THE NATURE OF DIVERSIFICATION

by Steve Brown

The other day a Boston banker called us to tell us that we were foolish in our Laker pick for the NBA Championship. To make matters worse, he also added that we had our thoughts on diversification all wrong. "It's for suckers," he said. He had our attention.

"Diversification is the admission to your Board that you don't know how to extract value in lending. If you really know your market, then there is nothing wrong with being focused. I will take commercial real estate that I know rather than diversify away into consumer credit."

This banker had a good point - you wouldn't trade Kobe Byrant from the Lakers because he scores too many points or get rid of Ray Allen from the Celtics because he scores most of his points from behind the 3-point line. Of course you wouldn't. The reason is that you know Kobe and Ray are proven scorers. Unfortunately, we can't say the same for bank underwriting. We highlight this argument, as it goes to the core of banking. Understanding when to diversify will help set bank strategy.

Just like our basketball all-stars, we would agree with the non- diversification theory if a bank can point to its track record and give us quantification of a competitive lending advantage. We would expect to find that a bank with superior lending produces higher returns in both good times and bad. If true, then we would agree that diversification would serve to INCREASE risk and lower return. The simple fact is that probably less than 15% of all banks can make this argument and have the facts bear them out.

Unless a bank can articulate and prove their lending prowess, we continue to believe diversification is critical. In a twist to our Boston banker's comments, we say diversification is the admission that it is difficult to extract ongoing lending value. In addition to liking the Lakers, another difference with our Boston friend is that we are OK with the admission that we are not superior lenders. We don't share the same lending-centric view.

Lending, in our view, is just one of the many products of banking. To succeed in banking, we don't have to be an excellent lender, just an efficient one. Because most banks do not possess the necessary skill, experience, process and information to fully exploit a particular lending niche; the goal of banking is more about extracting value from the customer. In fact, we would argue that banking is the creation of long-term shareholder value through providing value added financial service solutions to profitable customers. This is a customer-centric view.

To score in this area, banks need to provide a variety of profitable products and services - loans, deposits, cash management, insurance, asset management and consulting. Of those, since loans create the greatest amount of credit risk, then diversification should be employed as a strategic way to manage that risk. While doing so will reduce margins, if done properly, it will also help stabilize earnings over the long-term. This leaves the bank to derive its above average returns from the relationship with the customer, which is a whole lot less risky.

To the extent a bank cannot generate enough diversification on their own, they should explore other options. Extending liability duration or funding C&I loans are a few ways to diversify. In this manner, banks can insulate their lending or deposit/interest rate risk and focus more on customer management.

On a risk-adjusted basis, we have argued for years that lending is usually not the most profitable product a bank has, so why exploit it? We think it is more important to diversify in areas where you don't have a sustainable competitive advantage and focus more on managing the quantity and quality of the customer relationship. The customer is your all-star and deserves the bulk of the bank's resources. Placing emphasis here will give you Kobe-like performance and ensure another win.

BANK NEWS

FDIC Deposit Guidance

The FDIC issued guidance on deposit placement and collection activities, outlining steps banks should take to ensure all marketing materials, statements and disclosures given to customers are accurate with respect to insurance coverage and reflect the terms and conditions of the arrangement between the customer and the bank (as well as with the banks that receive customer funds).

Assisted Acquisition Guidance

Regulators issued new guidance to address supervisory considerations related to bargain purchase gains and the effect such gains have on the acquisition approval process. The guidance highlights accounting and reporting requirements as a result of business combinations of failed institutions and indicates approval of an acquisition may be conditioned on the acquiring institution's commitment to maintain specified levels of capital to address the risk of significant retrospective adjustments to the bargain purchase gain or other risks.

Uniformity

FNMA & FHLMC have announced a new initiative to standardize and improve the consistency and quality of data for appraisals and other loan information. The goal is to enhance the depth of collateral, borrower and loan data submitted to them; by creating uniform data standards and collection processes.