WHAT KIND OF GROWTH ARE WE TALKIN' 'BOUT HERE?

by Steve Brown

One of our favorite songs is a new country western about a guy that gets in an argument with his wife and then hears her say "I'm gone." He neglects to ask any questions, so after she leaves; he is left wondering if she is gone for the day, for the night or for the rest of her life?

That song would have provided a catchy soundtrack to a recent strategic planning meeting. The bank CEO started the meeting off by saying the board wanted 6% growth for 2009. Later in the conversation, the CEO admitted that he wasn't sure if the board wanted earnings growth, branch growth, customer growth or total asset growth. While most of the management team went to work in the morning session focused on asset growth, it came out later in the day that the board actually wanted earnings growth.

For the average community bank, gaining earnings growth is a song of a different tune. For a high performing bank that has already refined its tune, earnings growth is usually derived from a combination of asset and customer growth. A plan usually has only a moderate probability of succeeding, as not only does management have to execute, but a whole host of other variables (such as credit, funding, rate of new customer acquisition, etc.), must fall into place.

On the other hand, by shrinking the balance sheet, capital ratios are automatically brought back in-line, funding costs are reduced (as more expensive money is driven out of the bank) and credit risk is definitively lowered. Doing this increase the odds of success, as all management has to do is to execute. More importantly, most banks are currently asymmetrical in their earnings sensitivity curve. That is, since funding, credit and capital are already strained and most banks, CEOs will find that earnings are more affected by reducing assets than gaining them. Quantitatively, banks that reduce assets by 1% gain more than a 1% improvement in ROE. On the other hand, more than 80% of banks (as of 1Q) will gain less than a 1% increase in ROE if they add 1% to their asset base. A near-majority of banks will actually reduce ROE if they add assets.

We have taken the liberty to model all FDIC insured banks and make that basic model available on our BIG Metrics product under the "What If" feature. Here, banks can log on and see the sensitivities that drive their ROE. Bank management can ask - if they want to grow assets, what will happen to ROE?

For example, for most banks, funding cost will increase. Let's say your cost of funds will increase from 2.00% to 2.20% under an asset growth plan. Banks may see a 0.20% hit to margins and then decide to increase loan yield in order to compensate. The yield on assets now goes up 0.20% to offset the higher cost of funds, but the bank most likely will find that their ROE goes down. It just so happens that our subject bank, like many banks, is more sensitive to funding than to their yield on earning assets.

The extent of that asset growth either helps or hurts earnings largely depends on an institution's overall sensitivities. This is different for every bank. National banks tend to be more fee driven, so growth in the number of customers tends to have the greatest affect on ROE. Banks with high overhead costs and a low cost of funds tend to be more asset growth sensitive (especially if they have a large percentage of fixed costs). Banks with an already high cost of funds, elevated leverage and exacerbated credit risk, would be well-served to reduce assets by loan participations or sales.

The song of growth has many different rhythms, not all of which will have shareholder's singing. Knowing your bank's sensitivities and understanding what notes will get you to your objective are important in carrying out any strategic plan. Otherwise, as the song goes - "ah man, this might not be good."

BANK NEWS

Bank Takeover

The OCC closed ANB Financial ($1.9B, AR) and the FDIC was named Receiver. ANB was reportedly closed as a result of unsafe and unsound business practices, primarily related to construction and development loans. As of March 31, ANB reported non-accrual loans to gross loans of 36.6% and non-accrual loans to allowance of 609%. The bank's loan portfolio breakdown at that time was 78% construction & development (of which 19% was 1-4 family construction and 59% was other construction & land); 7% was in 1-4 family residential and 9% was commercial. On the deposit side, brokered deposits to deposits were just under 87%. ANB was handed over to Pulaski Bank & Trust ($1.3B, AR), a subsidiary of Iberiabank Corp. ($4.8B, LA), who agreed to assume control over ANB's bank locations. This marked the 3rd closure of a bank this year, following Douglass National Bank ($59mm, MO) closed in January and Hume Bank ($19mm, MO) closed in March.

Key Branches

Key Corp is in the process of renovating 650 of its 900 branches. Renovations will include image stations and profitability technology at teller stations. Several branches will pilot an area to support the bank's Key4Women program. The new area will provide office space, research support and educational venues that are targeted to support women who run small businesses producing less than $10mm in revenue. In addition, the bank's branch plan calls for the opening of 148 more over the next 5Ys.