FIGHTING FROM STRENGTH

by Steve Brown

Over the last year, banking has felt like a fight. When it comes to lessons in fighting, even experienced martial artists still revere Bruce Lee. Bruce Lee was not just a great fighter, but also a spiritual person and philosopher. His system of fighting, Jeet Kune Do, is a composite of many styles and is still used by many fighters today. One of the major tenets of Jeet Kune Do is to analyze what works for a fighter and to emphasize the form and technique that suits the fighter best, then discard what is not suitable. Until Jeet Kune Do, fighters worked hard to learn a system, instead of developing a system to match their strengths.

The analogy in banking is strong. Many banks work hard to book loans and grow deposits without understanding what works for their specific bank. The same deposit at a lower cost and the same loan at a wider spread is always preferred, but unrealistic. This is because the market, if at all efficient, will eliminate above average returns. Banks must study which loans and deposits earn the largest return and form their business model to maximize those instruments.

One way to do this is to rank loans and deposits on a risk-adjusted basis, allocating overhead and attributing costs through funds-transfer-pricing (cost-attributed, risk-adjusted ROE). This allows a bank to rank all instruments (assets and liabilities) from the most to the least profitable. Management's job is then to stratify the results into three categories: 1) above average performing (top 25 percentile), 2) average performing (middle 50 percentile) and 3) below average performing (bottom 25 percentile). Management can then execute on a three-pronged strategy: retain and defend the above average performing instruments; migrate the average performing instruments into the top quartile; eliminate the below average quartile.

Unfortunately, bankers face a number of problems with this strategy. Jeet Kune Do emphasizes that a fighter must know himself, in very honest terms, to understand his or her strengths and weaknesses (both physical and spiritual). In similar fashion, oftentimes bankers struggle to really know their bank and have a realistic view of its capabilities. Few bankers have the ability to calculate the gross revenue on individual instruments, much less cost-attributed, risk-adjusted ROE.

Interesting developments unfold when a banker has a profound understanding of their institution. As we have said before, the majority of the top quartile cost-attributed, risk-adjusted ROE instruments are deposits and not loans. Despite this fact, many institutions still spend a majority of resources on lending activities. The average commercial loan's cost-attributed, risk-adjusted ROE is under 10%, while the average measure for deposits is well over 20%. The distribution around those averages is also telling - loans demonstrate returns below targets (negative skew) and fat tails (low kurtosis). Meanwhile, deposits are more evenly skewed and show much smaller tails. Deposits deliver exactly what management wants - higher profits and less variability around the mean.

Another striking fact (bad pun intended) is that all else being equal, higher margin loans are less profitable. This is counter-intuitive, as many bankers struggle to book loans at higher margins, without paying all that much attention to the risk they deliver. Since higher return usually indicates higher risk, unless the bank faces a non-competitive marketplace, chances are the bank is designing a balance sheet with high earnings volatility. The quantification and management of risk is a difficult job. One bad loan will reduce the return on a portfolio disproportionately more than the higher yield anticipated. The conclusion is simple - the average bank's ability to underwrite risk becomes worse, as the risk of the loan increases, even though the risk is being offset by higher nominal yield. Banks that emphasize lower risk loans, despite their lower net interest margin will, on average, outperform their higher risk-taking competitors.

To be a great fighter or a great banker, one must often challenge traditional beliefs. By paying attention to the inner bank, one can learn what is working and what is not.

BANK NEWS

Now Official

The National Bureau of Economic Statistics said the US officially entered recession in Dec. 2007. If it lasts just 5 more months, it will surpass the recessions of 1981 and 1973, which lasted 16 months each.

Layoffs

JPMorgan said it will cut 9,200 jobs (about 21% of the overall workforce) at Washington Mutual as it moves to improve profitability following the acquisition. The majority of cuts will occur at WAMU headquarters (3,200) and San Francisco (1,600).

M&A

Greensfork Township State Bank ($158mm, IN) has entered a deal to acquire Symphony Bank ($57mm, IN) for an estimated $3.9mm. Symphony has lost over $2mm since its opening in 2005 and at 3Q end 6.6% of loans were past due.

Econ Predictions

Since so many banks are working on strategic plans during this time of year, you may be interested to know the National Association for Business Economics is predicting unemployment will reach 7.5% in 2009 and Fed Funds will stay at 1% through the year. Meanwhile, a prediction by Goldman predicts unemployment will rise to 8% and GDP will shrink 2% in the 4Q of 2008 and then fall 1% in 1Q of 2009 before flat lining in 2Q and rising 1% in the 3Q.