



## LOANS & LENDING

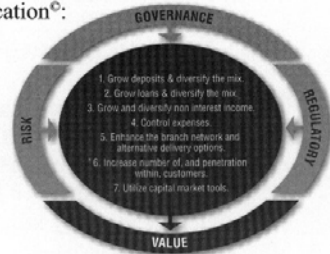
### GROWING LOANS AND DIVERSIFYING THE MIX

By Nicholas Ketcha, Jr. and Matthew Miller, FinPro, Inc.

With the continuing flat yield curve and the 17 Fed Funds rate hikes from June 2004 to June 2006 adding 4.25%, most community banks are experiencing material margin compression. In order to combat the difficult rate environment one major strategy those banks are striving for is additional loan growth and diversification of the mix to enhance the yield on interest earning assets. As a result, competition for loans remains fierce as many banks are pursuing similar tactics.

At FinPro, we have long been advising our clients to differentiate themselves from competitors using the 7 P's of growth and diversification<sup>®</sup>:

1. People
2. Product
3. Promotion
4. Purchase
5. Price
6. Place
7. Process



FinPro's Seven Ways to Build Value<sup>®</sup>

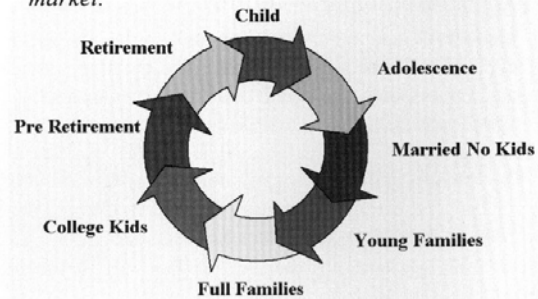
1. **People.** *Paying for the best producers will generate significant results, but the Bank needs to be ready to hire/fire quickly.*

Hiring the best lenders is a key to grow the commercial real estate and C&I portfolio. Each new additional lender should be able to generate a minimum of \$8.0 million per year and manage a portfolio of up to \$50.0 million, depending upon the size of the organization. Strong lenders typically will have a book of business and can bring portions of the book within three to six months.

However, the supply of strong seasoned lenders has declined as the demand continues to increase. This is due to the fact that the level of training within the industry for the next generation of lenders has diminished. As a result, the typical cost for a new lender has increased significantly over the last few years. In some of the more urban markets these lenders have demanded and received salaries of over \$100 thousand per year. The break-even math for a \$100 thousand lender is an average loan balance of \$6.3 million (assuming a 2.0% spread on the loan originations and 25% of salary for benefits/payroll taxes). As such, every dollar originated above the \$6.3 million average balance increases the bank's profitability.

The high salary requirement based upon future performance has made companies more inclined to offer incentive compensation, thereby reducing the payroll risk to the bank. This also allows management to be more inclined to decrease the lead-time for substantial loan pipeline creation.

2. **Product.** *Banks need to match the loan products offered to the individual segment needs within the market.*



Historically, banks have focused solely on product offerings and not upon the demands of the individual segments in the market. The easiest and most prevalent way to increase production had been to decrease loan rates charged to consumers. However, with the advent of the internet and the large marketing budgets of national mortgage brokers, many loan products have become commoditized. As a result, competition over rate is intense, especially in the retail loan area. The best way to compete in this type of environment is to focus on the customer needs and bundle these needed products.

One simple way to compete in the retail loan department is to identify where the bank's customers are within their lifecycle. For example: offering student loans and first mortgages to a market that is in the retirement phase is a waste of valuable resources.

Banks are becoming even more scientific in their approach. The process is to create natural market areas for each branch, gather customer segmentation information based upon the market definition, and group branches with similar customer characteristics. A SALES culture is created from the data: Segment identification, Ascertain the needs, Link products to needs, Effective delivery of products.

3. **Promotion.** *The rifle approach is more effective than the shotgun approach to marketing.*



## LOANS & LENDING

### GROWING LOANS AND DIVERSIFYING THE MIX

(...Continued from Previous Page)

Most banks today still rely on the shotgun approach with regards to advertisement. The idea is to maximize the coverage of the advertisement by placing a good rate in the newspaper or advertising it on the radio.

More sophisticated banks have begun to segmentize the customer base and directly target the individuals based on product need. In addition, the type of media, whether it be radio, newspaper, magazine or direct mail, are becoming specific for each type of customer. To complete the package, banks have also identified specific customer traits to include in the advertisement, a tactic which allows the customer to feel as though the advertisement is specifically addressing them.

- 4. Purchase.** *Create strong participation networks of banks with similar underwriting criteria.*

Smaller community banks with lower legal lending limits need to create participation networks with other local community banks in order to increase the amount of loan origination capability. One of the only problems with this type of arrangement is that the loan participations tend to go in one direction, out, and most banks do not get the return favor. When creating the network, the goal should be equal play. Also, make sure to create the network with banks that have similar underwriting criteria. Otherwise, senior management will be spending an inordinate amount of time chasing deals that will not be approved by the loan committee.

The purchase/sale of loan, the purchase of investments and borrowings can also help institutions manage their interest rate risk and portfolio concentration risks.

- 5. Price.** *Banks can't wait for the yield curve to go back to normal.*

As previously mentioned, current competition for loans has reduced the rate that Banks can competitively offer. Banks have even begun to extend the balloon period for commercial real estate loans to ten and fifteen years. The concern across the industry is now rate vs. risk return. However, banks need to continually evaluate their interest rate risk position and determine how much of a current product they should originate. Banks have begun to place internal lending limits on the type of loan by price for specific balloon dates, repricing periods, and maturity dates. Once established, Banks are filling the buckets quickly for the lower rate products and

using relationship management to fill the other buckets.

Being priced out of the market is a strong competitive disadvantage that banks need to continually evaluate. Growth at a potentially lower spread versus holding spread with limited growth discussions between senior management and the Board should be a regular occurrence.

- 6. Place.** *Expand the Bank's Lending Footprint through loan production offices.*

Expanding the banks' footprint into new areas will allow the Bank to increase loan volume. Many banks have explored the possibility of establishing loan production offices in markets with desirable demographic and competitive characteristics. The LPO will allow the bank to quickly enter the market into cheaper space and allow the lending staff to develop customer relationships. The LPOs can also be used as a testing ground for future branch office markets.

- 7. Process.** *Streamline the process for the customer and quicken the approval process – establish internal limits and policies for management approval.*

A number of banks still require the entire Board of Directors to approve each individual loan. This can cause timing issues for the Bank and prospective customers. It also slows down the process to a level that is not competitive with other institutions in the market.

Community banks have begun to set higher internal lending limits for senior management and are allowing the management team to approve all the loans that conform to the policies set by the Board of Directors. Each of the lender/management team will have to attest to the accuracy of the loan application and that it meets the underwriting standards set by the Board. All exceptions are still approved by the Board of Directors loan committee

#### Summary:

In today's competitive rate environment, community banks need to be prepared to address the changing markets but likewise need to remain focused on meeting the demands of its established customer base. By regularly assessing its use of the aforementioned 7 P's of growth and diversification, community banks can more ably position themselves to meet these challenges.