Reprinted from

AMERICAN BANKER

THE FINANCIAL SERVICES DAILY

What Does and Doesn't Matter in M&A Strategies

Friday, April 15, 2005

By Steinar Ryen and Oliver Sommer

What is the optimal size for a bank? Is there a natural point at which cost and revenue efficiencies and economies of scale become dominated by diseconomies of scale and scope?

In our recent review of the 150 U.S. banks with more than $4 billion of assets, we found no necessary connection between performance and size or growth rate.

Banks should consider a disciplined approach to mergers and acquisitions and be aware of three myths:

Bigger is better. We found no significant correlation, positive or negative, between size and performance indicators (ROA, ROE, and efficiency ratio). The average

Myth 1: Bigger is Better

compound annual growth of the banks we studied was 15% from 1999 to 2003. The average ROA was 1.3%, the average ROE was 15.4%, and the average efficiency ratio was 56%.

Industry and academic research has argued that economies of scale and scope are most relevant in small-bank mergers. Through the mid-1990s it was generally accepted that efficiencies were exhausted somewhere in the asset range of $2 billion to $10 billion. A 1994 Fed study cited such acceptance.

But using data from the 1990s, a 1997 Fed study found that banks achieved scale benefits at up to $25 billion of assets. It attributed that change to larger banks' enhanced leverage ability; lower open-market interest rates; the removal of regulatory restrictions on bank branching and holding company expansion; and improvements in technology (automated teller machine networks and credit scoring) and applied finance (derivative contracts and off-balance-sheet activities).

Smaller banks' increased access to more sophisticated technology potentially offsets those factors. More products and services have become available to players of all sizes; proprietary customer relationship management tools and data warehouse products and services are no longer the domain of large companies only.

Our examination of the top 150 banks did not reveal any significant difference in financial performance between banks with assets of more or less than $25 billion. On the contrary, we found high-growth, high-performance organizations at both ends of the scale.

Myth 2: Smaller is Better

The $190 billion-asset U.S. Bancorp tops the size, growth, and performance charts with 20% annual growth from 1992 to 2004, a 22% ROE, a 2.1% ROA, and an efficiency ratio of 42%. Its focus on customer service has proved itself over more than a decade of spectacular performance.

Toward the opposite end of the size chart, the $5 billion-asset Pacific Capital Bancorp outperformed on all measures: a 28% ROE, a 2.1% ROA, and an efficiency ratio of 47%.

Smaller is better. Observers have questioned the shareholder value of the largest mergers and acquisitions. Bank of America Corp.'s stock price plunged almost 10% in the month following its October 2003 announcement that it was buying FleetBoston Financial Corp.

But with a fourth-quarter return on equity of 16%, a 1.4% return on assets, and an efficiency ratio of 51%, Bank of America is demonstrating that with effective customer integration, bigger can be good.

Myth 3: Growth and effectiveness are conflicting objectives

The consensus has always been that the average cost curve in banking is a relatively flat U, and that the largest banks are actually at a slight cost disadvantage compared with smaller ones. But the research substantiating that view is limited, and we found no indication that big banks are at such a disadvantage.

One reason the U-shape may no longer be operative at the top end is that big players can flex their buying power. By using reverse auctions, online bidding, and automated and coordinated procurement, they can cut waste dramatically. They also have the benefit of national branding, merchandising, and marketing and promotion.

Growth and operating effectiveness are conflicting objectives.

We also found no correlation between the rate of asset growth and performance indicators. A widely held belief among bank executives is that you have to choose growth or operating effectiveness. Our findings did not support this view.

A widely held belief among bank executives is that you have to choose growth or operating effectiveness. Our findings did not support this view.

Among the 150 largest banks, 21 had compound annual asset growth of over 25%. There are less efficient, high-growth companies, like Commerce Bancorp Inc., with a 66% efficiency ratio and 36% annual growth, but companies like U.S. Bancorp have achieved similar growth levels over a longer period and have demonstrated outstanding efficiency.

The other end of the scale - the banking companies that actually contracted - contains a full spectrum of performance, from bottom-decile performers like UMB Financial Corp., with compound annual asset growth of minus-1.2%, a 0.5% ROA, a 6% ROE, and an efficiency ratio of 85%, to Bank of Hawaii Corp., which by focusing on its core markets has reduced assets by more than 10% annually since 1999 yet delivered a 22% ROE and a 1.7% ROA.

So what distinguishes the banks that achieve consistently from those that do not, if size and growth rate are not per se primary drivers? In our experience these are the four key components:

Sticking to the strategy.

The former Signet Corp. created Capital One Financial Corp. as an integral part of its growth. Signet, recognizing that it could not realize its vision for information-based consumer credit growth within the constraints of the existing company, let Richard Fairbank and Nigel Morris drive Capital One as a separate entity.

In the following decade Capital One grew to $20 billion of market cap and delivered staggering annual shareholder returns of 34%.

Focusing on execution.

Ambiguity is the best defense for protectors of the status quo and the worst enemy of change agents. Action programs must be specific - what is expected when, by whom, and at what cost and benefit?

Quantifying expectations, specifying time lines, and tracking results achieve real impact.

Focusing on customers.

Staying close to changes in customer behavior and monitoring and countering any developments in attrition is critical.

Establishing effective measurements and tracking.

The right tools for monitoring strategic impact are vital.

You should develop measures - such as customer and employee satisfaction, process change achievement, and financial effects - that fit the company's objectives and needs. In addition to financial measures, success indicators include tracking core customer segments in terms of share of wallet and channel usage; production and cross-sales; and in-depth customer attrition data. What gets measured gets done.

***

Mr. Ryen and Mr. Sommer are managing directors of Aston Associates, a Greenwich, Conn., advisory firm that specializes in strategy and operational design.