SHRINKING THE BANKING SECTOR

by Steve Brown

An article from Wharton entitled, The Shrinking U.S. Banking Sector: On Balance, Who Benefits? came out this week. It argued that the long-awaited consolidation is starting in banking and it is really no big deal, since the US can survive with fewer banks. The article broke little new ground, so it is not worth going into detail, but we do want to comment on a couple of items that we hear from bankers and analysts as we travel around and tie it back.

One point of the article is that the US is "over banked." We often hear this and while it very well might be true, we can tell you that no one really knows. We have struggled to figure out what an "equilibrium" price should be for both loans and deposits and it is an impossible endeavor. While there are irrational players in banking as with all industries, the average price of both loans and deposits appears mostly rational and largely in-line with risk. Banks, unlike Starbucks or other purveyors/manufacturers of tangible goods, can supply an infinite amount of product to the market. As such if we only had 4 banks competing for loans, you could still see irrational pricing that might indicate we are overbanked. We wonder if Canada with its 22 financial institutions is under banked. In the US, few banks have ever failed because there were not enough customers. Banks fail when they run out of liquidity or have credit issues. In fact, it was just a couple of years ago that 100% loan-to-deposit banks were common - not a sign that indicates there are too many banks.

Another article point (and a favorite of investment bankers) is that banking regulation will drive many small banks to merge as they cannot survive. We are no fans of more regulation and any time you start making decisions that run counter to market forces, you are going to get some irrationality. However, it remains to be seen what the true cost of regulation is. Like all edicts, some will be good and some bad. Every day we hear that a $300mm bank can't survive and must merge to stay competitive, but that may be a fallacy. For starters, while the cost of banking has increased with Dodd-Frank, so far it is not prohibitive. Like SOX, DFA may require a bank to add another full time person, but at the end of the day, the change in the cost of regulation will not be material to drive a bank out of business. The biggest killer is the tighter controls on leverage. Forcing banks to only use core deposits, carry higher capital ratios, and maintain greater liquidity has a far larger impact on earnings than any compliance mandates.

Interestingly, it can be argued that lower leverage could result in more stable income and if done right, over the long-term, may actually result in higher risk-adjusted earnings. Further, even if average leverage is brought down from 8:1 to 6:1, it is still better than you can get in almost every other industry available for capital - even better than hedge funds.

Finally, current regulations are driving up costs for large banks (over $10B) much more than for community banks. If anything, the current regulatory trend makes community banking a more efficient vehicle to attract capital. As such, we predict a $300mm community bank will be able to survive just fine going forward. Above $300mm in assets, size has little bearing on earnings over any long-term period of time. The quality of management, geography and loan allocation are must larger drivers.

There is little doubt that the industry will continue to change, but we believe it will change for the better, be less loan dependent and more service driven. While we will be talking more about this at our upcoming EMC Conference in the next couple of weeks, we politely ask all those that won't be attending to please take a few minutes to complete our survey on the topic, so we can register your opinion. In exchange for your time, we will not only give you the survey results, but will send you our presentation (after the conference), on the Top 10 Profitable Products and Services That You Must Consider For 2012. To take the survey, please follow the link in our "Related Links" section on the bottom right of this page.

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Top Ten for 2012 Survey

BANK NEWS

Servicing

The FHFA has instructed FNMA and FHLMC to establish uniform servicing requirements for delinquent mortgages. As part of the process, GSEs are to adjust servicing fees based on performance.

Better Servicing

Bank regulators have ordered the 14 largest home loan servicers to submit plans to clean up operations by mid June and then get it done within 60 days thereafter. Under the rule, banks will have to provide a single point of contact for borrowers that become delinquent; set "appropriate deadlines" for deciding loan workouts; and have enough staff.

Reg Q

The end to restrictions on paying interest on demand deposits in the 3Q is expected to drive up the cost of funding in this area only slightly be our calculations (less than a 4% increase), as banks become more competitive as they seek to retain existing and attract new business customers.