BANKING STRATEGY AND 4Q BANK PERFORMANCE

by Steve Brown

"How is your chess came lately?" Usually, that question is all it takes to set strategy. If our opponent frames their answer with regard to themselves, or exhibits some level of arrogance such as "I have been decimating opponents," you are teed up to play for a trap (by showing weakness, playing to the person's ego only to set up an aggressive counterattack). On the other hand, if the competition answers in terms of the game itself, such as "my pawn development as been weak," then you should play more cautiously and prepare for a protracted tactical battle.

In banking, the opponent is the economy and right now it is exhibiting little bravado. In fact, since we don't fully understand what we are facing, we must continue to probe certain areas to determine strength or weakness. In times like these, strategy will unfold over years, not months and it would not surprise us if it takes until 2015 before banking sees great strength again.

It helps when setting strategy to understand where you are. For the 4Q, the average community bank reported negative earnings, based on our analysis of the first 7,000 banks to file their Call Report. In particular, we highlight some of the most significant 4Q trends for banks with $300mm - $1B in assets:

- Total assets fell an average of 2.5% during the quarter, net loans and leases decreased 3.8% and deposits shrank 1.7%.

- Capital ratios rose steadily over the past three quarters and this group of banks ended the year with a Total Risk-Based Capital ratio of 13.65%. Banks have been active at adjusting their balance sheets for lower capital consumption.

- At 3.67%, non-current loans continued to climb but at a much slower pace than during the previous 4 quarter stretch (up 1.1% QoQ and 60.9% YoY).

- Return on Equity sank into negative territory (-0.21%), driven by higher charge offs, lower NIM and higher ALLL.

- "Modified ROE" (which excludes charge-offs) came in at 9% for this group, up 11% QoQ and 18% YoY.

- After trending upwards for 9 months, NIM dropped slightly in Q4 to 3.60%, although funding cost improved for many.

- Banks continued to deleverage their balance sheets and increase liquidity as the loan-to-deposit ratio fell 2.2% QoQ and 7.8% YoY to 82%. Most deposit growth occurred in non-time deposits.

- Non-interest bearing account balances increased 3% during the quarter, the first significant increase in 12 months.

- Non-interest income to total revenue reversed a 3 quarter trend, falling to 16.2% during the quarter.

- Revenue per full-time employee remained steady at $208k.

- About 150 banks have "critical" Tier 1 Leverage capital ratios below 5%

Given this, tactics for many banks will continue to be net capital formation and/or protection. To achieve the creation of capital, banks will need to take a hard look at their position and their core competencies to understand the path. To enhance their capital position, some banks may be better served to shrink, others must strategically grow (a current underutilized tactic) and still others must seek out a merger partner.

One thing that is certain is that banks can use all the information they can get right now to make strategic choices. Our assistance in structuring loans/liabilities, loan pricing, credit stress or profitability is now more important than ever. We also call your attention to BIG Metrics, where a subscription starts at $1k per year for most banks. BIG Metrics is designed to put basic analytical information into all banks hands as early as possible. For more information, or to see more 4Q trends, go to: https://biganalytics.bancinvestment.com/. Having the data can help your bank regain its competitive advantage and turn a challenging position into a winning proposition.

BANK NEWS

Sworn In But Worried

FOMC Chair Bernanke was sworn in for another term at a closed door ceremony at the Federal Reserve. Following the ceremonies, Bernanke indicated he was worried about the economic recovery and that "far too many people remain unemployed, foreclosures continue at record rates and bank credit continues to contract."

CDFI Initiative

The Treasury is enhancing a program announced in Oct that focuses on Community Development Financial Institutions. Under the program, CDFIs would be able to apply for Treasury investments of up to 5% of their risk-weighted assets (up from 2%) and would only owe a 2% dividend on the money (compared with 5% for TARP). CDFIs would have to focus on lending to small businesses in low- to moderate-income communities to qualify.

All About Cashflow

A study by TransUnion finds the percentage of borrowers who are delinquent on their mortgages but are paying their credit card bills on time has grown to 6.6% in the 3Q, up from 4.9% in the 3Q of 2008. The data shows cash-strapped Americans will pay their credit card bill before they pay their home mortgage to free up cashflow.