Profitability Inspection

by Steve Brown

Many home inspections are relatively routine undertakings, but there are others that unmask really bad problems reminiscent of the 1980s movie The Money Pit. Some real-life examples from home inspectors include a shed built to support a multi-level staircase, electrical disconnect boxes located directly under a working faucet, and a breaker box right above the bathtub. These examples lend credence to the term buyer beware. Certainly it's in a buyer's best interest to make sure he or she isn't quite literally throwing money down the drain.

Banks should also inspect themselves on a routine basis to make sure various parts are in order. To help in this effort, we'd like to share with you some interesting nuggets we gleaned from an analysis of a select group of client banks on our relationship profitability system. The banks have assets ranging from $400mm to $3B. All of them have a commercial focus, an established branch footprint and an efficiency ratio range of 55% to 70%.

For starters, our analysis showed that on a fully-loaded basis, roughly 35% of the group's operating expenses were attributed to the lending side of business. A recurring theme in all the banks we studied was the 80% / 20% rule. This is to say that 80% of profits were derived from 20% of relationship officers. In almost every bank, a small group of officers' (1 - 3) portfolios comprised over 40% of the bank's loan portfolio. These individual officer portfolio sizes were above $70mm.

This trend is troubling to us because despite the profitability of these large portfolios, there's a large risk to the bank should any of the loan officers decide to leave. If your bank has a similarly large concentration, it's worth a closer look to see if there are ways to mitigate risks.

Our research also found a significant number of relationship officers with portfolios of less than $2mm. Assuming a low level of corresponding deposit balances, officers with portfolios of less than $10mm were generally not profitable for the bank. While some of these loan officers are junior and in training, those that have been around awhile may need training or additional steps to get them to profitability. Further, after adjusting for the unusually small and large portfolios, the average officer portfolio size was around $20mm. It is important to think seriously about price points and the economics of continuing to pursue small, unprofitable relationships.

Our research also found that on a fully-loaded basis, 64% of operating expenses were attributed to funding. On a per account basis the annual cost was about $265. While these costs were lower than just a few years ago, there's still room to improve.

Branch consolidation may be one way to significantly trim expenses for the bank. In fact, Bain & Co. research notes that as currently configured, the typical US bank branch requires at least 5,000 teller transactions per month to justify the cost of operation. Bain estimates that 33% of the typical regional bank's branches underperform this benchmark.

More broadly according to Bain, if the 20 banks with the most branches whittled down their footprint and cut costs per branch by 30%, their total cost savings could more than surpass $10B. Although these statistics reference larger banks, it certainly behooves community banks to take a closer look at branch operations to see if there's room to improve.

Just as we expect home inspectors to perform careful analysis on our homes, banks also should conduct a thorough investigation of lending and cost management practices. Routine relationship and operational maintenance helps make sure the structural underpinnings remain in good working order.

BANK NEWS

Exam Focus

Regulators are warning bankers to expect closer reviews by examination teams on areas of cyber risk. Banks should have controls thoroughly documented and tested, along with strong risk management practices.

M&A Activity

1) Family Security Credit Union ($577mm, AL) will acquire Bank of Pine Hill ($25mm, AL) for an unnamed sum.

Video Banking

Wells Fargo is reporting its pilot program that lets customers talk to bankers on video using their laptop, phone or computer has really been popular. Customers can just click a button online from 9am to 9pm and instantly connect. Wells plans to continue to roll out the service through 2017 to various units.

Tech Hiring

Banks seeking technology talent should know employees of tech firms are now pushing their employers to give them both cash and equity as valuations tank. This could provide hiring opportunity for banks.

Big Change

A change in the way mutual funds can offer money markets (change in the $1 fixed NAV price) that launches in October is projected to have a big impact on the industry. For example, iMoneyNet projects the number of money market mutual funds will probably decline by 50% as a result of the change.

Stronger Employees

Research by Deloitte and MIT on digital disruption finds the primary ways organizations are strengthening their digital innovation capabilities are: developing existing employees' digital capabilities (25%), contractors and consultants (17%), external relationships or partnerships (16%), recruiting employees with digital talent (14%) and recruiting leaders with digital talent (8%).