THE KAFAFIAN GROUP INC.
...helping banks perform better℠

Performance Measurement
Strategic Management
Process Improvement
Board & Management Advisory Services
Financial Advisory

Second Quarter 2017 | Volume 9 Issue 2

TKG Perspective

Teaching & Speaking Engagements

Pennsylvania Bankers Association
Advanced School of Banking
The Penn Stater Conference Center
State College, PA **July 16**
How Do Banks Generate/Measure Revenue and Performance?

Pennsylvania Bankers Association
Advanced School of Banking
The Penn Stater Conference Center
State College, PA **July 21**
Panelist – Leading Through Change

Maryland Bankers Association
Maryland Banking School
University of Maryland Inn & Conference Center
College Park, MD **July 31**
Bank Financial Principles

New Jersey Bankers Association
Senior Management Conference
Borgota Hotel & Casino
Atlantic City, NJ **September 12**
Issues and Answers to Distribution and Delivery Channels

Conferences, Conventions & Other Events

Maine Bankers Association
Annual Convention
Newport Marriot Hotel
Newport, RI **September 14-17**

Pennsylvania Association of Community Bankers
Annual Convention
Coeur d'Alene Resort
Coeur d'Alene, ID **Sept. 20-24**

PICPA
Financial Institutions Conference
Best Western Premier Central Hotel & Conference Center
Harrisburg, PA **September 25**

New York Bankers Association
Financial Services Forum
The Breakers
Palm Beach, FL **November 8-11**

Are You Asset-Driven or Deposit-Driven?

By: Jeffrey P. Marsico, Executive Vice President

Over the past sixteen years we performed an analysis to determine if stock pickers rewarded one strategy more than the other. In two of the three times we did this, the deposit-driven strategy won out. The last time we did it, asset-driven banks were rewarded with higher market multiples.

Although surprising, we should have anticipated the flip. In 2006, when the Fed Funds rate stood at 5.25%, bank deposit spreads were 2.84%, based on those banks within our profitability outsourcing service. Add the fee income as a percent of deposits, and the revenue delivered through deposits was 3.40%.

Compare that to the fourth quarter 2016, when that number was 1.55%.

Conversely, spread driven through all loans was 1.99% in 2006. Today, it's 2.47%. No wonder banks have been growing loans faster than deposits for the past couple years, driving up loan-to-deposit ratios, and improving profitability. It was this phenomenon that resulted in higher price/tangible book and price/earnings ratios for banks with relatively higher yield on earning assets as opposed to those with lower cost of funds.

My theory, after performing the first two analyses that favored core funded institutions, was that growing core deposits is more difficult than growing loans. As simplistic as this might read, it's easier to give someone money than to take it. Markets reward business models that are more difficult to replicate. So my thought process goes.

But because of the long-term yield curve issue, the value of deposit gathering declined, and greater profitability was achieved by institutions with higher yields on earning assets. The reduced value of core deposit gathering is playing out in the branch consolidation that is occurring mainly at large banks. There is less willingness to carry low-deposit branches because they are a drag on profits. In that, we agree.

The spread situation is slowly improving in branches, with recent Fed Funds rate increases resulting in the 125 basis points we have at this writing. Deposit spreads expanded seven basis points in 2016 and we anticipate this trend will continue. The stock market has performed very well since the national election, as have bank stocks.

So let's take a look at where banks with the top yield on earning assets trade today versus banks with the top cost of funds.

We searched on all publicly traded financial institutions between $1 billion and $10 billion in total assets. We want a good sampling of banks that have decent trading volumes, understanding that the larger the bank, the higher trading multiples. So we eliminated banks that traded less than 10,000 shares per day. We also eliminated banks with a greater than 2% non-performing asset to asset ratio, with significant fee income, represented by their non-interest income to operating revenue ratio being greater than 30%. That yielded 171 financial institutions in the measurement universe.

Then we sorted by yield on earning assets, and cost of funds. We looked at the top 10 for each, but manually eliminated specialty banks that might be doing something unique to drive up that number, or experienced a one-time event that impacted those numbers.

The results are in the accompanying table.

	Averages	
	High Yielding Banks	Low Cost of Funds Banks
Total Assets (000)	$4,201,661	$5,220,411
NPA's/Assets (%)	0.79	0.52
ROAA (%)	1.30	1.20
ROAE (%)	10.76	10.04
Yield on Earning Assets (%)	5.02	4.05
Cost of Funds (%)	0.54	0.11
Price/Book (%)	183.8	188.8
Price/Tangible Book (%)	214.8	237.6
Price/Earnings (x)	18.3	20.7

Financial data for year ended 2016. Trading data at June 7, 2017

Source: S&P Global Market Intelligence

The scales appear to have tipped back in the direction of the markets favoring low cost deposit driven financial institutions.

But it's close, and those that believe otherwise or may be pursuing an asset-driven strategy can rightly point to potential flaws in the above statistics. We don't want to be a "figures don't lie but liars figure" firm that doesn't weigh all sides nor look at greater data sets.

It should be noted that there were no overlapping institutions in the top 10 yield on earning assets and cost of funds banks. In fact, there are big disparities in the averages for each. Top yielding banks had a 97 basis point advantage in yield on earning assets, and the low cost banks had a 43 basis points advantage in cost of funds. That lower difference is a key contributor to higher yield on earning asset banks being more profitable, for today.

In spite of any qualms about the analysis, the results are consistent with what I wrote above. Markets tend to favor core deposit gathering strategies, even in the current environment of greater profits being delivered by more asset-driven institutions. The rising rate environment portends greater profits in the deposit gathering activity, and the markets seem to be reacting to this potential.

The Federal Reserve indicated that a "normal" rate environment for the Fed Funds rate would be 3%, 175 basis points greater than where it stands today. When I ask bankers their "beta" assumption in their ALCO models, i.e. the perceived amount the bank will have to raise deposit rates in tandem with Fed Funds rate increases, the number ranges somewhere between 45%-75%, depending on the bank's mix of deposits. A greater proportion of core deposits typically yields a lower beta, and therefore greater spreads and profitability in the deposit gathering activity.

I am generally skeptical of these betas. Recall that when the difference between rates on a money market mutual fund and a bank money market account was notable, say over 100 basis points, money market mutual funds won out. Now that the difference is minimal, depositors choose banks and deposit insurance. This is what drove up banks' average balance per account from $64 thousand in 2006 to $148 thousand in 2016, and contributed to the deposit growth experienced by banks during the Great Recession. Will depositors stick with this strategy if we allow the difference between bank money market accounts and money market mutual funds to get larger? I'm not so confident.

I have greater confidence in the perceived value by market participants of the core deposit balances and potential at your institution. If bankers continue to grow their average branch deposit size and maintain their mix of deposits while deposit spreads widen, profits will improve and markets will continue to notice.

I will close with what I tell students in the class I teach at the ABA Bank Marketing School. If you are a business bank and would like to fund your bank with core business deposits, then you need about 60 net new business checking accounts to fund one $2 million commercial real estate deal. Which is harder to achieve and therefore replicate?

That is why I believe building a core funded institution is more difficult than an asset-driven one, and why markets tend to award greater market multiples to core funded banks.