CUTTING OFF YOUR NOSE DESPITE YOUR FACE

by Steve Brown

We are not sure where that saying came from, but we get the gist. More importantly, bank CEOs get the gist since, it is almost mandatory to cut cost in order to generate more earnings and capital given this market. The question arises, where do you cut?

The answer to that question is easy - cut unneeded capacity now. If you have too much infrastructure, above what you need for the next 2Ys, it may be time to cut variable expenses associated with that slack and reconsider strategic objectives with regard to fixed costs. While not ideal, in times of shrinking earnings, expenses need to be cut quickly in all but those investments with the highest return or projects where cutting certain expenses would not result in a major set back.

Getting specific, if you don't have slack in your organization, what do you cut? That is a much tougher question, as the last thing you want to cut are investments in the future. Money spent on advertising, marketing, customer service and training fall into this category. At every downturn we see bank CEOs immediately cut these 4 categories and it usually end up doing more harm than good. Cut these, and your earnings may look good in the short-run, but it will strangle your long-run viability.

While cutting costs can have a positive impact, before you make wholesale cuts in spending or radically alter the way you do business, remember that certain expenses help maintain and improve your competitive position. By cutting these critical expenses, you can end up hurting yourself and, in some instances, even threaten the very survival of your bank. Here is a summary of costs that have hurt bank management in the past:

Accounting, audit, risk and analytical services: In tough times, bank management needs critical information about its financial position, credit, operations, legal and overall risk position. Not fully understanding your financial options, tax/legal ramifications, loan pricing or stressed credit position can push you into trouble. In good times of growth and earnings, a mis-priced loan or under-reserved exposure can easily be negated through growth. In bad times, the same move can spell disaster.

Insurance: Insurance protects you from a wide variety of catastrophes, both human and natural. Don't hesitate to examine your coverage needs when things are tight, but don't slash your coverage indiscriminately. You'll only reduce valuable protection that could make the difference between the life and death of your business if a major catastrophe occurs.

Technology: Information and technology systems are not only key to cutting costs, they are now de rigueur in many aspects of customer service. Banks must become more efficient and the best way usually is through enhanced technology. Pushing off installing a new core, profitability or cash management system could hurt long-term efficiency. A downturn may be the perfect time to install a new system, as staff is often freed up.

Physical Plant: Banks may want to pare the budget when it comes to purchasing/leasing property, equipment and vehicles, but they shouldn't slash it. Attractive branch and office surroundings can make the difference to a potential customer seeking business with a solid bank that looks like a winner. In volatile economic times, customers are more open to moving relationships and an attractive branch may help. Also, don't forget about the importance of preventive maintenance:

Serious reductions on maintenance and improvement costs can end up costing banks far more later on.

Credit & Collections: In a downturn, credit quality becomes the life blood. Few bank CEOs would consider cutting staff in this area, although we have seen it done. This is probably the last place you want to reduce overhead.

When times are tough, you'll want to cut expenses, and you should. The measure of your business acumen during these difficult times, however, will not be the size of the cuts you make, but the wisdom you employ in making them. Besides, noses are important.

BANK NEWS

Thrift 1Q

The OTS is reporting thrifts lost $617mm in the 1Q, as they added a record $7.6B to loan loss provisions (a 38% increase from the 4Q). Meanwhile, loans 90 days or more overdue + REO increased to 2.06% of assets, a 24% jump.

Real Estate

The Department of Justice has reached settlement with real estate brokers that will ensure online brokerages get full access to listings of homes for sale. The settlement will not take effect until later summer.

Bank Loan Performance

For 1Q, the bank loan charge off rate hit 0.97%, up 29% from 4Q. The jump was driven by residential real estate foreclosures. Every category increased with the exception of agriculture. For delinquencies, the level hit 2.83%, up 15%. Examiners took noticed as commercial real estate loans suffered the largest increase (more than residential) of any category and spiked to 3.46%, up 27%. If the past relationship holds, the spike in delinquencies is expected to equate to a 0.65% charge off rate by the end of June (from its current 0.48%).