FORGET THE COMPETITION

by Steve Brown

Albert Lamorisse, in addition to being a bad French film director, also invented Risk - the famous Parker Brother's strategic board game. Players in this game control armies in an attempt to conquer the world by dominating and eliminating other players. To win, players need to know the competition and decide when, where and who to attack.

While it is like that in war and many board games, it is not like that in banking. That is because the goal in banking is to produce an above average return and not necessarily eliminate the competition. After we analyzed more than 3,000 banks from 2004 to 2008, we found that statistically, competition in banking doesn't matter. That is, the number and type of competitors in the market is not a predictor, nor is correlated to, net income performance. Banks in heavily competitive markets tend to do just as well as banks that have few other banks in their market. While we agree the bank across the street might serve to drive up deposit rates, chances are that a competitive marketplace is adding performance in other areas.

The causes of this are severalfold. For starters, competition increases as opportunity increases. Large, growing and lucrative markets usually attract other banks and bank branches. As such, the market, as a function of expected profit per branch, stays relatively constant. For every time you lose a loan deal to the bank across the street, you most likely gain another piece of business from another competitor.

Similar to the above, banking centers tend to attract more business. The presence of other banks in the marketplace actually serves to boost the economy by making credit cheaper which thereby spawns other business development. As a result, the cities and towns with multiple banks usually have faster and longer economic development than areas with fewer banks. In addition, competitive areas attract quality talent and other resources more inexpensively, thus making banks in fast growing markets more efficient (while costs may actually be higher, productivity is greater).

Finally, competition in banking serves to provide better information to participants, thereby allowing banks in competitive markets a more efficient allocation of resources. This is counterintuitive, but some of the most profitable loans made are the low margin, low risk ones (since credit quality overwhelms all other loan performance factors). As such, the presence of competition serves to better highlight those high quality borrowers and provides more transparent pricing to the marketplace, which aids in overall efficiency. Furthermore, competition drives banks to obtain lower cost structures and product innovation.

While everyone loves a monopoly, monopolistic companies are inefficient. In any given month, while competition may hurt, in the long run, competition serves to produce a better bank. If competition doesn't have any strategic statistical significance, then it follows that bankers should limit spending strategic resources on worrying about the competition and devote more time making sure execution is as crisp as it can be. In this manner, banks will be better positioned to obtain global domination.

BANK NEWS

Failure #33

Westsound Bank ($335mm, WA) was taken over and sold to Kitsap Bank (WA). Kitsap will purchase $49.3mm in assets (comprised of cash, cash equivalents, marketable securities and loans secured by deposits), all insured deposits and 9 branches. The FDIC will retain $9.4mm in brokered deposits and the remaining assets for later disposition. Westsound had been hit hard with losses on construction loans, as nonperforming loans reached $132mm at the end of 2008.

FNMA Needs More

Housing agency giant FNMA has asked the Treasury for $19B to cover additional losses in its mortgage portfolio. The Treasury has set aside $200B to help FNMA and FHLMC. Meanwhile, FNMA reported it lost $23.2B in the 1Q, as its mortgage portfolio saw increases in delinquency and default rates (due to higher unemployment, falling home prices and home revaluation).

New FDIC Office

The FDIC will open a temporary office in Jacksonville, FL, in order to assist with the orderly liquidation of failed banks on the Southeast.

FRB NY

Following last week's retirement announcement (initially planned for year end), Chairman Stephen Friedman abruptly resigned yesterday in the midst of questioning regarding stock purchases at his prior firm Goldman Sachs. Deputy chair, Denis Hughes, will stand in during the interim.

Z

The Fed approved a final rule that revises disclosure requirements for mortgage loans (Reg Z). This is the finalization of an interim rule issued last summer that requires more and earlier information on mortgage costs, penalties and interest.

Banking Trivia

The Vatican Bank is the only bank in the world that allows ATM users to select Latin to perform transactions.