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Equipment Financing Offers Unique Opportunities and Challenges for Banks

By: Lawrence Marsiello
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Lawrence Marsiello, Managing Director – Pine Brook and former Vice Chairman and Chief Lending Officer of the CIT Group discusses how banks can benefit from entering the equipment finance and leasing market, but acknowledging the uniqueness of the field is critical to success.

Equipment financing is definitely in vogue in the banking sector. With many new entrants to the market expected, a closer look at the drivers and potential pitfalls of this development is worthwhile.

The banking sector is back with a vengeance. Based on recent FDIC reports and other industry-specific data, the banking industry has rebounded nicely from the credit crisis of four years ago. Reported earnings continue to expand, capital bases have replenished, and the number of banks on the regulators' problem list is declining. (In the first quarter of 2013 only a handful of banks actually failed.)

As part of a continued and steady recovery, astute, forward-thinking banks must recognize and act upon the need for new sources of recurring revenue and profits that complement existing activities. In the past several years we have witnessed many banks entering the equipment finance business via acquisition of an existing platform, or alternatively, by a team lift of equipment lenders. Equipment finance offers a viable means of boosting higher-yielding asset generation and diversifying revenue sources while leveraging the bank's existing market position and infrastructure. In addition, the bank is likely to capture increasing earnings from an expansion in capital spending driven by overall economic growth.

While pursuing opportunities to invest in alternative forms of recurring asset generation, bank boards of directors and management teams must still remain cognizant of growing challenges and monitor the impact of these activities on their earnings.

Earnings and quality asset growth from C&I lending and other traditional forms of bank lending is increasingly challenging. We see downward pressure on net interest margins – the difference between what a bank earns on its lending activities after deducting what pay outs on deposits and other liabilities. This squeeze is a consequence of the Federal Reserve Bank's monetary policy, as evidenced by Quantitative Easing and Zero Interest Rate Policy.

Furthermore, if we slice a bank's loan portfolio by vintage, we find that, as borrowers pay off older loans made at higher interest rates, they are often replaced by lower yielding loans. In addition, competitive pressures (too much money chasing too few good loans) insidiously compels banks to stretch on covenant, structural and collateral protections. Unchecked banks are faced with a lower-yielding loan portfolio with some yet-to-be-determined degree of higher risk.

In the short run, some banks have successfully bolstered profitability by some combination of three tactics:

1. Improved efficiency and cost reductions – Banks have become better at managing expenses via process re-engineering and other methods.
2. Curtailing loan loss provisions – As evidenced by the low level of loan defaults and stable level of delinquent loans.
3. Fee enhancements – An artful policy of charging fees to consumers and business customers has bolstered the non-interest income line.

Unfortunately, the earnings lifts from these highlighted activities are not sustainable, as the primary benefit is realized when they are initiated, but subsequently declines over time. The recurring value generated from equipment financing and leasing thus makes it a very compelling option. However, banks must be aware of the challenges they face as they consider entering this business.

First and foremost, bank management needs to take steps to nurture and protect the desirable attributes of the equipment financing unit in question. We have seen too many instances over the years of well-intended bank management eventually stripping the acquired unit of the very characteristics that had originally fostered profitable asset growth—much to the dismay of the bank's equity holders.

Here are five major challenges banks must prepare for as they consider entering the equipment finance business:

1. **Equipment Financing is Different Than Traditional C&I Lending** – Does the bank possess a well-respected

executive and subject matter expert to manage frequent post close/launch operating issues, and successfully reconcile different perspectives on sensitive subjects such as pricing, risk profile, legal documentation and compensation? Transitioning a previously unregulated equipment finance unit into a regulated environment is often a painful and tedious process requiring skill and patience.

2. **Industry Specialization Correlates to Success** – I have found that units with cycle-tested industry/equipment specializations have consistently outperformed generalists. These teams possess a deep-rooted knowledge of industry dynamics, prospective borrowers and the volatility of underlying equipment values securing the loan or lease. Examples of industry specialization include construction, transportation, healthcare, telecom both hardware and software, to name a few.

3. **Functional Specialization and Unique Lease Economics** –Specifically in the case of leasing products, bank management must be aware of the intricacies of lease economics and have a working understanding of critical factors, including potentially accelerated equipment technical obsolescence and its impact on ascribed residual values, the availability of required servicing to assure ongoing borrower satisfaction, and ensuring an uninterrupted payment stream.

4. **Potential for Organizational Disruption** – A bank needs to map how the equipment financing unit operations fits within and complements the sales, prospecting, and account management of line bankers. Avoiding resource-sapping internal conflicts on borrower, market ownership or overall, bank-wide credit line availability assures a successful collaboration, and cross selling without adult supervision.

5. **Need for New Risk and Pricing Models** – Equipment financing calls for extending an amortizing loan or lease typically for as long as five to seven years. On the liability management and funding side, a bank needs to possess funds transfer pricing and risk-based pricing systems and models to effectively match fund asset terms and duration. Equipment loans are often quoted as a fixed premium over like term or average life Treasury swaps. Although a bank may be flush with low cost deposits, the ability to lock in the spread between the interest rate on a five year amortizing loan with cost effective liabilities, such as certificates of deposit, is important in mitigating liquidity and margin erosion risks.

There currently exists a promising investment opportunity that banks can benefit from by entering the equipment finance and leasing market. This business is distinct from the expertise and experience of many otherwise successful banks. Only those management teams that acknowledge the uniqueness of the field and are prepared to face specific challenges will see an increased probability of generating recurring asset growth, cash flows and equity returns. Taking steps to secure sufficient resources, establish an operational structure, and focus on execution will help garner a strong return on investment.
