

WHAT DOES 'SURVIVAL' REALLY MEAN?

Fourth in a series: Contraction is inevitable. How do we maximize the winners?

* * *

The daily news cycles of the last week produced two insightful glimpses into what small to medium sized commercial banks will need to survive.

The first was Jamie Dimon's testimony to the Senate Banking Committee. His comment on the size of his bank's estimated compliance costs in the wake of Dodd-Frank was an important benchmark.

The second was an article in The Wall Street Journal on the flurry of merger activity among small banking institutions.

What happens when you can't be shocked anymore

J. P. Morgan's CEO estimates the annual bill for compliance related to Dodd-Frank at about a billion dollars. The sheer size of that number was stunning, although it generated a stony silence from the Senators, perhaps because they (and we) are all inured to the magnitude of the numbers of business today.

After all, if a \$2 billion trading loss is viewed as barely material to the financial results of Mr. Dimon's bank, why should compliance costs of half that amount seem unusual?

I remember how the executive management at First Security Corporation used to remind managers how much revenue it took to increase earnings per share by a penny. The number was enormous in relative terms and demonstrated just how difficult that task was to accomplish.

That's why I thought that a teachable moment was lost in front of the Senate Banking Committee. Political leaders need to understand how they are tilting the playing field--both as to the direction and the degree of the slope.

Changing numbers bode permanent shift

The Journal's story about the increase in merger-related discussions among very small banks was instructive for very similar reasons. It's become increasingly more difficult for banks, especially smaller ones, to figure out how they are going to be able to achieve satisfactory--or should we say adequate--returns on stockholder equity in the years to come.

It's not simply a matter of waiting until loan demand revives to pre-recession levels.

No. The structure of the industry is changing and that change is permanent. Compliance activities cost money--real money--as do all labor intensive activities in our industry.

How to move the needle again

Survival planning for independent banks today needs to take two tracks.

The first and obvious one is to ask what can an individual institution do to maximize the probability of its own long-term survival.

The list should include:

- • Inventorying the existing human skill sets.

- • Thinking about the nature and scope of both the current and future product suites.

- • Examining with a cold and calculating eye the company's ability to earn a return on equity consistently in the upper quartile of peer bank performance.

I say upper quartile to give some specificity to performance measurement. "Superior" or "outstanding" are terms more suitable to marketing executives than to the strategic planners who are attempting to see forward around the curve of the earth in a very difficult business environment.

We need to be specific as well as realistic in our goal setting.

The other line of analysis should include the ability to preserve the company's business base, maintain shareholder value, and provide some kind of safety net for bank employees.

This line of reasoning does not maintain as a categorical imperative that the bank remain independent. I think that's the important insight to the Journal article. Maybe a strategic merger, one undertaken to maximize reasonable outcomes for the bank's principal constituencies, is the most sensible long-term solution among competing alternatives.

I remember when Boatmen's Bank decided to be acquired by Nation's Bank sometime in the mid-1990s. Boatmen's management candidly explained that its strategic planning process had shown that the company likely did not have sufficient capacity to adequately fund the development of technology platforms to maintain the bank's competitive posture while achieving appropriate returns for its stockholders.

Better for the shareholders and its banking public to recognize this early on and maximize value by timely, rather than belated action, management reasoned. This was an extraordinary conclusion--and admission. Boatmen's was a huge banking company of its day and ranked in the top ten or so of companies by total assets.

Let's not forget our foundation: The customer

Bank customers, especially borrowers, can experience significant negative consequences resulting from mergers and consolidations. Perhaps the surviving entity has a different product line or a very different delivery model that will profoundly alter the relationship between the bank and the borrower.

In this day of banking giants and very specifically defined product lines not to mention lending philosophies, perhaps some customers will be shut out or have a more restricted access to credit. Cumulatively this can have a huge impact on a local community's access to credit if or rather, when a locally owned and managed bank passes from the scene.

This is not a casual concern today. Smaller banks, those generally under half a billion dollars in total footings, will be impacted profoundly in any consolidation with a regional institution. It's inevitable that there will be major changes felt by the staff and the customers--but perhaps it's not inevitable that there will necessarily be losers. Perhaps there are some business models that will preserve what is good and valuable in how community banks underwrite credit and are "present" to their borrowing customers.

Avoiding engulfment

Our industry is facing another wave of contractions. Scale is critical in dealing with increasing fixed costs associated with compliance and marshaling the necessary assets to successfully mount and sustain a long term strategy.

Developing some alternatives to a "Pac man" outcome by a community bank will take some imagination, not to mention a degree of candor among the management group and principal shareholders.

An "all or nothing" approach to a satisfactory outcome is risky, and some tradeoffs are probably necessary and appropriate to figure out what makes the most sense and then ultimately to get a deal done.

It's time for community banks to honestly consider what is best for each of their various constituencies. There aren't going to be many perfect outcomes but a well-conceived plan is probably the most important step in assuring a decent result.

Unfortunately, there will losers as well as winners, but the winners can outnumber the losers with a little proactive effort up front. It's going to happen either with us or without us so let's control the outcome as best we can for our mutual benefit and the good of the customers and the communities we serve.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days

of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

You can get word about these columns the week they are posted by subscribing to ABA Banking Journal Editors Report e-letter. It's free and takes only a minute to sign up for. [Click here.](#)