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External Forces Affecting Today's Community Banks

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Successful mutual community banks in today's market must forge their way through many external barriers, including unpredictable interest rates, competition with other institutions, and new technology. In order to get a clear understanding of today's community banking environment all three of these external forces are important to monitor. Priorities must be examined because timing makes a difference. History repeats itself and people repeat what they have done in the past. The mutual community banks serve these people and can offer their community members more than just a good rate, a friendly face, or the next new product.

The decade of the 1990's was a time of strong economic growth, steady job creation, low inflation, rising productivity, and a surging stock market that resulted from a combination of rapid technological changes and sound central monetary policy. This was also the beginning of the dot-com bubble. Because the spending did not keep pace, we ended the era with a negative spending gap. American people spent more than what they earned though wages were not increasing. When profits were rising we were not investing back into ourselves.

The ease of obtaining credit occurred during the early 2000's and the American dream of owning a home became larger than life, with risky loan programs coming forth such as low-documentation (low-doc) and no-documentation (no-doc) lending. This trend enabled people to get too far into debt without the real capability to pay loans back. The government programs such as Fannie Mae, Ginnie Mae, and Freddie Mac all played a role. It was during these times that the underwriting standards known as the Five C's of credit (collateral, character, capital, conditions, and capacity) were not being practiced as they should have been. Banks and brokers made money selling high risk loans to the secondary market.

Fast-forward to 2008's economy when the housing bubble burst leading to the great recession. This was a financial crisis that created multiple problems within the recession including overleveraged financials, falling asset prices, and weak household balance sheets to name a few. Since 2008, community banks have been having difficulty earning a profit because rates have been held extremely low by the Federal Reserve's (Feds) strategies. The economy is stuck. The interest rates on mortgage loans were lowered substantially when the Fed flooded the bond markets with quantitative easing. This was the Federal Reserve's tactic for dealing with the economic crisis.

Because the interest rates on the loans that are being booked today will be there for the long-term and the deposit rates are typically short term, it is hard to predict cash flow on a mutual bank's balance sheets. Mutual community banks make money with something called Net Interest Margin (NIM) or the difference between the interest income generated by lending and the interest paid out to depositors. They borrow on the short end of the curve (1–6 months) and lend on the long end (15 -30 years). The fear is that all the loans currently being booked won't move (be paid off or refinanced) and the deposit rates could increase. When the cost of funds rises faster than loan rates, the bank's balance sheet is stressed. Reasonable cost varies from bank to bank and paying attention to this, as well as comparing against competitors is essential. A positive NIM is the current day dilemma. A bank's strong profit margin is the main objective in order to stay in business and remain strong. Even more important is the length of time the bank can go sideways and hold pace. If the mutual bank does not have strong management skills, careful planning, and strong reserves then it may not withstand the current day's stress test. This may be the most important external force. There are many banks trying to do the same thing, which is to make money in a volatile rate environment and move with the times.

Consumers are not rational or logical in all circumstances. They don't have the information of "smart investors" and they are not as "price sensitive" as they may look; they are driven by convenience. Price is not the only factor even though it seems like the only thing the news and media want to focus on, (lowest rates ever) but life events still happen. People will still need loans. Which bank they go to for those loans will most likely be driven by habits and what is convenient.

If you were to ask your employees what they think about your institution, what would they say; how would they define the company? Your employees' ability to sell and be a positive influence in the community is important. Now more than ever the community bank needs to embrace the industries' transformation and re-examine their strategies and business models. To succeed they are going to need to learn how to be more efficient with the way they do business. A mutual bank could sell out to a larger stock owned bank and no longer do business as "a community bank" if it weren't focused on two key elements: its employees and the customers that live within the community.

There is also the fact that bricks and mortar no longer seem to matter. Today's consumers are indifferent to who is providing core services like deposits, payments, and credit. Now more than ever a bank needs skills to manage risk. Only those community banks that have managed the risks efficiently through the interest rate challenges will still be doing business in the near future. A continued focus will need to be placed on this area. While downsizing may save money, there remains a need to be staffed to full capacity and give employees enough time to gain the knowledge and understanding of the issues and new technology.

These technologies include virtual currencies, online banking, mobile wallets, big data, and social media. The new competitors are not just the banks down the street. Instead they are Wal-Mart, Amazon, Google Wallet, Pay Pal and Facebook. These competitors are bigger and better financed and we cannot ignore them. The right choice of where to spend time and attention, and which of these technologies to focus on first could be the key to longevity.

Consumers will shop around and again go for what's convenient and easy to access. They spend their time busily going about their day and the next new technology comes along, and it becomes what everyone uses. A key to a smaller bank's success is going to be timing. Looking at what these new products are, we need to focus on the products that are within our grasp, not the ones that will be better developed by the larger, wealthier companies. The smaller community bank can always step in and offer the products further down the road. They do not need to be first on the block.

Some of the products include the following:

- Point of Sale – New payment systems offer customers faster and more convenient transactions (Apple pay, Square)
- Peer to Peer Transactions – P2P transfers from one bank to another allows instant money transfers between mobile devices (popmoney, venom)
- Non-Traditional Credit Data – Loan approval in record time, include kabbage the fastest growing company in small business finance history, karrot uses non-traditional account data to access a loan applicant's creditworthiness
- Payment-Based Lending – square capital offers small business advances which are paid back by taking a portion of their payments
- Peer-To-Peer Lending – Lending Club which connects borrowers and investors

It will be critical for community bankers to stay abreast of these products and not lose sight of what the next new convenience technology is.

One excellent example was recently reviewed in the magazine Bank News[1]. Neil Underwood, president and chief operating officer of Live Oak in Wilmington, N.C. and his development of nCino, a cloud-based Bank Operating System was profiled. This new charter opened in 2008. It needed to do business efficiently or else it would never raise the capital to survive. It started out by turning to the Small Business Administration loan program (SBA) with a twist. This mobile banking operating system fuses loan origination, customer relationship management, intelligence, and reporting. Since its development it has risen to the rank of third-largest originator of SBA loans in the United States. The average loan duration time was reduced from three months to six weeks. Prior to nCino, closers used to close 40 loans each year. Now, they are able to close 60. This new bank is becoming a real success.

To be everything a bank should be in terms of customer advocacy and convenience to succeed in today's market, this example personifies an effective approach. It goes above and beyond what is expected; working with the financial institution's core and getting results with exceptional efficiency.

It need not matter if you are a bank doing business online or in the same building that has been there for decades, today's business opportunities are affected by many external forces. The facts of doing business and focusing on your customers, the current economic situation, and technology will always be relevant. The true key to your success will be the ability to move forward and respond with fresh energy and strong assets to back that drive to succeed.

Interesting points!

[1] <u>Bank News</u> – October 2014 "Commercial Lending Goes High-Tech: A Case Study By: Neil Underwood"