ANOTHER REASON NOT TO GROW

by Steve Brown

One of the most overrated metrics in banking is asset growth. Bankers love to grow assets and when asked why, most say a larger bank gives them more options, greater liquidity, allows for economies of scale or provides some element of "gravitas."

In the past, our research has focused on the lack of correlation between earnings performance and asset size. Now, there is a growing body of evidence that suggests asset size may actually hinder performance in a downturn. With 95%+ of banks reporting for 2Q, recent statistics support this assertion.

Large regional and national banks such as Washington Mutual, National City, Wachovia and others have clearly had problems and exhibited high sensitivity to the recent downturn. Even excluding these super-large banks, the same trends appear for community banks. For the sake of labeling, we will break banks down into asset sizes between $300mm and $1B (which we will term as "Small" for the sake of discussion) and between $1B and $3B (termed "Medium").

Both of these cohorts have relatively the same balance sheet composition, deposit leverage, asset growth and loan concentrations. Both have relatively the same yield on earning assets. Despite these similarities, Small banks returned a 5.6% ROE versus 3.5% for Medium banks. What explains this difference? Part of the answer can be found in the fact that Medium banks suffer from "diseconomies of scale."

The difference in performance over the past year between Small banks and Medium banks lies in loan risk. As of 2Q, Medium banks had a larger percentage of non-accruals and past due loans than Small banks. This is a result of 2 factors. One, is the fact that to achieve the same rate of growth, Medium banks have had to increase underwriting risk and taken on greater risk exposure. Our data finds the average loan at the Medium bank has slightly lower risk-adjusted pricing (by 40bp), a higher LTV (by 2%), a lower FICO score (by 35), a longer duration (by 0.7) and the largest factor - a higher loan balance (by $1.5mm).

Despite these differences, loan attributes only explain a small portion of the correlation. The larger factor is personnel allocation. Small banks have $3.5mm of assets per employee versus $3.9mm for Medium banks. From our Relationship Profitability service, we find that as of 2Q, on a loan and credit officer basis, Small banks tend to have approximately 32 loans per lending/credit officer vs. 44 for the Medium banks. In strong economic times, the difference in the number of loans has little impact on performance. However, in times of financial stress, banks with a fewer number of loans per officer, tend to be more proactive in uncovering and working out problems. This aspect can also be seen in the fact that each loan/credit officer in a Small institution tends to handle $12mm of past due balances versus a whopping $35mm for a Medium bank.

The net result is that Small banks have non-performing loans equal to 1.91% of total loans, compared to 2.23% for Medium banks. Meanwhile, non-accruing loans make up 1.70% of loans for Small banks versus 2.05% for Medium banks. These differences end up having a material influence on earnings, as Medium banks had to take greater net write-downs by almost double (1.05% of loans at Medium banks vs. 0.53% for Small banks) and had to increase loan loss reserves at a faster rate (by 10bp per quarter).

Now it may be that Medium banks are just faster at recognizing problems (as a higher % are publicly traded) or this is an aberration of data, so drawing any definitive conclusions would be premature. However, so far during 2008, a larger asset size has not helped banks achieve greater profitability and, in many cases, may have also been a factor in producing lower earnings.

BANK NEWS

Closed

The FDIC shut down Columbian Bank and Trust ($752mm, KS) on Friday, marking the 9th bank failure this year. Citizens Bank and Trust ($1.03B, MO) has agreed to purchase Columbian's insured deposits and also $85.5mm in assets.

Home Equity

In the 2Q, home equity non-accruals jumped 165% as delinquency rates doubled to 2.00% compared to last year. Banks under $100B in assets took softer hits in contrast to those over $100B, whose non-accruals for home equity grew 179% and delinquency rates hit 2.2%.