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Small-Bank Options: Sell Out, Fold Or Change

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Consolidation is a fact of life in banking, so it's easy to shrug off dire predictions that the next wave of mergers will swamp the community banking sector.

But the case is becoming ever more convincing. There are plenty of reasons, but one in particular is receiving less attention than it deserves: Bank operating revenue has been declining for more than a decade.

"It's an untold story. The industry's dirty little secret," said Anita Newcomb, a consultant in Columbia, Md. "The operating revenue trends are disturbing. The question is why, as an industry, are we not talking about this?"

Operating revenue often takes a backseat to banker concerns about the increasing cost of compliance or new restrictions on fee income. But at least one policymaker put the issue front and center recently.

"We're at a tipping point. There is a limit to how far reductions in loan-loss provisions can boost industry earnings," FDIC Chairman Sheila Bair said when she unveiled the industry's first-quarter results. "At some point, if banks are to continue to increase their profitability, they will have to grow their revenues."

The trend is hitting hardest the roughly 7,000 banks with less than $1 billion in assets. As a percentage of average assets, operating revenue at these banks has fallen to 4.45% at the end of 2010 from just under 6% in 1999. (See chart; the recent uptick among the largest banks is due to trading gains.) There are myriad measures of industry health and some of them, including credit quality, are improving. But nothing is more basic than operating revenue. It's net interest income plus noninterest income; so it shows how much banks are making on loans, products and services before deducting noninterest expenses and loan-loss provisions.

"This is all about your core business model," said Newcomb, who has worked with community banks for 25 years. "To me, it is the most important indicator of how well a company is doing."

The vise squeezing banking is obvious: Fee income is getting killed at the same time that weak loan demand and low rates are crushing interest income.

At banks with assets of $100 million to $1 billion, net interest income as a percentage of average assets has been falling since 1995, when it was 4.3%. It dipped below 3% in 2009 and, thanks to low interest rates, ticked back up to 3.5% by the end of 2010. But the trend is undeniably ugly.

Noninterest income isn't any prettier. It has been falling since 1999, when it hit 1.68%, and settled at 0.9% in 2010.

A crunch like this is never easy, but it's coming at an especially tough time for community banks. Compliance costs are climbing and regulators are demanding ever higher capital levels.

When interest rates rise, operating revenue will be under even more pressure as banks are forced to pay more for deposits. It's not hard to imagine investors fleeing and weak institutions either failing or selling.

The problems stretch beyond banking. The economy is growing slowly, the housing market is stuck, unemployment is high and, government deficits are widening. To top all that off, the banking industry's image may be at an all-time low.

Throw all that together, and the anecdotes you hear about bankers just wanting to chuck it all sound persuasive.

"I've had several CEOs tell me that if they could see they would get 5% on their money, let's say on CDs, they would get out of the banking business," said Frank Keating the president of the **American Bankers Association**. "It's just not worth it. The headaches, the angst, the regulatory burden. They are getting squeezed."

The squeeze isn't exactly news either.

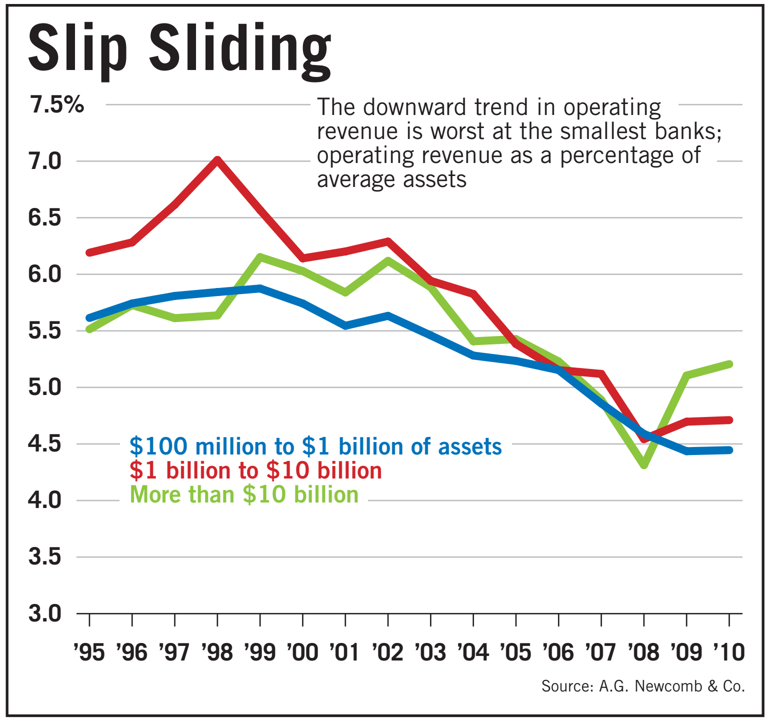
In 1990, banks with less than $100 million in assets made up 70% of the industry by number and held 9.1% of its assets. By 2000, these banks accounted for 55% of the industry by number and held just 3.5% of its assets. By 2010, it was down to 34% of the industry and just over 1% of its assets.

The picture isn't much brighter for the next tier. The number of banks with $100 million to $1 billion in assets did grow over the past 20 years, accounting for 57% of the industry at yearend 2010. But its share of industry assets was whittled to 9.7% in 2010 from 22% in 1990.

The number of banks in the $1 billion-to-$10 billion range hasn't changed much over the last two decades, but their share of the assets has dwindled, to 11% in 2010 from 36% in 1990.

Of course the industry is now dominated by banks with more than $10 billion in assets. By number they make up just 2% of the industry, or 107 companies, but they control 78% of the assets, up from just 33% in 1990.

These trends are expected to continue, and even accelerate, by 2020. The largest banks will own more of the assets and the sub-$100 million crowd will continue to shrivel.



"The majority of bankers have not moved to thinking about what they have to do to survive. They are still in a boxer's crouch," said Charles B. Wendel, the president of Financial Institutions Consulting in New York.

The trend in operating revenue "is a huge problem," Wendel said. "That operating revenue number will continue to decline and decline until the bank becomes irrelevant or simply sells."

Goosing revenue may not be easy, but the formula is no mystery either: Banks have to sell more to more people. They have to figure out which customers, products, business lines, employees and branches make money and focus capital, training, technology and pay in those areas.

None of this should be news to bankers.

Wendel recently dug up a report that his former firm wrote for clients 20 years ago. It was titled "The Art of Banking in a Period of Declining Revenues."

"Virtually everything in that report is fundamental, but most banks don't do very well on the fundamentals," Wendel said. "Management doesn't have the experience, the self-confidence or the courage to commit to taking the necessary steps."

Why is that?

"There are always objections [to change], and they [senior management] buckle," Wendel said. "I know that sounds inane, but they do. They just buckle. They just don't want to fight against the internal politics, the internal pressures."

In a good economy, banks can muddle through. Those days are gone. "The rising tide isn't there anymore," Wendel said. "If bankers think they don't need to take steps to change, they are dead ducks."

Newcomb agrees.

"Too few banks have a real focus on monetizing customers," she said. "That means having the products and services in place, and then having your people trained to sell those services. We are still suffering under an old model where the commercial lenders focus on loans. That model just doesn't work anymore."

Newcomb is predicting "consolidation like we have never seen." By 2020 she expects the industry to total 4,900 institutions — or fewer than half as many as today.

Wendel expects even more dramatic consolidation to leave just 3,000 institutions in operation nine years hence.

Maybe a banking industry half the size of today's is big enough. Maybe not.

But lawmakers and regulators ought to be giving that question some thought before it's too late. And for any CEO who wants his bank to be among the survivors, the time to focus on fundamentals is now.

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