THE MIGHTY (BUT SHORT) SANTA FE

by Steve Brown

Back in 1868, the Atchison, Topeka & Santa Fe Company started on the largest railway of its time. The Santa Fe railroad was to run from Topeka, KS all the way to Santa Fe, NM. After years of hard work, laying tracks across relatively flat Kansas, the line came to La Bajada Hill, a steep, 800ft. elevation incline 20 miles outside of Santa Fe. Unfortunately, the construction engineers were not talking to the locomotive engineers and when the latter came out to inspect the track, it was determined that the Baldwin steam engines could never make it up the grade under full load. Seeing the mistake, the Company did what any determined company would do Â– end the railway, save the budget and call it a success. As a result, the Santa Fe Railroad never actually made it to Santa Fe.

In similar fashion, banks that set out to achieve an 18% ROE can come up short because they fail to properly plan and manage profitability. To help, we have gathered some interesting facts culled from our profitability work for 2007.

When it comes to branches, the average, well-run, profitable retail branch has $130mm+ in loans, $190mm+ in deposits, 9k accounts and 4k customers. The cross-sell ratio averages 2.8. Branches that can achieve this profile tend to produce a 23% ROE. When it comes to loan calling officers, the average top performing officer manages $45mm in loans and $8mm in deposits. ROE for this group averages 18%. When it comes to deposit calling officers, the average officer is responsible for $25mm in deposits and $16mm in loans, for an average ROE of 44%. Interestingly, the top 10% of profitable customers utilize 3.48 different products, while the least profitable customers utilize 3.50 different products.

The top 3 items which hurt bank profitability according to the 2007 data include: 1) Poor loan pricing/structuring (contributes 60% to lower than average ROE), 2) High rate CD promotions (contributes 22%) and 3) Excessive fee waiving on deposit accounts. The most profitable account at the bank is business checking, while the least profitable is student checking. The most profitable CD structure in 2007 was the 1Y or 1.5Y, which tied. The least profitable CD Structure had a 5Y maturity, but it was closely followed by the 3 month CD. An interesting deposit fact we dug up Â– a bank had an equal chance of losing money with public funds than making money last year. For that matter, 21% of the average bank accounts lost money for the institution (this compares to 14% for 2006) due to mispricing. As in year's past, the 90-10 rule still applies, as the top 10% of profitable customers for the bank contributed more than 85% of profits.

Based on this data, what are the top 5 things banks can be doing to increase profitability in 2008? 1) Find out who the top 10% of your customers are and aggressively protect them Â– having a profitability system can help bankers start measuring these metrics; 2) Figure out how to market, bundle products, segment customers and sell more business DDA accounts; 3) Get a loan pricing model so you know if the loans you make contribute to profitability or take profitability away. If banks can increase the average life on profitable loans (through prepay protection, longer maturities, etc.), loan profitability will exceed credit risk (i.e. most of a loan's credit risk is between years 2 and 3, not on the tail end). 4) Cross-sell profitable products to your profitable customers, particularly on the deposit front. 5) Figure out who the most profitable customers are, figure out ways to keep them and figure out why they are profitable. Then work to develop programs to target similar accounts.

If you would like more information on how to increase profitability, be sure to come to our upcoming Executive Management conference in San Francisco on March 9-12. If you attend, you will leave with enough ideas and education to make sure you are not caught short in achieve your profitability goals. You can register to attend by going to the link below:

Related Links:
http://www.pcbb.com/2008Conf_Summary.asp

BANK NEWS

Housing Weakness

Countrywide said foreclosures and late payments on single family residential loans jumped in December to their highest level in 5Ys.

More Housing Woes

Moody's said losses from loan defaults may lead it to downgrade FHLMC's underlying financial strength from "A-," but said the company's senior long-term debt rating would not be cut (i.e. remain "Aaa"). FHLMC recently took steps to shore up capital by selling $6B in preferred stock and slicing its dividend by 50%.

Recession

Wall Street firms expecting a recession in 2008 include Goldman Sachs, Merrill Lynch and Morgan Stanley.

Consumer Weakness

Capitol One, the largest independent credit card issuer in the country, cut profit forecasts by 20% due to ballooning loan losses. The company set aside $1.9B in loan loss provisions in the 4Q.