THE ECONOMY: FROM A BANKER'S PERSPECTIVE

Pictured clockwise from top left: Dan Durkin, Ted Winnowski, John Rickman and John Eskildsen

Ferguson Wellman's Ralph Cole sat down recently with four clients from the banking industry: Dan Durkin, former president and CEO of Pacific Northwest Bank, John Eskildsen, former president and CEO of US Bank of Oregon, John Rickman, former president of US Bank, and Ted Winnowski, former president and CEO of Key Bank and Centennial Bank. The following are highlights of their conversation regarding economic trends. This transcript has been edited.

Q: Let's start right out and talk about housing. What can you tell us about the housing market and how consumers are affected by it?

Eskildsen: There's no question consumers have been tapping their net worth during the past couple of years, by using home equity lines of credit. The consumer has also felt better about spending money, with housing prices going up so fast. I just read that housing prices increased

16% in Oregon over the past 12 months. I would guess prices would rise by some amount less than that in the coming 12 months. More importantly, so much of this cycle has been dominated by adjustable rate mortgages that are starting to reset—not to mention interest-only mortgages. This will lead to a slowdown in consumer spending.

Rickman: The creative financing we have seen is really amazing. I do think it has created a bubble in some markets. And I think hedge fund activity has been financing some construction markets as well—perhaps about 10% of them.

Winnowski: I think some of the second home markets are going to do just fine. In Palm Springs and Arizona I've been seeing people with lots of money to spend. Baby boomers have been creating wealth and inheriting wealth and really do have the money to spend. I believe these people will continue to spend in a higher-rate environment. It will be the people on the lower-end, who had to stretch to afford specific properties, who are really going to feel the squeeze of higher rates. So I think the real estate market will flatten out rather than go down.

We are seeing speculators' holdings coming back onto the market with properties they bought or developed during the past couple of years. This will increase the inventory on the overall market. These speculators purchased investment properties with little or no money down; now they need to sell those places because the payments are starting to add up. The middle-income consumer is tapped out, but the more well-off consumer will continue to do well—in part because [stock] dividends have been increasing and wealth in a good economy has been accumulating. Demographics will also help support real estate prices, particularly in the Southwest and other warm weather locales.

Rickman: In Portland, the high end of the market is slowing, but the low end is still strong.

Winnowski: I agree. [Economic] growth in Oregon is still strong. Portland is becoming the "Boston of the West." Compared to Seattle and San Francisco, which also attract talent, Portland appeals to those who want job opportunities plus a certain lifestyle. Having said that, I also believe property values here are peaking.

Eskildsen: For people from Seattle and California, Oregon still looks like a bargain.

Q: Let's talk about your industry and big banks vs. community banks. Will there still be such a thing as a regional bank in five to 10 years?

Rickman: I see the industry continuing to move toward mega-banks and community banks. Mega-banks can still make a lot of money in merchant banking and commercial lending. The consumer side is very tough, very competitive.

Dan Durkin

Durkin: The basic question for big banks is, Can they deliver good personalized service? I think the answer is no. Small customers are being pushed to use the Internet while branches become more transaction- [vs. service-] oriented. Big banks are great for larger customers. They can offer an amazing array of services for big corporations. But they lose on the smaller end to good-quality customer service.

Winnowski: One advantage for small banks is that, unlike before, most services are scalable.

Eskildsen: Big banks have gotten better. US Bank, Wells and Bank of America have all improved their service in recent years, but they still haven't caught up to community banking in their level of service.

Winnowski: Let's face it, people like doing business with a local community bank. The other thing that's made community banks better is the scalability that's available now. Before, community banks couldn't offer services like cash management. But with the technology available now, they can offer a wider array of services.

Durkin: Technology has been huge for community banks. It really has been a great equalizer.

Rickman: Technology has really helped big banks during the most recent recession. The ability to monitor loan portfolios is light years ahead of the prior cycle in the early 90's. This allows bankers to spot trouble sooner, and do something about it. Before, by the time it hit your radar screen, it was too late. Or the credit was in real trouble.

John Rickman

Q: What keeps bank CEO's up at night?

Eskildsen: Not a lot. This credit cycle has been so good, and companies are so awash in cash, that bankers have to feel pretty good about their loan portfolios. I think they're still focusing on and working on cutting costs. It is a very competitive industry, and they have to continue to find ways to cut costs.

Rickman: Hiring qualified people, especially qualified lenders, is one of the most challenging aspects for banks right now.

Q: Are people not going into banking careers?

Rickman: A number of years ago, the bigger banks had great training programs. The one we had at US Bank was a great program. We'd train lending officers and then they'd get hired away by the independent banks. Then there was a lot of consolidation, and the new banks kept growing and needing more people. The bigger banks reduced their portfolios and lost people they didn't replace. The training programs at the big banks were eliminated. The newer bankers just haven't been through the training cycle.

Q: Why did banks fare so much better through the last cycle? Were they tighter about lending or better about their lending practices?

Rickman: I think they had better internal systems to monitor credit. So, when there was deterioration, they were on top of it. Automation has allowed you to be able to follow your portfolio much better. And so you're on top of your credit. You react faster. You can monitor your loans more tightly and get back in touch with borrowers sooner, so things don't get as bad. Before, by the time you got back in touch it was already too late.

Durkin: The overall interest rate environment has been lower, too. Companies that get in trouble generally are the more leveraged. Usually, when you're at the end of a cycle, rates are going up and you just get chewed up with your interest expense. Interest rates have been so low and borrowing costs had not been very significant as a percentage of total expenses, like they had been in earlier cycles.

Winnowski: All that's left for a bank, for an earning asset, are: good business loans, construction loans, obviously, or long-term income-producing real estate. And, on the deposit side, I still think it's the blocking and tackling: getting those low-cost deposits, and getting those business loans, which they're going to need. They'll need more business loans by qualified commercial lenders in order to survive the next slowdown, because there's going to be less real estate and other earning assets.

Q: When does a big bank decide, OK, it's time to go buy another bank? And when does it decide, OK, I can't do it any more on my own, it's time to sell? How does that process work?

Winnowski: I do think a lot of smaller banks will continue to merge. Why? Because of management, people, image, marketing needs, all those traditional things. I'm not sure there's a lever as to when M&A activity picks up or when it doesn't, but I think it's a little dependant on whether or not the margins are there in the existing banks to make a decent profit, and whether some other bank wants to get into a market.

Durkin: [Mergers] also happen when a bank's stock price is relatively low compared to the market. Community bank stock prices have been relatively strong over the past few years.

Eskildsen: If you go in and the stocks are overvalued, you just can't pay the price to make it worth it.

Winnowski: The opportunities come about, if any bank is not going to do well, for a couple of reasons. Banks are getting bigger; they're getting to the point where top management can't go to the next level, or is reluctant to go to the next level, because they're close to retirement age. That comes into play. Or, if a board is divided on what direction it wants the bank to go in, they say, Oh, we'll sell out. Those are the kind of things. I think the bigger banks have learned, through this last big go-round of acquisitions, that you don't just go out and buy willy-nilly, because there are definite merger and integration challenges each bank has faced. We will probably see more M&A activity this year, because I think it's going to be harder for some of the banks to make those incremental increases in their earnings. Their stock price may suffer a little bit, so they'll look for that opportunity to purchase another bank. I think the environment is heading us in that direction. It may be additional income for the acquired, rather than the acquirors.

Ted Winnowski

Eskildsen: I'll tell you this. There are a lot of investment bankers out there trying to make things happen. That's what they do for a living. They make sure CEO's are aware of all the options available, anything to provoke action.

Q: We have a new Fed Chairman this year. Do you have any advice for him?

Rickman: He will follow Greenspan's and Volcker's lead. Why wouldn't he? During their tenures they really focused on inflation, and that has led to a modest and positive environment. Bernanke will raise rates in his first few meetings to establish some credibility, and after that I imagine he will follow Greenspan's lead, either with gradual hikes in the future, or gradual easings. I personally think Greenspan did a good job and overall the Fed has been fairly accommodating.

Winnowski: I too think Greenspan did a good job, but I have a personal bias against the way he raises and lowers rates so gradually. I think it can end up making people wait to see where it all ends. I don't think it provides great information for people to act on, or to use in making business decisions.

Eskildsen: I think the gradual process leads people to believe that this process is an exact science, and that these controls are finely tuned. Interest rates are really a very blunt object in monetary policy. It works, but 25 basis points here or there—it's incredibly hard to see any impact.

Q: What about jobs and regional growth? You commented that housing should hold up in the Portland area because of good regional job growth. Where do you see this growth coming from?

Winnowski: I think software is a great growth area for us. I have always compared Portland to Boston. On the East Coast, you have cities like Washington and New York City, with very high costs of living and not necessarily the best overall family-friendly lifestyles. Whereas Boston has its Route 128, we have our own Silicon Forest right here. We have a much better quality of life than some of the bigger cities on the West Coast, like Seattle and San Francisco. That will always allow us to draw people to the area.

Durkin: Apparently, Portland is a destination for many recent college grads. That's great, but I'm not sure what they are doing for a living. Interestingly, the industry with the fastest job growth in recent years has been construction. I know we are trying to get going in the biomedical field, but it is a crowded area, and other communities may be better positioned in that industry than we are.

John Eskildsen

Eskildsen: I really think we have a good opportunity in software and technology in general.

Durkin: Boeing's surprising strength has helped our economy. Who would have thought that it would have been an area of strength four years ago?

Eskildsen: While the lumber industry is smaller than it used to be, it continues to be very important for our economy. We are the number one lumber state in the country, and Washington is number two.

Rickman: We have a strong agricultural base, especially nurseries.

Winnowski: What I do like about our state, and the Northwest region, is that we have a good mix of businesses. We don't rely on any one thing too much. While Seattle is booming, it really relies on Microsoft and tech. I think Portland will continue to slowly benefit from foreign trade.

Durkin: Unfortunately, we don't have a balanced tax structure in the state, and that hampers us. It definitely hurts our school funding. Tourism is one of our biggest industries, yet we have no sales tax to benefit from those visits. We rely way too heavily on a volatile income tax.

Winnowski: Vancouver benefits greatly from Oregon's tax structure. The urban growth boundary raises real estate costs and taxes in an unbalanced tax structure. These are impediments to our growth that result in a poor distribution of wealth.

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