DON'T LET ROE ANXIETY WRECK YOUR BUSINESS MODEL

Bankers have to find a middle way

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When I was being interviewed as the next CEO of First National Bank in Albuquerque several years ago, the matriarch of the ownership family told me something that I'll never forget.

The bank had been through a trying couple of years and due primarily to provisions to the loan loss reserve, it hadn't been profitable in a few quarters.

"I just want to be proud of the bank--like we used to be," she said, in a plaintive tone.

The family didn't completely depend on the dividend, which had been suspended the year before. But it was important to them and to the other shareholders. But it wasn't everything. The ultimate and more painful reality was that the bank had ceased to be a source of personal pride to the owners and directors as they dealt with the economic realities within the bank and within the Albuquerque business community. And they were willing to sacrifice some return to set things right.

ROE comes to the fore

This remembrance came to mind when I was thinking recently of a presentation I made earlier this year.

I was talking to a group of mid-career bankers at a multi-year banking school sponsored by a state banker association. Listeners came from diverse backgrounds, but all had seen several years of service in community banks, ranging in size from rural institutions of $50 million to relatively large metropolitan banks.

As I was drawn into conversations both during class discussions and outside of them, I was struck by the persistence of the idea among many participants that maximizing shareholder return seemed to trump all else.

What I seemed to be hearing was that it is simply enough to make as much money for the shareholders as possible without particular regard to the other constituents of a community bank.

Is this really what we want to be?

Time to rebalance our perspective?

I don't think that most of those representing these views were "absolutists" about their position. What struck me, though, was how remarkably un-nuanced such a view seems today, as the community banking segment of the industry struggles with issues of profitability, competition, and obsolescent business models in the face of technology and regulation.

One of the distinguishing characteristics of a community bank business model, as I grew up understanding it, was the commitment of most bank ownerships to their local communities and customers.

- • Community bank directors wanted enough capital so that capital adequacy wasn't an issue to customers.

- • They wanted excellent customer service and were willing to accept a lower ROE to provide it.

- • They valued the long-term service of their employees and the business continuity that resulted.

- • Returns were important . . . but they weren't everything. And they didn't completely dominate the thinking and the ultimate business motivations of the board of directors.

Return on shareholders' equity is a big part of the national conversation on banks and banking over the last couple of years. Bankers such as J. P. Morgan Chase's James Dimon have argued that anything that inhibits the ability of banks to earn appropriate returns on equity will cause capital to flow into other industries and can create competitive disadvantages to some of the largest domestic banks that compete internationally for business. It's a compelling argument.

Another compelling argument is that of the independent bankers who see an increased likelihood that their locally owned and operated banks are unlikely to be able to compete effectively. Their ability to earn an appropriate return on equity is threatened by the crushing costs of regulation and compliance.

Different causative factors exist at each end of the size spectrum--but the problem with its common expression of return on equity is persistent.

I am not a proponent of unfettered capitalism and understand how something as fundamental as banking to a modern economic society requires a degree of oversight. What seems lacking at the moment is a comprehensive view of the tensions involved in providing properly for the best long-term interests of banks' principal constituents. When looked at from this point of view, the size difference between J. P. Morgan and First National Bank of Mule Shoe shrinks into a bite-sized piece.

A reminder from the new economy

Not many days ago The Wall Street Journal carried a story about Yahoo's new CEO, Marissa Mayer, and how she's proceeding in her makeover of the internet company.

Her message to Yahoo's employees is simple: Product comes first.

Ms. Mayer ordered that Yahoo's stock ticker be taken down from the company's internal website. She meant this as a clear signal to the employees to think first of product and not of finance.

It's a simple gesture, but probably not one that most of the bankers I talked to early this summer would particularly agree with or more likely have even thought to do.

Impact of the urgency of survival--and getting over it

How many of you think of the problems facing our industry in terms of ability to survive?

Certainly many community bankers do. This arises based on a combination of factors: bank failures during the current economic cycle and the frequency of announced mergers and consolidations. The ability to make a profit is at the core of our ultimate ability to survive.

However, we need to think more in terms of what produces the profit--the combination and blend of convenience, technology, product line, service, and business smarts, rather than the end product of net profit.

An almost exclusive focus on profit only leads to shallow thinking and shallow efforts such as saving our way to prosperity or increasing fees on a banking public that has become averse to the levels of bank fees in recent years.

A rejuvenated profitability must come from different ways of doing things and different ways of thinking.

I guess it's always been that way. But with margins protected by generations of bank regulation there was not the urgency 30 years or so ago that exists today.

It's about time that we focused on what we can do rather than what we can no longer do. And as my consultant friend said to me, "Someone needs to tell the bankers that the buffalo aren't coming back."

We need to do new things in new ways and balance the tensions to produce acceptable outcomes for everyone.

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.

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