

How Commercial Lenders Can Succeed in 2007

By Mary Beth Sullivan

Relationship strength and recruiting are among the challenges financial institutions should address now.

The strategies used by banks over the last several years to deliver earnings growth will need to change to reflect the new realities of the 2007 environment. After years of record earnings growth for the banking industry, market and economic forces are combining to create a very challenging operating environment. Net-interest income will be under intense pressure in 2007 as margins continue to compress and loan demand weakens in sectors that provided growth in past years. Credit costs have already risen as loan-loss provisions have been increased; these costs will increase further from the historically low levels of early 2006. Rising funding costs are outpacing increases in asset yields for most banks.

Many banks have begun to tighten their belts to bring expense levels in line with lower expectations for revenue growth. However, positioning for success in 2007 and beyond will require more than efficiency gains. Meeting bottom-line earnings and risk-management challenges in 2007 and beyond will require many banks to change fundamental elements of their business strategies. Specifically, banks will need to take action to restructure certain lending relationships; to adapt their business models to drive growth in new ways; and to improve their sales, client management and project execution processes to maximize both efficiency and effectiveness.

Key Challenges for 2007

Most community banks will be working to address four key challenges in 2007:

1. Dependency on commercial real estate
2. Lack of relationship strength
3. Finding good lenders
4. Acquiring new-to-bank customers

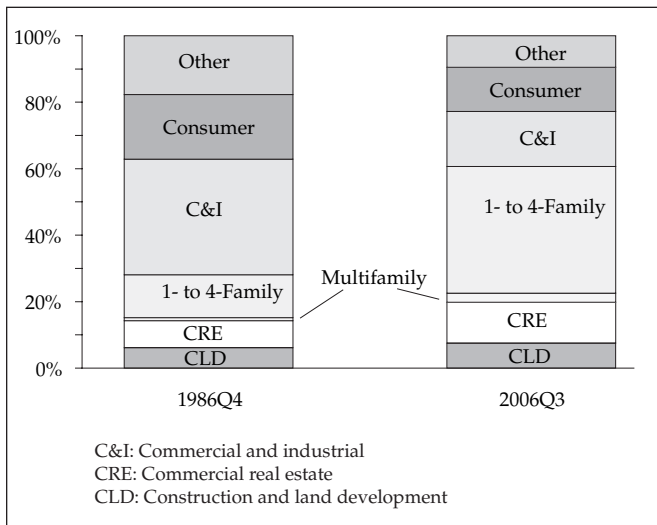
Dependency on Commercial Real Estate

There is no doubt that banks, and community banks in particular, have great advantages in the commercial real estate lending business. These advantages—local market knowledge and commitment, high visibility in their communities and willingness to negotiate flexible terms—have translated into phenomenal growth in loan outstandings in recent years. Between 1986 and 2006, the portion of banks' loan portfolios in commercial real estate increased by more than 50 percent to just over 12 percent overall (Exhibit 1). For banks with assets of less than \$1 billion, commercial real estate loans constituted nearly 28 percent of total loans in the third quarter of 2006. In the new environment of 2007, many banks around the country will need to decrease their reliance on the commercial real estate sector to reduce portfolio concentrations and to build sources of more sustainable and less variable earnings.

The guidance issued in December 2006 related to commercial real estate concentrations (CRE) and risk practices of commercial banks highlights increasing concern among banking regulators about the rapid growth in CRE portfolio outstandings. Many banks have been willing to compromise on structure, pricing and other aspects of lending policy to remain competitive and drive new loan volume. In the Office of the Comptroller of the Currency's (OCC's) 2006 credit underwriting survey, more than 30 percent of

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Exhibit 1. Change in Loan Portfolio Composition at Commercial Banks



banks reported easing their standards for CRE and middle-market loans.

Banks that relaxed their standards did so primarily by reducing prices; increasing advances; and easing guarantor requirements, repayment terms and covenants. These practices led to big problems for many banks in the late 1980s and early 1990s, when rampant real estate speculation, increased competition for commercial loans and the loosening of interstate banking restrictions led banks to increase dramatically their CRE lending activities in new and unfamiliar markets without a corresponding increase in back-office operational investments and improved internal risk-control practices. As a result, more than 1,600 banks failed between 1980 and 1994.

A related and important issue for the long-term health of community banks in the United States is the recent slowdown of CRE and residential construction loan demand in many parts of the country. This poses a serious challenge to banks that have relied on these lending areas to drive the majority of their growth. These banks will need to build new sources of income to diversify their earnings streams and ensure sustainable growth going forward.

Lack of Relationship Strength

Bankers love to talk about the importance of building customer relationships. However, cross-sell rates remain very low for most banks across the country. In

fact, bank customers often do not even think of their bank when needs arise for which their bank can deliver a solution. A large regional bank manager interviewed for this article experienced this reality firsthand when a business client, looking to transition his company to the next generation, called on its accounting firm and not its bank for help, although the bank has experienced wealth management advisors who do this kind of thing for a living. The lack of strong and deep customer relationships that cross product lines puts banks at much higher risk of customer attrition and makes banks even more susceptible to price competition.

Finding Good Lenders

Banks can no longer rely on hiring lenders and their books of business away from the competition; it is simply too expensive to expand staff this way. In the 2006 American Bankers Association (ABA) community bank competitiveness survey, 92 percent of bank participants said it was hard or very hard to fill business lender positions with qualified candidates. Employment services company Manpower Inc. found that 50 percent of establishments in the finance, insurance and real estate sector would have hired more permanent professional staff if they could find more candidates with the right skills. More than 25 percent of companies in the sector indicated that talent shortages were causing them to offer higher compensation for professional positions compared to the prior year.

In addition, many community banks have learned the hard way that lenders recruited from bigger banks are not just expensive to hire. These lenders often have a very hard time adjusting to the community bank model.

Acquiring New-to-Bank Customers

Funding costs are a major concern for most commercial banks today. As a result, commercial DDA balances are more valuable than ever. However, existing customers have moved their funds out of DDAs to take advantage of higher-return investments. As a result, incremental DDA balances will come largely from new customer relationships. Banks must look to the sectors of the marketplace that are growing and tend to hold funds in DDA accounts for extended periods of time. They must build the industry sector expertise to beat the competition at attracting these companies.

New Strategies Required for 2007

Addressing these challenges in 2007 will require banks to alter their strategies from those focused on driving volume to strategies focused on maximizing efficiency and risk-adjusted return for the bank. Four key strategies should be embedded in any sound plan for 2007:

1. Optimize current portfolios
2. Target growth in the services sector
3. Cross-sell additional services to drive profitability
4. Shift from lender mentality to advisor mentality

Optimize Current Portfolios

Improving the risk-adjusted return on existing loan portfolios should be a priority for all banks in 2007. To optimize portfolios, commercial bankers across the country must address specific issues, including concentration levels and other issues that are now being closely scrutinized by the regulators.

First, loans to marginal borrowers (including those in troubled industry sectors), loans approved with significant exceptions to loan policy and loans to borrowers for which any important element of the structure of the loan is not in place (such as those where principal guarantees were not required but should have been) must be either targeted for restructuring, repricing or pruning from the portfolio. There is simply no other way to manage effectively the combined issues of yield compression and deteriorating credit quality.

Second, to improve efficiency, banks must continue to reduce costs to service lower-end commercial accounts. This includes a continued effort to streamline, standardize and centralize elements of the loan approval and renewal processes that do not add value in direct ways to the customer relationship. In addition, bankers must seek to improve their underwriting analytics, placing more emphasis on borrower cash flows and less emphasis on collateral value.

Third, banks that have relied heavily on CRE lending to drive earnings will need to ensure they are classifying appropriately CRE vs. owner-occupied real estate, so as not to overstate CRE loan balances, and make other improvements to loan portfolio information systems. Improved portfolio information

systems will ensure banks can target their repricing and restructuring efforts appropriately.

Target Growth in the Services Sector

As the commercial real estate and residential construction sectors slow, banks that are positioning for longer-term success will look to shift proactively toward a greater emphasis on the sale of products used by the growing business services sector. Capital-intensive industry continues to move overseas. Today, three-quarters of the U.S. workforce can be classified as working in the service sector. This sector is far less reliant on traditional financing; most of these businesses are smaller, generate good cash flow and require little in the way of traditional large-scale financing. These businesses need cash management, merchant services, insurance, short-term trade financing and other nontraditional commercial services.

A good example of an underserved, niche opportunity is the home owner association market. First National Bank of Arizona's Community Association Banc is one of only a handful of banks that target the large, growing and still underserved home owner and community association market. Companies in this market sector represent untapped sources of core deposits and fee revenue for banks, but they have distinct needs that must be met to win their business. More banks will be working in 2007 to identify and target underserved niches within the broader services sector.

Cross-Sell Additional Services to Drive Profitability

Returns on stand-alone lending are under intense pressure and have been for years. Many regional and large banks now recognize that there is virtually no profit in lending to larger corporations. The middle market is beginning to head in this direction as well; it is getting harder to make a profit on stand-alone loans to midtier companies. As margin compression continues and costs for personnel and compliance continue to rise, multiple product sales to business customers will be necessary just to break even on the customer relationship.

Cross-selling bank services in the midtier sector has proved difficult for many banks, and it is more difficult for community banks that lack a large menu of product choices. Some banks, however, are succeeding. Success starts by sensitizing the relationship managers who see themselves as lenders to the importance of deposits and the cross-sell of other services to the profit equation. Wells Fargo's "Gr-8" effort is focused on selling a minimum of eight services to every client. In a December investor presentation, Wells's CEO, Dick Kovacevich, reported the wholesale/commercial side of the bank averaged 5.9 products per customer.

Shift from Lender Mentality to Advisor Mentality

As we've discussed, lending is a great service from which to build a profitable, sustainable customer relationship. Too many community bankers continue to think of themselves as lenders, rather than business advisors who can add value to their clients well beyond the lending transaction and thereby compete on the basis of knowledge, not on the basis of price.

A good place to start when seeking opportunities to provide advice and cross-sell additional services is to use the knowledge gained about a company during the credit approval process. Banks must consider sharing their analysis with their customers and quantifying for those customers the gain to be realized in their operating income by making improvements to reduce inventory costs, to improve accounts receivable conversion rates, to better manage their cash position and the like. They need a shift in mind-set: The customer's information and the analysis of this information should be used to provide value to customers in ways beyond the approval of the credit under review.

Community Trust Bank in Pikeville, Kentucky, has implemented a training program for commercial banking in which new bankers are provided with credit and other training to become a "trusted advisor" in their local markets. Other banks, including Flag Bank in Atlanta (now part of RBC Centura) have begun to hire new commercial bankers from the industry sectors with which they do business, finding it more effective to teach banking skills, for example, to someone with deep knowledge of the property management industry than to hire a trained banker and teach the reverse.

Getting Started

Banks must transition to new ways of doing business to compete effectively in the challenging environment in which they find themselves in 2007. To begin this transition, banks must first focus on optimizing their loan portfolios through improved loan portfolio analytics and tighter practices for underwriting, managing exceptions and the like. All banks, regardless of size, should produce at least five fundamental types of portfolio reports to manage the performance of lending businesses effectively:

1. Portfolio composition
2. Portfolio risk
3. Portfolio profitability
4. Portfolio credit quality
5. Loan officer assessments

More complex lines of business, such as land development and construction and income property lending, present unique risks and require additional, specialized reports to ensure adequate analysis. To be effective, portfolio reports should help the management team anticipate potential issues; provide timely, benchmarked measures of composition, credit quality and profitability; and include analysis and recommendations, rather than just pure data.

Second, banks must innovate to provide customer value. Innovation should center on opportunities to improve the cross-sale of additional services to existing commercial clients. During the planning and budgeting process, many ideas related to potential new products and programs are typically collected and considered. However, real brainstorming around these ideas and creative thinking about opportunities rarely takes place during the budget process. Andrew Hargadon, associate professor at the University of California Davis, focuses on innovation and makes a compelling case in his book, *HOW BREAKTHROUGHS HAPPEN: THE SURPRISING TRUTH ABOUT HOW COMPANIES INNOVATE*,¹ that innovation most often derives from recombining existing ideas in new and exciting ways.

Banks must undertake more formal and regular value-innovation brainstorming sessions. These should include a review of ideas developed during the budget process, additional input from frontline employees and from business partners outside the company and structured approaches to filtering and evaluating ideas. Customer value innovation can help banks adopt best practices, create inno-

vative approaches to capturing new business and frequently realize incremental improvements that will generate measurable profit growth.

Third, banks must improve communication and training. More than ever, the silos of separate operating units must work together to implement new strategies for profitable growth. Getting commercial banking, insurance, investments, treasury management, wealth management and other business lines to work together requires improved communication and training. Three messages bear repeating in 2007:

1. Every business customer should hold at least five products with the bank.
2. Deposits are the strongest driver of customer profitability, and cash management services drive deposits.
3. We aren't lenders. We are advisors.

Endnotes

- ¹ Andrew Hargadon, *How Breakthroughs Happen: The Surprising Truth About How Companies Innovate* (Boston, MA: Harvard Business School Press, 2003).

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