effort focused on doctors and dentists. The push, dubbed the Medical Real Estate Loan program, provides 100% financing for 15Ys to medical professionals interested in purchasing, building or renovating their offices. Loans can also be used to upgrade equipment and/or refinance existing loans. This isn't surprising, since our research finds these types of loans are 20% more profitable and carry a lower risk profile than the average community bank borrower.