WHEN BAD MARKETS HAPPEN TO GOOD BANKS

by Steve Brown

Is there such a thing as good management in a bad market? We have thought a lot about this and can answer yes. As we prepare for our annual Executive Management Conference coming up in May, one of the quantitative data points that jump out is the fact that geography does matter. On a statistical basis, it is the largest single determinate of ROE performance and failure, explaining 14% of both positive and negative performance. While underwriting, reserves, capital and even diversification impact performance, geography has the most predictive power.

Let's explore that for a second. This means that if you took a good management team and drop them into a hot market in 2005, such as Las Vegas, NV; Port St. Lucie, FL; Gilbert, AZ; or Moreno Valley, CA; they would have most likely resulted in a problem bank by 2010. Before you send a rebuttal, let us further explain. The only way to avoid the classic geographical pitfall is to have a great management team. There are only about 3 dozen instances that we have found that a bank has been in a hot market, yet controlled operations enough so they did not suffer a downturn in performance. This means that on a ballpark basis, a great management team occurs in banking only about 0.4% of the time Ã¢Â€" extremely rare.

To be a great management team, a bank would have had to ensure enough diversification by setting allocation limits for both major lines of business (such as construction) and sub-lines of business (such as limiting amount of developer exposure). In addition, they would have had to focus on loan/deposit pricing and drive sales based on customer profitability. All this is no small feat in and of itself.

Next, the management team would have done something extraordinary that we have only seen done a half-dozen times in our 25Ys in banking. They would have gone to the board and said, "While we know our competitors are putting up 18%+ ROEs and 20% growth rates to garner a 4x book value multiple, we want to not grow or branch into other markets where the economics are just 25% of our market. Yes, this will quickly destroy short-term value, but we should make it back in 5Ys." Half those great management teams would have been laughed out of the board room or caved in due to pressure. It would have taken a great management team paired with a great board to comprehend the risk & make this extremely disciplined decision.

In order to optimize both short-term and long-term value, the best strategy is to monitor diversification and then either purchase non-correlative assets such as C&I, agriculture or consumer or branch to acquire assets in a non-correlative geographical area (one that is driven not by speculation, but by core growth such as energy development, technology, etc.). In some areas, this may be 100+ miles away. Through this manner, a bank would gain enough geographical diversification to be able to add assets in both the new (slower growth, non-correlative market) and the bank's home market. The strategy would have to be further refined that the bank would have to target low margin loans, that are in the lowest 10% of risk (having a risk-adjusted loan pricing model would have helped). In order to compete on sub-3% margins, the bank would also have to organize their bank for efficiency with a low cost operating structure.

Of course the other strategy is to get into a hot market, inflate the balance sheet and then sell before a downturn. While that might be a great short term strategy, we will say that when the music stops things can get ugly quick. It doesn't take a great banker to pull that one off Ã¢Â€" just a lucky one.

BANK NEWS

Private Investment

The FDIC will meet next Monday with PE firms on guidelines for bank investment. A similar meeting was held last August just prior to the setting of stricter rules.

MBS

Bernanke expects FNMA and FHLMC MBS to continue to receive Gov't backing until expiration or repurchase, while advising Congress to form a new system for funding mortgages.

Community Banks

In response to the most recent senate bill, Bernanke urged for continued oversight of all banks including those under $50B in assets, noting the regulatory authority as a necessity for a stable financial system.

Money Laundering

Wachovia, now owned by Wells Fargo, will hand over $160mm to settle federal charges for inadequate anti-laundering programs which may have allowed the transfer of illegal drug money to and from Mexico.

M&A Off

Failing regulatory approval, Metro Bancorp Inc. ($2.1B, PA) and Republic First Bancorp Inc. ($1.0B, PA) have called off merger plans.

Less Loans

According to SNL Financial, loans and LOCs to board members and other insiders dropped nearly 33% last year to $5.48B at 10 of the nation's largest banks.