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High-Performance Financial Management

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The building of significant shareholder wealth is directly linked to high-performance financial management. Making the right financial management decisions, using the right tools, and working with the right partners can provide an accurate, projectable, and dramatic increase in shareholder value. Developing a strong financial management strategy is absolutely essential for owners to be able to fully capitalize on the day-to-day operating strength of their bank. Often, one of the few ways for banks located in slow-growth markets to enhance shareholder value is by prudently using the right financial management strategies.

Financial Management Opportunities Today

Financial management is all about maximizing the return on investors' capital given a specific set of balance sheet conditions and earning opportunities—always recognizing that the source of most assets and liabilities is customers and the source of earnings is management. The basic business of banking is very straightforward. Every successful bank focuses on building strong loan and deposit relationships, developing new as well as traditional sources of non-interest income, managing overhead in a cost-effective manner, and, most important, continually improving customer service—the non-negotiable of successful community banking. These strategic imperatives are conceptually easy to grasp but they can be, as one banker said, "devilishly difficult to implement." We all know "the devil really is in the details" of these basic blocking and tackling tasks. Yet, to be consistently successful, every bank must consistently perform them exceedingly well. Financial management is, quite simply, all about how to fully capitalize on the fundamental operating strengths of the bank. The challenge is to make sure that the proper financial management steps are taken to maximize long term shareholder value.

The Opportunities Development Cycle

Many excellent financial management opportunities go through three distinct stages in their development.
First, initially they may appear complex from a financial analysis, legal, accounting, and regulatory viewpoint, and in some instances they may even seem counter-intuitive. For example, in the early 1980s, many banks began instituting voluntary treasury stock redemption programs—put simply, stock buybacks. Understanding these programs from a financial analysis and accounting perspective took some time, yet from an implementation standpoint, treasury stock programs proved to be relatively easy. The idea that buying back stock was one of the best investments available for the continuing shareholders took time to be fully understood and accepted. Eventually hundreds of bank holding companies used stock buybacks to support their stock prices, provide shareholder liquidity, and put excess capital to use. Most important, as a direct result of these stock buybacks, they increased their earnings per share and their share prices rose. Yet initially, many banks were skeptical.
Second, virtually every new financial management opportunity was either first used or developed by the major bank holding companies. For example, the major banks were the first to aggressively capitalize on stock buybacks and trust-preferred securities. Today one of their major focuses is on the sale/lease back of billions of dollars worth of bank facilities . . . well before the rest of the industry.
Third, once it becomes clear that these techniques are highly beneficial to shareholders and are relatively easy to implement, they become broadly accepted as an everyday, ordinary part of the banking business, e.g., issuing trust-preferred securities. In summary, the techniques, while initially appearing complex, are often quickly capitalized upon by the major banks and then by banks of all sizes. The pattern is repeated again and again.

Securitization: The Great Enabler

Securitization, as we know it today, began with Lewis Ranieri's creation of the mortgage-backed securities market, which reshaped and revolutionized the mortgage banking industry, enabling millions of Americans to own their dream homes at highly competitive mortgage interest rates. Securitization has allowed hundreds of banks (with assets ranging from under $100 million to over $10 billion) to issue trust-preferred securities, enabling them to raise capital on a cost-competitive basis without diluting shareholder equity. Of interest, large publicly held banks and privately owned banks are now on an equal footing. This would have been impossible from an individual bank's perspective before the advent of trust-preferred pools made it an everyday part of the banking business.

Securitization, as illustrated by the trust-preferred pools, has become one of the great enablers of financial management and will be even more so in the future. Securitization has leveled the playing field. The good news is that it's just beginning, and today even more cost-effective approaches are either being introduced or are on the way to enable banks to manage their assets even more effectively. Of major interest, many of these innovations will be coming from leading community bankers in the next 12 months.

Sale/Leaseback of Bank-Owned Facilities

The next big thing is already here: capitalizing on the sale/lease back of bank-owned facilities. A majority of the major banks have already capitalized on this opportunity. These institutions have overcome the attachment to their bank-owned facilities in return for significant financial rewards, including increased earnings, flexibility regarding the use of capital by freeing up capital from real estate ownership to other purposes, and in the process, building greater long-term value for their shareholders. Now we see banks of all sizes throughout the country evaluating the potential benefits.

Today banks have approximately $100 billion in bank-owned facilities on their books, very often carried below current market valuations. In the next decade knowledgeable observers estimate that over 50% of the bank-owned facilities will very likely be sold or partially leased back. Many of these will be on a floating-rate basis, eliminating the "funding mismatch" of paying long-term, fixed-lease payments on funds raised and reinvested in short-term earning assets. We believe the impact of sale/lease backs of bank-owned facilities will provide billions of dollars of increased capital, increased current earnings, and a significant increase in long-term shareholder value.

Financial impact - In virtually every instance, the sale/lease back of bank-owned facilities increase the earnings, capital, and valuation of the bank. The magnitude of the impact will very from bank to bank. Here is a quick overview.

Increased earnings -The sale/lease back, in effect, converts nonearning assets into earning assets. Using the sale proceeds, many banks can easily earn a spread over and above the lease payment.

For example, on a floating-rate lease, the bank might lease back space at LIBOR plus 200 basis points and lend the proceeds from the sale at LIBOR plus 300, thus locking in a positive net spread on the reinvested proceeds of the transaction over the long term.

Increased capital - Banks are able to harvest the off-balance-sheet value imbedded in their real estate. A major benefit is increased regulatory capital reflecting both the gains recognized and a significant reduction in 100% risk weighted nonearning assets on the balance sheet. The banks gain greater flexibility regarding the use of capital by freeing up capital from real estate to other more productive purposes. In addition, if the bank has large unrecognized gains, taking those gains reduces the need to sell additional stock to increase capital. As one banker said, "I increased capital at virtually no cost and without dilution of the current shareholders' ownership."

Increase in value - The bank stock market and potential acquirers place little value on bank-owned facilities. Their focus is on earnings and earnings growth. When a bank sells some of its facilities and then leases back all or part of those facilities, the net result most often is an increase in both capital and earnings with no dilution.

Clearly, the value of a bank to its current owners as well to future owners is in its earnings, not in its bank-owned facilities.