MEN WHO STARE AT (SCAPE)GOATS

by Steve Brown

We do this neat pseudo-paranormal party trick - tell us where a bank is starting up and we will look into the future and tell the bank what there average ROE will be in 5Ys. The trick usually gets us a free drink, some fawning by the accounting types and is termed "hocus pocus" by the CEO. Dismissing the trick is a mistake, as the prediction is amazingly accurate.

How do we do it? The trick is simple and rests on the assumption that banks tend to take on the profitability of the community in which they serve. Statistically, a bank's state accounts for 16% of ROE, while local demographics account for more than 27% of ROE. Make an assessment of an area's economic and demographic composition, adjust it for the quality of management and presto, you have a fairly accurate prediction.

The trick rests on the assumption that to be a community bank, you need to bank the community. If that is a bank's plan, then it follows to reason that if successful, the bank will take on the profitability, return and risk of that community - not really hocus pocus, just straight cause and effect. This assumption also underscores the common refrain that a bank is forced to take action because that is what the customers demand. "We need to make construction loans because that is what is being done," "We need to price at Prime less 1% because that is where our competition is," and our favorite, "We can only bank what the market gives us." Thinking like this gives bankers a great excuse to explain current performance, so if you are looking for a scapegoat in this financial crisis, look no further.

However, bankers may want to rethink using the community as a scapegoat. Some bank managers act as if they have no free will, nor a strategic planning process. Because bank management is basically a group of leveraged portfolio managers, setting targets is one of the most important items to be accomplished, as it has the greatest impact on ROE. Every bank's strategic planning process should start and end with the question Ã¢Â€" "Where do we want to go and how are we going to get there?" What follows should be a proactive positioning on what asset, customer and deposit mix everyone wants. If you don't want construction loans, price them to the point of indifference. Conversely, if you want more C&I because you need diversification and deposits, then price the relationship package accordingly. Setting a goal that C&I lending should go from 12% to 25% of the portfolio over the next 3Ys (and adjusting resources to accomplish the job) is a much more proactive way to manage.

In similar fashion, customer mix, fee revenue and deposit mix should also be actively managed. Just because you bank the community, doesn't mean you have to bank everyone. In fact, if you can't capture certain customer types (like professionals) you want in your community, moving outside the existing geographical boundary is a far better choice then suffering lower profitability by banking local restaurants, grocery stores, mechanics and wineries (some of the most unprofitable customers a bank has).

We have a variety of tools to help bankers get proactive. Setting allocation goals and then assigning resources (people, capital, risk, etc.) to accomplish that goal is fantastic way to make sure our party trick no longer works.

BANK NEWS

Credit

According to the Fed Oct survey, nearly 15% of banks tightened lending standards over the 3Q, down from 35% in July and 80% last October. 16% banks imposed stricter lending standards to firms below $50mm in annual sales and 15% on credit card loans compared to 33% and 35% in July respectively.

Untapped & Closed

The Capital Assistance Program, created in February for infusing banks with capital through preferred stock, was closed today with no investments.

CRE Stress

90% of bank holding companies that underwent the Treasury's stress test and were required to raise capital have done so. The one bank that has not, GMAC, is expected to utilize TARP this quarter.

Correspondent Concentration Risks

The Fed has extended the comment period on the guidance until 11/27.

FHA

The Washington Post reports that the agency has burned through a huge cash reserve and could soon wind up with what amounts to an automatic taxpayer bailout if fortunes don't improve.

Proposal

Look for Senator Chris Dodd (D, CT) to present his misguided proposal to create a single U.S. regulator and strip both the Fed and the FDIC of their respective bank supervision authority.

Consumers

Credit outstanding dropped $14.8B to $2.4T over Sept., declining for an 8th month in a row. MOM revolving lines fell 13.3% at an annualized rate while non-revolving credit shrank 3.7%.

Freddie Mac

The Company reported a $5B loss for the 3Q, less than the $25.3B lost a year prior. Freddie Mac is not asking for additional funds from the Treasury at this time, however it does expect a need in the future.