Bauerle's Bank Notes

Fork in the Road

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"When you come to a fork in the road, take it," said Yogi Berra, the New York Yankee catcher who had an uncanny ability to make the obvious sound profound. That particular Yogi-ism came to mind as we listened last week to Andy Hasley, CEO of Allegheny Valley Bank and President of the Pennsylvania Association of Community Bankers. Our guest for the Black & Gold Financial Team program in Pittsburgh, Hasley presented a sobering yet hopeful outlook for community banks.

Banks' average return on assets is ⅔ of what it was in 2007, he reported. The Fed's zero interest rate policy has prevented banks from making much money on their investment portfolios. Fierce competition for loans has eroded net interest margins and covenant structures. Meanwhile, because customers who have cash hoard it and are not borrowing, banks' average loan to deposit ratio has declined to 72%, compared to 90% when Hasley began in the business 25 years ago. "Lots of banks also don't make money on trust and investment lines of business," he said, suggesting they should exit the business or outsource it. These intra-industry pressures have been exacerbated by competition from non-bank providers and by technological transformation that has made banks' existing business model obsolete. Despite these negative trends, Hasley made the case for community banks' continued relevance.

Hasley crisply ticked off required survival steps. Community banks have responded to margin compression by cutting costs, a tactic that has played itself out. Needed now are reinvestment in people and systems, shifting to a consultative service model rather than transaction processing, and deepening engagement in communities served. Also required are effective succession planning, improved risk and profitability management, and measures that differentiate community banks from their competition. "What makes people want to do business with *us*?" is the central question every successful bank must be able to answer, he said.

Former PNC Bank CEO Jim Rohr gave an interview to the Cleveland Plain

Dealer in March 2013 in which he derided community banks as weak and irrelevant. Asked what is reshaping the industry, Rohr answered, "technology." To illustrate, he cited smart phone mobile banking, saying PNC did not charge customers to process checks and other items by remote capture, but probably should do so given the cost to the bank and the convenience to customers the service represents. Rohr's answer, however, showed he too is struggling to adapt. His unspoken premise was that all competitors in the market have like business models and can act in unison when setting interest rates, fees and other charges. That was once true. Today, emerging technology-platform financial providers have a different business model: the newest technology, reduced human resources, few or no physical locations, and the ability to attract business by pricing it below the level traditional providers must attain to break even. That sea change threatens *all* banks, big and small. Think Southwest Airlines disrupting the staid world of Pan American World Airways, TWA and USAir.

I share Hasley's conviction that regional and community banks *can* survive, but only if they adapt to the point they have a good answer to Hasley's question, "Why us?" National Public Radio recently interviewed the CEO of Neiman Marcus. She said 25% of Neiman's sales are now made through the company's website. Yet the company continues to devote enormous resources to marketing Neiman as a retail destination for wealthy consumers. The annual two-of-a kind "his and her" Christmas gifts continue to define the brand. The rest is gravy.

In a parallel universe, Harley-Davidson has franchised its brand to investors who operate H-D retail stores. Motorcycles define the brand, but the highest volume, highest profit item sold by the stores is a Harley-Davidson tee shirt. Customers pay $25 for a 10¢ tee shirt from Bangladesh because it bears the name of an American icon. Although they lack the distinctive brand-power of Neiman Marcus or Harley-Davidson, regional and community banks have other ties that bind. Hasley noted that public opinion surveys show community banks' reputation has grown as New York and European-based banks have suffered multiple bouts of adverse publicity since the 2008 crisis.

Our takeaway from Hasley's presentation is that the greatest impediment to community banks' continued vitality is acknowledging the need to adapt and the corollary that they must spend money to make money. Cultivating customers, repurposing real estate, recasting the staffing model, and purchasing and using new technology all require time, energy and money, as well as other resources that do not reside within the four walls of any bank. We are here to help those institutions that embrace Hasley's message. For the rest, the fork in the road leads into the sunset.