Necessity is the Mother of Invention

By

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The banking industry's previously fundamental role in financial intermediation continues to decline. On both sides of the balance sheet, the traditional banking franchise has lost ground to other financial intermediaries, as nonbanking institutions capture traditional banking business with nonbank products. On the deposit (liability) side are all kinds of investment and savings alternatives. On the lending (asset) side are nonbanks, countless credit or lending products, the commoditization of products, securitization of loan portfolios, and the secondary market

Among the six major financial intermediaries (including private pension funds and state government retirement plans, commercial banks' 1998 share of total U.S. financial assets has decreased to less than one-fourth of the total. Thrifts' share fell to just under 5 percent. At the same time, mutual funds' share of total financial assets exceeded those of commercial banks. Among the six holders of U.S. financial assets, assets of property-casualty and life insurance companies, plus separate account reserves, accounted for about 19 percent.

At the end of 1990, mutual funds had one-third the amount of commercial bank assets and ranked fifth in assets among major financial intermediaries. Since then, mutual fund assets have grown at annual rates in excess of 20 percent, as compared with less than 6 percent growth by commercial banks and a little more than 7 percent growth for life insurance companies. In 1998, for the first time, mutual fund assets actually exceeded commercial bank assets.

Community banks must increase their fee-based activities, such as sales of annuities, insurance, and mutual funds, and expand their activities in asset management and related investment and risk management services.

Fee income is a necessity

With banking's asset, revenue and earning's growth rates slower than those of other sectors of the financial services industry, it is no wonder that the OCC recently warned, "the outlook [for bank profits] may be even worse for smaller banks." Many community banks are facing tough competition from nonbank and large bank competitors that offer both banking and nonbanking products. Their earnings and asset-quality are more susceptible to downturns when interest rates move higher or net interest margins decline, as they have the last eight years. Community banks' product offerings are typically narrower and less diversified. Indeed, a study issued at the end of last year showed that banks under $10 billion in assets are the least profitable segment of the industry on a profit-per-client basis. "In addition to their fixed-cost problem [of making fixed costs pay off over a smaller customer base]," said the American Banker, "the smallest banks' relationships are less profitable because they tend to provide only one service to each customer." Community banks suffer these slings and arrows of the marketplace right where it hurts - in squeezed profit margins, lower returns on equity, and lower stock prices or valuations.

While return on equity for all commercial banks was 15.34 percent for 1999 (up from 13.93 percent the year before), the 1999 ROE for community banks with less than $100 million of assets has fallen for seven years to 9.07 percent. Only 57.22 percent of the smallest had earnings gains, and 10.52 percent (or 543 banks) were unprofitable. ROE for banks between $100 million and $1 billion in assets was 14.24 percent. While only 2.4 percent of those were unprofitable, still only 71.4 percent showed earnings gains in 1999.

Community banks must increase their fee-based activities, such as sales of annuities, insurance and mutual funds; and they must expand their activities in asset management and related investment and risk management services. Why noninterest fee income? A critical measurement of banks is Return on Assets (ROA). With fee income, a bank can increase its "ROA" without measurably increasing its "A." Fee income entails little call on capital. Thus, fee-generating activities produce earnings that do not strain a bank's capital base and financial resources. And because fee-related activities are relatively risk-free, the bank need not increase credit risks to generate revenue and profits.

True, commercial banks have increased their noninterest income as a proportion of operating revenue from about 17 percent in 1960 to 44.1 percent in 1999, according to the FDIC's Quarterly Banking Profile. Despite this overall improvement, however, banks under $100 million in assets have lagged significantly in this department (as they have in other critical measurements) at 24.7 percent in 1999, down from 26.6 percent in 1998. FDIC financial reports for 1999 show that community banks between $100 and $300 million in assets have done somewhat better at 29.9 percent in 1999. Banks between $300 and $500 million in assets showed fee income constituting 34.6 percent of net operating revenue. Commercial banks between $500 million and $1 billion in assets achieved a ratio of fee income to net operating revenue of an even lower 31.1 percent.

Clearly, community banks must do more to grow their fee-based income. They need to be far more sales-oriented to achieve strong revenue and earnings growth, gain profitable market share and retain their customers. For too long, the emphasis has been on cost cutting, brought on by the "re-engineering" movement's efficiency-techniques, a tactic that posed as a strategy. But the universe of rising revenues and falling expenses is mathematically limited. Real growth is all about generating more revenue, and excess cost-cutting efforts disable the ability to do so. Only basic investment in new strategies, which has been lagging, will produce greater profitability. And, strategic planning is what ties everything together.

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Invention is required

As Fed Chairman Alan Greenspan said at the 70th Annual Convention of the Independent Community Bankers of America (ICBA) in San Antonio in March, banks have "to think more strategically today, and to carefully weigh the pros and cons of [new activities and affiliations] - including whether and how the economics make sense. Deciding how to translate the traditional and new financial powers into longer-term economic value for your customers and shareholders will be the leading challenge as we enter the twenty-first century. [Bankers must] take the time to understand sound practices and build the infrastructure necessary to succeed."

Only the day before Ellen Seidman, Director of the OTS, had said, "Effective strategic planning is absolutely critical to the future success and survival of your institutions. Identifying what you do best through the planning process, finding your niche in the local community and deploying capital effectively to these areas to provide superior customer service will give you a fighting chance against the big boys. Too many times we see the strategic planning process as a one- or two-hour meeting to set goals for the year. In today's financial services environment, that just doesn't cut it. You need to fully analyze and understand the risks involved and put in policies, competent managers and back office systems suitable for the activity. You should establish limits in line with the risk of the activity and the risk profile of your institution; monitor actual performance so you know what's going on; have sufficient capital to account for the greater risk; and you absolutely must have the active participation of a fully informed board of directors."

The message? One can't get something for nothing. One must invest to get a return. Lack of top-line growth, or investment therein, will continue alienating investors and cause P-E multiples to decline. If banks are to attain necessary levels of revenue and earnings growth, strategic planning and strategic investment in new fee-income opportunities like insurance are more critical than ever.

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