The Efficiency Of The Ratio

by Steve Brown

We have previously analyzed and discussed large bank year-end earnings and today we examine some of the interesting trends that surfaced during our analysis. In general, at first glance earnings looked pretty good for the largest banks. At the core, however, we found that these huge banks are having trouble generating earnings in traditional banking lines of business just like community banks.

One interesting trend to review is a significant increase in the efficiency ratio at these large banks. As a quick history lesson, we note efficiency ratios for banks under $1B were around 72% in 2009 and are now 71% - not much change. Meanwhile, banks over $25B have seen efficiency ratios increase during this same period from an average of 52% to 59%. Certainly the biggest banks have room to get worse vs. community banks given such low levels to begin with, but the trend is not good for them over the longer term to be sure.

In addition to all of that, community bankers also know that the biggest banks are completely different animals. These behemoths have far greater resources to generate non-interest income and they also operate in loan sectors given their size where many community bankers can only dabble. However, if we consider that a bank's efficiency ratio is a decent measure of its ability to turn resources into revenue regardless of origin, it would seem to indicate that the largest banks are using their recourses less efficiently. It is interesting indeed that this big bank advantage is lessening over time.

To go deeper, let's step back and define what is included and excluded in a typical calculation of the efficiency ratio:

o Non-interest Expense / Net Interest Income + Non-interest Income

Typically excluded from the calculation are loan loss reserves and gain/loss on the sale of securities. As a result, many banks use the efficiency ratio to measure whether expenses are under control, particularly in comparison to peers. Many banks also tend to focus on the numerator (non-interest expense) when thinking of efficiency to try and find ways to reduce it (expense cuts). Possibilities here in order usually include people, branches, spending less on office supplies and perhaps even turning off the heat in winter. Improvements can always be found on the expense side, but most banks at this point of the cycle have already made the easy cuts.

As a result, shifting efforts toward increasing the denominator may be a more successful tactic at this point. We heard that collective groan from our readers and know it is because so many bankers are already struggling to generate earnings. There are other paths though and it is important to remember the denominator is made up of net interest income and non-interest income. Non-interest income in the industry is declining (mostly as deposit charges disappear and mortgage refinancing slows), so we focus on the "net" part of interest income.

When we think about net interest income, we look at assets and liabilities that fund those assets. Certainly it is not news that asset yields have been declining, so a focus on reducing funding costs is one area that can still deliver results. It takes hard work over a longer period of time, but opportunity remains.

Let's look at a couple of examples of how a bank might improve its efficiency ratio. Bank A offers a CD special at an above market interest rate in order to try to bring in new customers and cross-sell loans. There is no infrastructure required and existing staff is happy to tell customers and prospects about the great new rate. This is neutral to the numerator of the efficiency ratio because there is no expense involved. However, this tactic is not neutral to the denominator, as net interest income declines.

Bank B puts top priority on controlling funding costs and knows peer comparisons only show what average is. They also understand that what is right for one bank may not be right for another. Bank B emphasizes client relationships and community outreach. Here, there is some expense involved, but the bank ends up with a less interest rate sensitive customer base and a bigger denominator.

Every bank has to design a path to lower funding costs with all its components taken into account to be successful. If you want help in efficiently finding that path, contact us or check out our website to learn more about PCBB's Liability Consulting service.

BANK NEWS

M&A

Citizens Business Bank ($6.6B, CA) will acquire American Security Bank ($426mm, CA) for $57mm in cash or about 1.33x tangible book value.

CU Closed

Regulators closed St. Francis Campus Employees Credit Union ($51mm, MN) and sold it to Central Minnesota Credit Union ($759mm, MN).

Consolidation

First Financial Holdings ($8.0B, SC) said it will consolidate its five banking divisions under the single name of South Sate Bank and change the holding company name to South State Corp. The banking divisions are First Federal Bank, Community Bank & Trust, The Savannah Bank, North Carolina Bank and Trust and South Carolina Bank and Trust.

Biz Competition

A report by Aite Group finds 32% of the largest 50 banks now offer a corporate mobile banking app and 56% more plan to launch one by the end of this year.

Relationships

Fed research finds borrowers with strong bank relationships "are associated with better credit availability" and "typically also find lower loan interest rates when relationships are stronger," so be sure to tell your clients it really is important to establish long-term relationships with your community bank.