WE GROWL AT GROWTH

by Steve Brown

You have to love the optimism of the canine mentality. For example, whenever someone comes to the door, the dog takes off to the front hoping he has visitors. Even though over the past 5Ys not one person has come to our door for him, he continues to wag his tail and remain hopeful.

As bankers, we are equally optimistic when it comes to asset growth. We love growth. Mention a 12% asset growth plan and we will start slobbering. The problem is that almost half the time, asset growth results in a lower net income than higher. In fact, in looking back at all community banks from 2004 through 2008, more assets only resulted in more net income in 53% of the cases. Now that is a little better than half, but not much. For every bank that grew the right way, there are almost as many banks that took on more of a credit risk than they should have, built overhead out faster than they should have or hurt productivity such that they added assets, but decreased earnings. Statistically, asset growth explains less than 1% of net income performance. Because of this low correlation, we submit to you that total asset growth is the wrong bone to go after.

We have nothing against growth. Profitable growth is a wonderful thing, but it is often hard to tell what profitable growth is. Adding customers, loans or deposits without a plan is pretty much a randomizing event. Unless you have a profitability system or loan pricing model to tell you if you are growing the right way, you could be going backwards. While slightly more than half the banks grow correctly, only 24% can grow assets and earnings consistently year after year. Our point this morning is that like asset size, growth is overrated as a strategic objective. Banks that choose to grow may be hurting themselves. If you consider how much time and energy is spent both at the management level and at the operating level trying to hit asset targets, we just have to tilt our head and give banks that puppy-like quizzical look.

Of course, the tail wagging part of this analysis is that high growth doesn't matter either. We took a cut at all those banks over the last 4 years that grew at a 10% pace or better and found pretty much the same result. Half the banks could handle high growth and half couldn't. This is important to keep in mind the next time your regulatory examiner is concerned over growth. High growth can be equally controlled and managed as slow growth. The rate at which a bank grows is really a function of management and the market. For any growth pattern, the trick is to grow earnings more than risk each year.

If you are looking for 2010 strategic objectives to consider, we would make an argument that customer service delivery, core deposit growth, loan mix and relationship profitability targets are all better drivers of net income. These are proven factors that are correlated to earnings. If you target asset growth again, you may just end up chasing your tail.

BANK INVESTMENT PERFORMANCE

April bank investment performance was solid with the average bank putting in a 70bp total return performance (8.4% annualized). Municipals were the best performing asset class followed by agency mortgages. Duration increased by 2bp to 2.91, as a result of stable prepayments in mortgages and higher rates. Average lives, on the other hand, went down 3bp (the difference can be explained by optionality). Book yield decreased by 5bp to 4.46%, due to calls and maturities.

BANK NEWS

TARP Capital

Treasury Secretary Geithner announced today the extension of the application period for funds from small banks (assets < $500M) by another 6 months. The amount of aid was also increased to 5% of risk-weighted assets, previously limited to 3%.

Greenspan

The former Fed Chair spoke and said that the housing market is bottoming out and it is "very easy to see" financial markets improving from here.

FHLMC

The mortgage GSE, still operating under conservatorship, asked the Treasury for $6.1B in more capital to offset still falling asset quality.

Social Security

A report from the Social Security trustees shows the fund will run out of assets in 2037, or 4Ys sooner than last forecasted.

Fed Examination

The recent Congressional testimony of the Federal Reserve Inspector General is both humorous and scary at the same time. If you missed it, check out the following link and imagine if you had that level of preparedness at your next exam: http://www.youtube.com/watch?v=PXlxBeAvsB8

Fee Waiver

Bank of America is starting to issue fee waivers to customers who have lost their jobs. Unemployed customers can waive 3 months of maintenance fees or insufficient fund/overdraft fees. The Bank is also reporting that it will role out a new (and lower) $10 fee for "small" overdrafts.