OUTSOURCING

by Steve Brown

If you're playing cards and you look around the table, and you don't see a sucker, get up and walk away from the game - chances are, you're the sucker. In zero-sum competitive endeavors, players who do not have the ability to assess their chances of success do not fare well. This is also true in banking.

Consider that the competitive landscape in banking has been profoundly transformed in the last 20Ys. From 1992 to 2009 we have witnessed substantial consolidation and increased sophistication in the lending and deposit markets. Over that time, assets for all banks in the country grew 190%, from $4.6T to $13.3T, which is a compounded growth rate of just under 6.7%. However, the amount of concentration in assets, loans and deposits has been staggering.

In 1992 it took the largest 154 banks in the country to account for a combined 50% of the assets, 50% of the loans and 46% of the deposits of all banks. This year it took just the largest 13 banks to account for half the assets, loans and deposits in the country. Now, just 330 banks (4% of all the banks in the country) control 85% of all the assets, loans and deposits.

We believe that not all economies come from size. However, it does produce efficiencies in key areas. When it comes to compliance, IT spending, risk management, procurement and corporate services, larger often means more efficient.

Community banks have an advantage in many ways by staying smaller. The community bank model thrives when the bank understands local conditions better than a national competitor. The model also works when the bank serves markets that are complex or too small to warrant large bank interest. Finally, the community bank model excels when a bank commits to a geographic region, product mix or customer base while the national bank's interest waxes and wanes with alternative investment opportunities.

Given this line of thought, the best bank model would be to gain efficiencies in those areas that are not a core competency in order to focus resources on those areas that are. We believe that in order to thrive, community banks must define their competitive advantage and outsource everything that does not capitalize on that advantage if the cost of purchasing the service is cheaper than producing it in-house. Community banks' competitive advantage is managing and growing local borrower and depositor relationships. While banks may be used to outsourcing functions like accounting, regulatory, marketing, HR and IT, banks should consider credit. For example, very few banks produce a credit underwriting or credit administration product that results in a competitive difference. In fact, these days, when it comes to workout and other time intensive credit functions, banks in-house abilities may actually hinder performance. Don't get us wrong, the decision to commit capital should remain the core competency of a bank, but the parameters to measure individual credit (underwriting) and manage the portfolio risk should be considered for outsourcing.

We have seen this development across the country for many banks. Slowly, but progressively, banks which lack critical size, shed commodity services in order to stay competitive. This has occurred with interest rate risk management, asset-liability management and portfolio risk analysis. Management must still make decision and manage the process, but the heavy lifting (the analytics and infrastructure) could be conducted by 3rd party service providers.

Our recommendation is once management becomes clear on the bank's competitive advantage, move quickly to find an outsourced solution that can save overhead and increase efficiencies. Over the next 10Ys margins will be difficult to maintain and fee income troubling to generate. As such, having low overhead costs and greater capabilities will help ensure that you are not the sucker, as the odds of producing above average returns will be in your favor.

BANK NEWS

M&A

Florida Shores Bancorp ($176mm, FL) has entered a deal to purchase controlling interest of Shamrock Bank of Florida ($70mm, FL) for an undisclosed sum. Shamrock Bank will be renamed Florida Shores - Gulfcoast.

Earnings

BofA produced a lower-then-expected 3Q loss of $2.2B, after problems continued in their consumer, credit card and CRE portfolio. In related news, Ken Lewis, will give up his $1.5mm in salary and bonus for 2009 in order to appease shareholders and the Pay Czar. All this explains why Ken never smiles in any of his pictures.

CU M&A

Credit Union 1 of Kansas ($95mm, KS) and Credit Unions United ($141mm, KS) plan to merge into one chapter.

Foreclosure

According to RealtyTrac, REO's rose over 20% in the 3Q and nearly 938k homes received a foreclosure filing in the 3Q, up 5% from the 2Q. On a monthly basis, September filings dropped 4%.

Exemption

An amendment is expected to pass within the next week making community banks exempt from the proposed Consumer Financial Protection Agency's governing rules and exams. Banks with less than $10B in assets will remain subject of current regulatory agencies in regards to consumer protection laws.