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The Increasing Role of Banks in Equipment Finance: Establishing a Sustainable Engine for Growth

By Charles B. Wendel

Today bank-owned finance companies account for more than half of all new lease originations. What were the drivers of this evolution, and what are the implications? Will banks continue to dominate?

Editor's note: This article is based on the October 2013 Foundation study titled Rise of the Banks: Establishing a Sustainable Engine for Growth, *by Charles B. Wendel. The study is available at* www.leasefoundation.org.

Coming out of the recent downturn, commercial banks are playing a more important role in the equipment finance space, an area that for many banks is also becoming an essential part of the financing solutions they offer clients. Not only are banks growing their share of new business volume but today, more senior bank managers view equipment finance as a "core" business: one that can build customer revenues with additional product sales and in some cases serve as an introductory product for their bank with prospects.

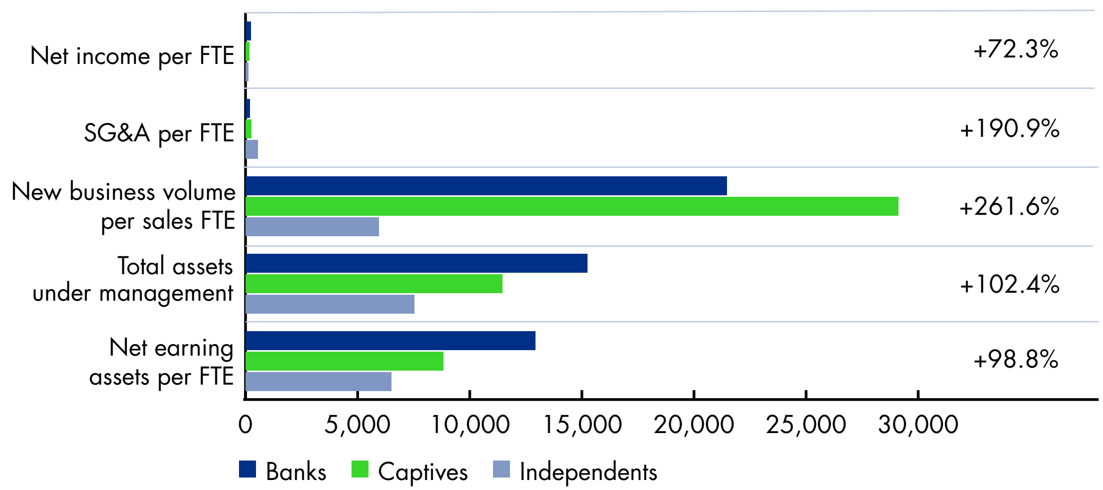
Whether through acquisitions or by hiring experienced teams, more banks continue to engage in equipment finance. However, preferences and policies limit bank activity to certain aspects of equipment finance, providing a continued growth opportunity for independents and captives.

STRONG CURRENT PERFORMANCE

Commercial banks have been increasing their share of new business volume, now up to 55% for 2012 versus 50.5% in 2011. While initially some of that relative share growth may have resulted from decreased activities by some captives and independents, over the past 12 to 18 months more banks have been heightening their marketing focus in this area. One executive from a bank-owned lessor commented that a few years ago he was told by his senior management to focus on quality control and account maintenance. In recent months the emphasis has shifted to maintaining quality and growing assets.

As banks have grown share, they have been able to demon-

Figure 1. Comparative Operational Efficiency (in $000 per FTE*)



Source: 2103 Survey of Equipment Finance Activity, table 30b.

strate stronger portfolio quality even as the overall environment improves, outperforming independents and captives in most metrics tied to the portfolio performance, productivity, and returns (Figure 1). Strong risk management policies and credit selectivity resulted in new full-year bank losses for 2012 being only seven basis points versus 28 for the industry.

Further, even in a low interest rate environment banks continue to benefit from a significantly lower weighted average cost of funds versus their competitors. In 2012, bank cost of funds was 1.28% versus 1.59% and 2.67% for captives and independents, respectively. Overall, this indicates a positive and improving performance picture for banks, encouraging more bank participation.

WHY BANKS ARE EMPHASIZING EQUIPMENT FINANCE

The list of banks building equipment finance groups has been increasing steadily. In particular, regional and community banks not previously in this space have now discovered its attractiveness. Among those entering or further building their equipment finance businesses are BBVA, City National Bank, MB Financial, Signature Bank, Synovus Bank, Union Bank of California, Umpqua Bank, and MainSource. These banks range from $3 billion to $100+ billion in assets. Several banks that have long been in the industry are adding staff and new specialty capabilities.

The factors driving bank initiatives in equipment finance vary from a defensive reaction to competitors and constrained avenues for growth to an active commitment to embracing this area as a core offer for the commercial bank. Today, banks face a relatively slow economy with limited areas for revenue growth, particularly on the consumer side. In some cases regulatory constraints also narrow the revenue options.

The net result is that banks can no longer rely on traditional consumer products such as mortgages, debit cards, and overdraft checking, among others, to drive growth. Branches, once considered the hub of bank activity, have experienced 10% or more yearly drops in transaction volume, with a higher number of branches achieving at best minimal profits.

On the commercial side, mortgage lending activities have been declining in the face of concerns over concentration risks and limited new investment opportunities. Even traditional commercial and industrial lending has experienced shrinking margins as more banks try to move into that space. At the same time, while the banks face limited lending options, many are also capturing increased levels of deposits that they need to put to work.

In short, bank management needs to find new growth avenues that offer a good risk profile and attractive margins. Equipment finance is one of the few areas with those characteristics. More banks have also realized that failing to offer equipment finance can open the door to a bank or nonbank competitor providing that capability. One executive whose bank recently launched an equipment finance initiative said that he "hated" seeing potential assets leave his bank and that his bank entered leasing to "round out our capabilities for our customers" and better ensure their retention.

Cross-sales

Not only can providing equipment finance decrease account poaching, but it can also help to fulfill an oftentimes elusive goal, namely cross-sales. Banks have long pursued the concept of cross-selling, whereby banks increase their so-called "wallet share" by selling multiple products to an individual customer. Among the benefits of doing so can be increased retention and higher per-customer profitability, as banks build off the strength of the relationship.

However, many banks' attempts at establishing a cross-sell culture have failed. Commercial bankers have often held on to their customers, defensively "protecting" them from other parts of the bank such as equipment finance. Reasons for doing so include concerns over losing risk assets to another part of the bank and lack of compensation for cooperating internally. For their part, equipment finance bankers have often failed to communicate with and work cooperatively with the commercial bank group.

Today, more banks have directly addressed the issues blocking cross-sell and are demonstrating the economic value of this effort. Most fundamentally, implementing a successful cross-sell effort requires senior management commitment. For example, in one case bank management insists that the equipment group handle all equipment finance opportunities.

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Compensation policies are also critically important to successful cross-sell. Basically, the commercial banker needs to receive the same compensation whether he or the equipment group completes a transaction; otherwise, fewer referrals will occur. At the same time, the equipment finance group should be a new deal source for the commercial bank. Several bank-owned lessors emphasize that they often "lead with leasing," whereby equipment finance serves as the first product sold to a target.

Equipment finance bankers stress that when they bring a new customer to the commercial bank, it quickly establishes them as heroes. Rather than being an elusive goal, cross-sell is now becoming a mainstay at more banks and an important element in improving revenue growth rates.

NEW ENTRANTS: BUY VERSUS BUILD

Of course, many regional and larger banks already operate well-established equipment finance groups. But newer players can either buy companies, attract experienced teams of leasing experts (commonly termed "lift outs"), or work with third parties to leverage their capabilities while minimizing a bank's up-front expense. As Figure 2 shows, each route has its pluses and negatives, with different approaches appropriate depending on a bank's specific needs.

Usually, banks making acquisitions may lack sufficient infrastructure in critical areas such as leasing operations and equipment finance risk management. Acquiring an existing player provides the buyer with a leverageable operations and risk infrastructure and processes and procedures that can be continued. This should allow the buyer to generate new assets as quickly as possible with a group that can hit the ground running. Unlike five years ago when few banks were actively pursuing the purchase of independents, today many independents find that they have multiple suitors, each wishing to take advantage of their originations capabilities while providing lower cost funds that immediately increase profits.

Figure 2. Buy Versus Build

BUY	BUILD
Positives:	**Positives:**
Provides infrastructure	No acquisition premium
Offers immediate impact to bottom line	May allow greater customization to bank needs
Quickly leveragable	Greater selectivity in choosing individual employees
Possible Negatives:	**Posible Negatives:**
Cost, may be dilutive	Need to acquire or already possess infrastructure
Culture/fit/integration	Cost of contracts
Management retention	Culture/fit/integration issues remain

Source: Financial Institutions Consulting, 2013.

While some banks prefer acquiring independents, others specifically avoid that approach. These banks prefer to hire a leader to build the business or bring in teams of experienced leasing personnel. Banks following this approach do so for various reasons:

- They want to avoid paying the premium required and the potential cost of goodwill on their balance sheet.
- They express concern that the leaders of acquired companies will lose their initiative and competitive edge in light of the major cash-out payments they receive.
- Bank management prizes a unified culture and believes it can preserve it better by selecting individual employees.

In addition, several bankers in the Foundation study noted that independents operate in a less bureaucratic and compliance-driven world. These bankers express concern that the culture of those companies would be difficult to adapt to a bank. Both bottom-line and cultural issues push these banks toward the build option. Of course, some banks will pursue a combined approach of acquiring and hiring, based on market opportunities.

Smaller banks and regional players often lack either the funds or the appetite to make the investment in infrastructure and people that any equipment finance venture requires. Instead, they partner up with a third party that possesses expertise in this area. For example, Union Bank of California recently announced a strategic alliance by which Marlin Business Services would provide equipment finance and leasing capabilities to Union's customers.

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Third-party arrangements can often be customized to meet a bank's preferences. Outsourcers can handle one or more of the following functions: underwriting, operations, monitoring, and billing, allowing the bank to focus exclusively on what should be its strongest suit: origination. However, third-party relationships have proven difficult to implement successfully. Volumes generated by the referring bank are often low, and bank management may perceive the revenues provided to the bank by the program as "not moving the needle" and, therefore, unimportant.

Banks going the third-party route need to make sure that their bankers are trained in the product set and compensated to sell equipment financing.

FOUR FUNDAMENTAL STRATEGIC CHOICES

Banks offering equipment finance, whether they are new to the business or established players, need to make strategic choices in at least four areas: how they originate transactions, the way and extent to which they specialize, the size of transaction they emphasize, and the complexity of the transactions they pursue.

As Figure 3 illustrates, at least 10 approaches exist to originating assets.

1. Direct origination. Focuses on generating lease assets based on expertise and market reputation, with a limited emphasis on cross-selling additional bank products. Banks are increasingly favoring this approach. They want to build deeper client relationships and believe that direct originations will ensure strong risk quality.

2. Lead with leasing. Results from direct origination led by the equipment finance group, with the intention and expectation of additional bank product sales by the bank. Banks need to differentiate them-

Figure 3. Equipment Finance Origination Game Board

Initiative	Pros	Con	Example
Direct origination – Independent	Business line control over credit and processes Quick decision making	Not bank relationship builder Can alienate leasing from core bank May lead to funding issues	1st Source
Direct origination – Lead with leasing	In addition to the above: Positions leasing as foundation product Leverages traditionally aggressive leasing sales staff	Could harm leasing relationship Requires giving up relationship control	Key Bank
Cross-sale to current accounts	Supports one-bank culture Encourages relationship "stickiness" Reduces origination cost	Commercial banker needs to screen Can lead to poor productivity	Signature
Cross-sale to bank prospects	Establishes importance of leasing Builds relationships with line bankers Potentially increases bank productivity	Productivity issues	Huntington
Vendor finance	Establishes origination partner Allows a "wholesale" marketing approach Creates cross-sell opportunity	Threat to quality Need to analyze portfolio regularly	Key Bank
Syndications	Opportunity to diversify risk Access to new markets, segments Fee generation	Rely on lead bank for ops/monitoring	Huntington
Lease portfolios	Low origination cost Portfolio diversification	Extensive due diligence required No end customer relationship	U.S. Bancorp
TPOs/brokers	Needs fewer originators, efficient	Quality control Requires strong analytics	FinPac
Referrals to third parties	Provides customer service Broadens product offer without cost	Quality of third party response Low fees generated	Union
Loans to independents	Good NIM Portfolio diversification	Sustainability of Independent Funding potential competitor	Wells Fargo

Source: Rise of the Banks in Equipment Finance, 2013 Foundation study, exhibit 8.

selves with clients, and leasing may allow them to do so while opening a path to further product sales.

> In addition to choosing the best origination channels, specialization appears critical to the success of banks in equipment finance. Selecting industries or "verticals" on which to focus is another basic strategic choice.

3. Cross-sale to current commercial bank customers. Involves the sale of lease products to current bank customers as part of a relationship building focus by the bank's relationship manager. Unlike a few years ago, more banks are successfully developing cross sales programs, as described above.

4. Cross-sale to bank prospects. Entails the sale of lease products to prospects as part of the commercial bank sales effort. Commercial bankers and their leasing partners now approach new business opportunities together. In years past, organizational silos often dominated, minimizing cooperation.

5. Vendor finance. Provides financing for end users purchasing equipment from a vendor; transaction may occur at point of purchase. This could also involve the bank as serving as a captive finance company for a vendor. Vendor finance allows banks to generate volumes without a direct sales force. The banks that are best in this area view the vendors as a key client, and they manage and monitor those relationships very carefully.

6. Syndications. Pursues buying and selling of pieces of larger exposures generated by other lessors, often to diversify risk and employ excess capital. In an era of relatively easy liquidity, syndication grows in importance as a way to increase assets and diversify portfolio risk.

7. Purchase of lease portfolios. Involves the purchase of portfolios from independents, captives, or other banks. This area suggests the codependent relationships that exist between some banks and their competitors.

8. Third-party originators (TPO)/brokers. Provides transaction opportunities from nonbank customers. As banks push for increased volume, some are rethinking their prior abandonment or avoidance of TPOs. Those that work with them stress the need for close monitoring and the willingness to "fire" TPOs, if appropriate.

9. Referrals to third parties. Outsources a lease opportunity to a third party in areas in which the bank may not operate, for example, small ticket. Some banks will focus exclusively on mid- to large-ticket transactions. Since they do not wish to invest in developing the technology and processes required for small-ticket transactions, they move these out of the bank while gaining a small fee, ideally preserving the customer relationship without building costly infrastructure.

10. Loans to leasing independents. Provides debt financing to independent lessors. This allows some banks to engage in segments that they are precluded from lending to directly, usually because of the concerns of internal risk management groups and the capital required. Banks can lend to an independent, funding deals with higher risk credits thereby earning a higher margin. If a bank lent directly to that segment, it would need to allocate increased capital to support the loan.

The above list is not necessarily all-inclusive, but it does capture the majority of options that banks have to generate revenues from equipment finance. Banks pursue multiple paths today, and individual banks are likely to change their approach going forward, depending on both market opportunity and internal appetite. As Figure 3 indicates, each approach has positive and negative qualities, and each shows that banks can succeed based on their individual skill sets and risk appetites.

In addition to choosing the best origination channels, specialization appears critical to the success of banks in equipment finance. Selecting industries or "verticals" on which to focus is another basic strategic choice. Some industry verticals are relatively common from one bank to another (such as healthcare, trucking, and municipals), while others are unique (such as taxi medallion financing, sports facilities, and shuttle buses). In many cases they are niche oriented.

In addition, some banks can develop a specialty, such as acting as both a principal and a paid advisor to structure large and complex lease transactions, allowing them to establish a strong fee-based business. This requires the ability to structure often-complex solutions for the client, execute them effectively, and provide the client with multiple financing products.

Deal Size

Regarding deal size, in general, banks have been moving up in their preferred transaction size and tend to avoid small deals, leaving those opportunities to independent players. To ensure profitability from small deals, companies need to develop strong credit-scoring capabilities and streamline internal operations while managing a high-volume shop. In many cases banks prefer to focus on more customized transactions — those that require greater risk structure — a capability many banks possess because of their long focus on middle-market and corporate banking requirements.

While transaction complexity may increase risk, banks pursuing those types of transactions justify that approach by the attractive returns those deals generate. One bank that buys participations specializes in deals that have multiple takedowns and multiple locations. This specialized approach generates a higher yield for the bank and also allows the bank to take advantage of the strength of its back-office operations area, a group that it believes distinguishes the bank's capabilities from others. This bank may be the exception, however, as other banks avoid complex transactions, often in response to the concerns of internal risk management and compliance groups.

Options related to the origination approach, specialization, transaction size, and complexity demonstrate the multiple strategic choices available to banks and the need for bank management to assess the various alternatives open to them. Determining which strategic paths to pursue requires consideration of a bank's current status in equipment finance, its risk management appetite and compliance capabilities, its skill set, and the competitive intensity of the markets and segments in which it intends to operate.

THE ONGOING ROLE OF INDEPENDENTS AND CAPTIVES

In recent years, both captives and, in particular, independents have suffered as a result of the downturn. Independents in particular have faced a higher cost of funds. At this point, however, performance has improved, and most bankers see independents as competitively vital. One banker summarized the view of others in saying, "I don't believe in the death of the independent." In fact, many see independents as well positioned for growth.

Much of that growth results from operating in areas many banks avoid. Frequently, independents (and captives) focus on a different tier of credits versus the banks. One banker underscored this point by saying, "It is difficult for us to do a 'B' credit. That is something independents can do more readily."

Independents can also focus on niches that most banks avoid, such as aspects of high tech, and can operate more easily in countercyclical areas. One banker mentioned the coal industry, which many banks are avoiding, allowing independents to write deals with stronger structures and higher yields because of limited competition.

Further, while many bankers are building their presence in equipment finance, as a group, they are less involved in writing leases that have substantial residual risk: another opportunity for independents. One independent noted, "That's why the banks call themselves equipment finance groups, not leasing groups."

The equipment finance and leasing business remains large and complex enough to allow both captives and independents to survive and thrive. Overcoming the banks' funding advantage, independents can apply expertise to a niche focus, can market where the banks cannot or will not operate effectively, and likely can adapt more readily than most bank-owned companies because of their flexibility and relative lack of internal bureaucracy. As long as ample funding remains available to them, independents remain well positioned.

FUTURE SCENARIOS: WILL BANKS CONTINUE TO DOMINATE?

Virtually every bank or bank-owned leasing executive who was interviewed as part of the research for this report for the Foundation expressed the view that banks were in this business for the long term and that banks would continue to have a dominant hold on business generation. Several factors contribute to this view, such as a major funding advantage for the banks, existing customer relationships that can be developed further, bank infrastructures that can be leveraged at low additional cost, improved compensation programs that encourage bank cooperation, greater focus on sales across the bank, and an increased risk appetite for nontraditional businesses such as leasing.

As banks are demonstrating, equipment finance is a business in which they can thrive, whether through acquisition or by attracting teams of experienced employees, and in a relatively short time benefit from high-quality and high-return asset growth. Importantly, as occurred during the last decade, it is also a business that banks can reduce without exiting, should the need exist due to bank liquidity or other issues.

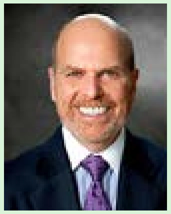
Overcoming the banks' funding advantage, independents can apply expertise to a niche focus, can market where the banks cannot or will not operate effectively, and likely can adapt more readily than most bank-owned companies because of their flexibility and relative lack of internal bureaucracy.

Banks may change their strategies and priorities related to this business, but wholesale abandonment of equipment finance appears unlikely, given banking's limited growth options and the growing positive impact of equipment leasing on overall bank performance. However, both independents and captives have capabilities that the banks do not possess, providing these competitors with exploitable advantages.

Banks and their nonbank competitors differ significantly in their view of the willingness of banks to remain in the equipment finance business through the next down-cycle. The bank industry's perspective about the future of equipment finance was summarized by one comment: "I do not see banks moving out. In a downturn, there will be a little tightening of the credit, a little more selectivity, and a little more price tightening."

However, this view contrasts significantly with one independent, who said banks were short-term oriented with many lacking commitment to this business: "Banks go in cycles. Leasing is just another product. Leasing is all we [independents] do. Banks go in and out of products all the time. If they stub their toe, they get out."

Of course, some banks will exit the business or replace their enthusiasm for equipment finance by focusing on another business line. But as the leader of a major regional bank lessor stated for most banks, including his own, this is "not a sideline, but a real business. … Bank-owned leasing companies will not have unfettered growth, but for the next few years there is a great growth opportunity for banks."



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