Community Bank Challenges in 2006
—And How to Overcome Them

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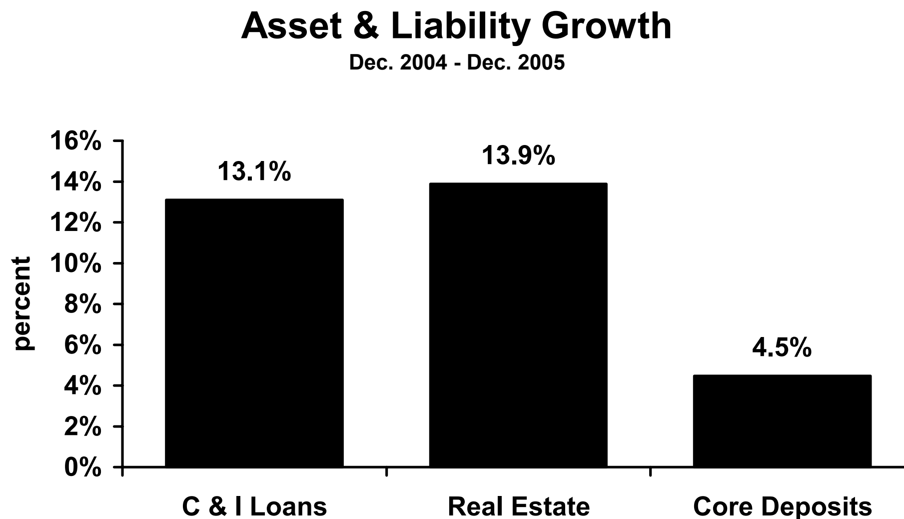
February 27, 2006

Community banks will face two major challenges in 2006: funding loans in an environment of weak deposit growth, and maintaining a top quality workforce. These issues developed over the course of 2005, but will separate the winners from the losers by the end of 2006.

Funding

Loan growth continues to be strong in the main categories pursued by community banks, commercial and industrial loans and real estate loans. Consumer loan growth, in contrast, has weakened. Deposit growth is also soft, thanks to the Federal Reserve's tightening moves. As a result, as shown in the chart, bank loans have been growing far more rapidly than deposits.



In 2006, C&I loans will continue to grow at a rapid pace, reflecting strong capital spending by businesses. Corporate profits have been strong, but starting in 2005, capital spending growth has been even stronger, requiring companies to use external sources of funds. Despite the recent upsurge in loans, corporate debt-equity ratios are still quite low compared to past years, so there is plenty of borrowing capacity out there. Add to that capacity a continued desire for new capital equipment and C&I loan growth will continue at double-digit rates.

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Real estate lending will decelerate in 2006, but don't expect it to fall off a cliff. New residential construction will slow, but non-residential construction will accelerate.

Deposits, on the other hand, are likely to slow from their current low level. The Federal Reserve will probably tighten another 50 basis points (from the level as of this writing, in February 2006), which will further slow deposit growth.

In short, loan volumes will continue to grow faster than deposits. What's a bank to do? There are two steps that many banks should take to avoid relying on expensive borrowed funds. First, think core deposits. If bankers have an "order taker" attitude, then deposits won't grow faster than average in the bank's market place. But faster growth is needed to fund loan volume increases. Faster growth of core deposits will require taking market share, probably from large banks. That task should occupy the thoughts of senior management.

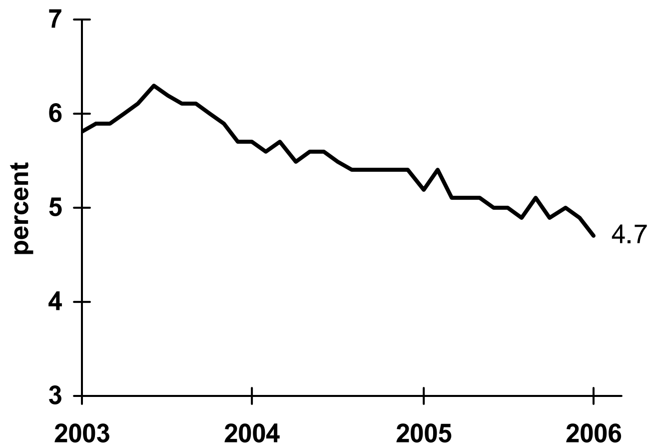
Not only should the CEO and CFO think core deposits, but everyone in the bank should be thinking deposits. Make clear to all staff, from new tellers to senior loan officers, that gathering core deposits is a top priority. Measure performance in growing deposits, because what gets measured is what gets better. Reward top performers in celebrations with plenty of hoopla. Banks that don't have strong product offerings may not be able to improve their deposit platforms in time to avoid the deposit crunch of 2006, but good deposit gathering helps performance so much that the current challenge should be used to create a sense of urgency to get the job done.

As a second step, loan growth can be trimmed, often with an improvement in profitability. Not all loans are created equal. An analyst may calculate an average margin on the loan portfolio, but we all know that some loans are gems and others were made at very thin margins. Look at the loans with the thinnest profit margin. Now compare the interest rate at which those loans were booked to the marginal cost of funds. Don't look at the average cost of funds, but rather look at the most expensive funds. In many cases, that last, worst loan you just made isn't really profitable, or is adding only a very small amount to overall bank profits. Tightening the loan pricing model at this time may even enhance profitability.

Strong profit margins in 2006 will depend on growing core deposits and avoiding thin-margined loans.

Workforce Challenges

As the labor market tightens, banks will endure an increasingly hard time hiring and retaining good workers. Experienced loan officers are already in tight demand, a demand that includes most finance and accounting professionals, both inside and outside the banking industry. In 2006, however, tight labor markets will spread to the ranks of tellers and administrative staff.



A few years ago, when the unemployment rate was high, workers felt that jobs were scarce and they should be happy to keep whatever job they had. Since then, however, quit rates have risen as the unemployment rate has dropped. Employees are seeing more options and are taking advantage of the stronger labor market.

The first reason for many quits is that the employee simply isn't happy with his or her manager. Money is usually not as important as "soft compensation," verbal support for an employee's efforts. All too often, people in their first managerial position are unprepared for leadership and act like little Napoleons or like complete pushovers. A good training program for first-line supervisors will go a long way toward retaining valued workers. But the time to start employee retention efforts is before turnover becomes a problem. Banks which do not use recognition programs and training to limit turnover will end up paying more, one way or another. They may pay higher wages, or they may accept the higher turnover. Turnover, however, has its own costs: the costs of finding workers, the costs of training workers, and the costs of monitoring the performance of new workers to ensure quality customer service.

We have compiled a list of resources for companies interested in reducing employee turnover. (Take a look at http://www.conerlyconsulting.com/resources.php.) As usual, strategy for improvement begins with measurement.

For seasoned loan officers, the tight labor market has been around a while. Not everyone has caught on that good loan officers are worth a lot—including many of the officers themselves. Even banks that have great managers and good employee recognition may be lagging in pay for loan officers. For them, it's time for a good salary comparison. It may not be necessary to bring every officer up to the local market wage, but top performers should not be substantially undercompensated, or they'll have a bad taste in their mouth when they learn their worth.

Conclusion

Community banks will be challenged in 2006 by two issues that need immediate attention. Even if they do not show up in the first quarter, immediate action is needed to stave off serious problems that will impact earnings. Solutions take months to implement, so it's time to get started right now.

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