Financial Services Risk Advisors
Performance | Solutions | Success
FSRA

We are all familiar with TBTF, but is "Too small to Succeed" a reality?

In a recent letter to Ashville, NC based Ashville Savings Bank (ASBB) CEO Susanne DeFerie, activist investor Lawrence Seidman asserted that the bank is "too small to succeed" and should therefore immediately begin locating an acquirer. Mr. Seidman raises and important question currently being contemplated in the board rooms of community banks around the country: is "too small to survive" a reality?

We can use Mr. Seidman's investment in ASBB as an example to help answer this question. According to American Banker, Mr. Seidman owns 6% of the shares of ASBB, worth approximately $6.23 million as of August 20, 2015 (the day before he wrote his letter). Let's compare that investment to one of similar size in ASBB's neighbor institution, North Carolina based Bank of America (BAC), which is positioned firmly in TBTF territory. The market value of Mr. Seidman's investment in ASBB would have purchased him approximately 0.0035% of Bank of America on the same day, or approximately 372,687 shares. At its most recent year-end, Bank of America reported a diluted earnings per share after extraordinary items (DEPS) of 36 cents, making Mr. Seidman's hypothetical share of earnings worth approximately $134,000. By comparison, ASBB reported a DEPS at their most recent year-end of 59 cents a share, making Mr. Seidman's actual share of earnings worth approximately $155,000.

As we have shown, Mr. Seidman benefitted from an additional $21,000 share of earnings by placing his investment in the smaller bank over the larger one; however, an investor cannot spend hypothetical dollars locked up in DEPS, so we need to look at actual return on investment over the same period. From December 31, 2014 to August 20, 2015 ASBB shares appreciated $2.22 resulting in a market value gain on Mr. Seidman's investment of approximately $583,000. Over the same period, bank of America shares decreased $1.17 per share, meaning that even adjusting for the three quarterly dividends of 10 cents a share that Mr. Seidman would have been entitled to, his hypothetical investment in the large bank would have lost $324,000 in value. Mr. Seidman benefitted more than $900,000 in less than eight months by investing in a small bank over the large one.

Finally, we need to look at optics to better understand the argument for "too small to succeed". Small banks are not able to take advantage of the operating efficiencies occurring from the economies of scale enjoyed by the large banks. Both Bank of America and ASBB had abysmal efficiency ratios for their size at the most recent quarter, however Bank of America's was nearly 20 points lower than that of ASBB; and, ASBB's efficiency ratio in the mid-80s is significantly higher than the average for its peers. The argument exists that small banks are less able to handle the increased cost associated with a business model more reliant on branch networks, the ever increasing regulatory burden, and outsized employee bases that suppress revenue per employee numbers well below that of their larger counterparts. These arguments all have merit as larger banks are able to compartmentalize employee costs, and where Bank of America would have a department of hundreds of employees performing accounting reconciliations for example, where each employee in the department might be expected to perform 1,000 reconciliations a month, ASBB might only have one employee who handles all of their reconciliations, which might only be 200 a month. Bank of America is significantly more efficient in its 1:1000 ratio than ASBB in its 1:200 ratio, and where the only thing the employee at Bank of America worries about is perform reconciliations each day, the ASBB employee is likely to "wear several different hats". There are however, no lack of competent resources out there like FSRA, that allow small banks options to outsource many of their operations and compliance tasks, allowing them to pay for only the service that they use, without carrying excess cost. At ASBB, a reduction of $1.2 million a year in operations expense would bring its efficiency ratio in-line with that of its peers in the mid-60s, and coincidently would return an additional $74,000 a year to Mr. Seidman. $1.2 million may seem like a lot for a small bank, but remember a mid-60s efficiency is only the peer average meaning that 50% of banks that size are doing even better.

We can conclude, that while the old operating model of self-contained operations, and high head count for "small" banks may not survive, there is absolutely a place for nimble, customer focused, high ROI "small banks" to continue to service their customers who have grown accustom to personal service with a smile, and shareholders who value a solid return on their investment. By re-evaluating their strategy, migrating to a more efficient operating model, and developing options where they pay for only the service that they use, small banks are able to not just merely survive, but succeed.

Contribution of this article was provided by Nick Rossini, Nick is a Managing Director with Financial Services Risk Advisors. The author can be contacted at Nick@FSRAdvisors.com. FSRA is a risk management advisory practice specializing in audit, risk, compliance, and strategic initiatives for banks and financial institutions. For more information on FSRA visit their website at www.FSRAdvisors.com.