

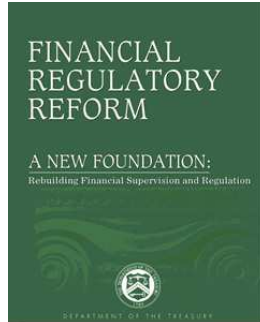
Considerations for Consumer Banking in the Post-Reform World

It's an understatement to say that events over the last three years made it difficult for managers to focus on much beyond short-term survival tactics.

While the industry overhaul legislation remains to be fleshed-out by rulemaking, the fundamentals of it are now clear. It is time for the survivors to begin to consider how to adapt and compete in the new environment. As managers develop plans for moving forward, there are some important considerations that will affect consumer banking in the years ahead.

Different Profit Dynamics for Checking Accounts – For years, much of the industry built its consumer checking account strategy around free checking. However, regulations pertaining to overdraft and NSF fees have permanently changed the profit dynamics of the checking account. Profitability will be further eroded by reductions to interchange fees on debit card transactions. It is incumbent upon managers to refine consumer deposit products to increase perceived value on the part of consumers, better align product features and pricing with segment-specific behavioral considerations, and develop new fee-based services to integrate into the product line.

Bigger May Not Necessarily Be Better – Increased size and broader geographic coverage will bring more costs, increase



the complexity of consumer compliance, and increase the potential for litigation. Institutions with more than \$10 billion in total assets will be subject to direct examinations by the CFPB. Practically speaking, this means they're going to be subjected to a higher level of scrutiny and adherence. Also, these institutions must establish a risk committee and will be subject to annual stress testing for capital adequacy, implying latter that funding incremental growth of the loan portfolio through leverage will be constrained. Lastly, the Federal preemption standard has been weakened, so federally-chartered thrifts and national banks operating in multiple states will be exposed to greater risk of litigation from state authorities. Managers need to account for these implicit and explicit costs when evaluating the relative attractiveness of asset growth opportunities.

The Risk-Return Equation Has Been Permanently Altered – Many banks found success in serving subprime borrowers. Limitations have been placed on credit card issuers' ability to revise interest rates and levy fees based on changes to the borrowers risk profile. Many of the mortgage products designed for the subprime segment have been curtailed or

proscribed and residential mortgage originators must determine if the consumer has a reasonable ability to repay the loan. The CFPB has broad authority to curb practices it deems to be unfair, deceptive, and abusive. The latter term could be broadly defined and could conceivably include the rate of interest, various fees charged on the account, or inadequate disclosures. Collectively, these changes mean that banks will not be adequately rewarded for serving subprime borrowers, will bear the burden of justifying any pricing that falls outside of industry norms, and will be incented to withdraw from serving segments where risks cannot be adequately priced.

The regulatory changes coupled with projected slow economic growth pose significant challenges to the consumer banking business for the foreseeable future. Many of the strategies that helped generate growth before the crisis will either not be permitted or will be significantly less profitable. Managers should plan accordingly.

CPG can help you address post-reform issues including:

- ◆ Product redesign
 - ◆ Asset diversification and growth strategies
 - ◆ Acquisition integration
 - ◆ New regulatory reporting and analysis requirements
- Contact us at 202-337-7870 today to discuss how we can help.

Big Bank Repositioning is Underway

In the wake of regulatory overhaul, several of the largest bank holding companies are divesting business units. Below are some examples of recent steps taken by the nation's largest banks.

- ◆ Goldman Sachs Group and Morgan Stanley are planning to spin off proprietary trading units that would be restricted under the Volcker rule. Morgan Stanley is spinning off its hedge fund, FrontPoint Partners.
- ◆ Bank of America Corp. is contemplating a possible sale of its stake in BlackRock, as well as the bank's \$3 billion proprietary trading operations.
- ◆ Wells Fargo & Co. is in the process of closing its Wells Fargo Financial stores nation-

wide and will stop originating nonprime mortgages.

- ◆ Citigroup continues to divest non-core assets. It recently announced that it was divesting its private equity and co-investments businesses, announced that it would sell its UK internet bank, and announced

the sale of its \$3.5 billion multifamily loan portfolio to JP Morgan Chase & Co.

- ◆ JPMorgan Chase & Co. has not announced any divestitures, however plans have been drawn to divest the bank's \$21 billion hedge fund Highbridge Capital, as well as its \$15 billion private equity arm if necessary.

Region	Net Income (\$000) 2Q2010	Net Income (\$000) 2Q2009	Change
Goldman Sachs Group	613,000	3,435,000	-82.15%
Morgan Stanley	1,984,000	33,000	5912.12%
Bank of America	3,123,000	3,224,000	-3.13%
Wells Fargo & Co.	3,145,000	3,249,000	-3.20%
Citigroup, Inc.	2,725,000	4,245,000	-35.81%
JPMorgan Chase & Co.	4,795,000	2,721,000	76.22%

Source: CPG analysis of data from SNL Financial, LC 2010. Net income is after extraordinary items.

The Importance of Small Community Banks

American Banker Viewpoint, August 12, 2010

New regulatory and legislative initiatives have given rise to concerns that increased regulatory costs, both implicit and explicit, will make it difficult for small community banks to continue operating and may force them to sell or seek strategic mergers.

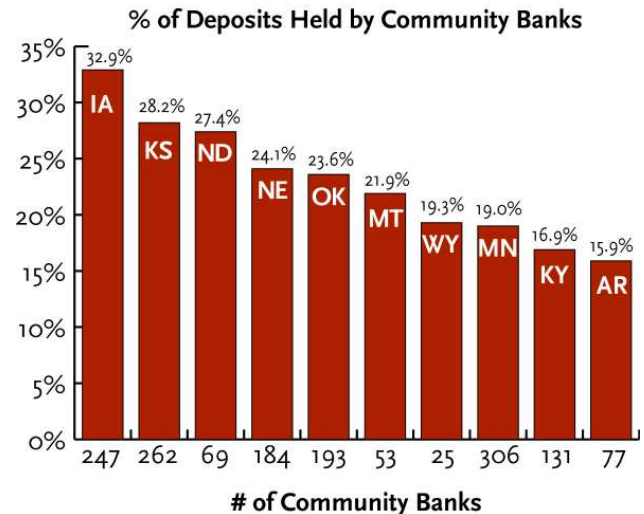
The graph on the right shows that small community banks play a critical role in providing banking services in many states. Small community banks, defined as those with \$250 million or less in assets, hold over 20% of total deposits in six states. These states are less densely populated and have communities that are often located far apart. The demographics and geographic characteristics of these banking markets often make them less attractive to large banks and also suggest that mergers between small community banks aren't likely to yield significant operating efficiencies.

In light of these considerations, regulatory authorities would be well advised to modify their approaches to implementing certain new policy directives in small community banks. For example:

- ◆ The prevailing examination approach seems to be to insist on write-downs and reclassifications of commercial real estate loans or other loans whenever there is a doubt about the condition of the loan. This is not always the right course of action. Examiners must give the benefit of the doubt to management when appropriate. Otherwise they risk hindering the ability of small banks to lend monies and remain competitive.
- ◆ Small community banks should not be required to raise and

maintain capital levels significantly above the minimum regulatory levels established for well-capitalized banks. The recent crisis was not caused by excessive leverage among community banks.

- ◆ Regulators should allow, without penalty, small community banks to use certain types of non-core funding such as FHLB advances and CDARs reciprocal deposits. These are vital forms of funding for institutions that do not have the wherewithal to build expensive retail deposit gathering capabilities.



Source: CPG analysis of SNL Financial, LC 2010.

New De Novo Banks Weathered the Economic Storm

CPG analyzed the group of 297 de novo banks that began operations in 2006 and 2007. The results surprised us. The mortality rate among those newborn banks was a low 3.4 percent. An additional 3.7 percent merged. Among the 276 survivors, the majority were profitable by 1Q 2010, had loan to asset levels approaching industry norms, and manageable levels of nonperforming assets to boot.

Studies have shown that, in contrast to start-ups in other industries, almost all de novo banks survive their first years of operation. This makes intuitive sense given the regulatory scrutiny that new charters are subjected to as well as their large capital cushion. The period of greatest vulnerability begins after the first five years or so, when the bank has completed its initial growth spurt and meaningful earnings growth becomes harder to achieve.

Region	De Novos Formed 2006-2007	# of Failures	# of Mergers (Closed or Pending)	Financials of Active De Novos, 1Q2010 Median			
				Total Assets (\$000)	ROAE (%)	Loans/Assets (%)	NPAs/Tot. Assets (%)
Southeast	116	5	5	149,179	0.43	72.14	3.37
West	72	1	4	104,129	-2.30	71.47	2.07
Midwest	39	2	0	98,811	3.16	77.72	0.75
Southwest	33	0	0	130,505	1.50	71.50	0.73
Mid-Atlantic	32	2	2	136,066	3.46	73.67	1.14
Northeast	5	0	0	99,061	2.30	64.20	1.64
National	297	10	11	122,521	0.84	72.78	1.73

Source: CPG analysis of data from SNL Financial, LC 2010. Data as of March 31, 2010. Excludes banks affiliated with an existing holding company and specialty purpose charters.

Announcements

CPG is on Facebook! For real-time updates on the latest in CPG thought leadership – including sneak previews of Wire articles – check out CPG's page and become a fan today.



Read Gary Stein's article "Fewer, Leaner, and More Engaging" in the September issue of the *ABA Banking Journal*.

CPG welcomes new Consulting Associate Joe Cady. Joe has over 20 years of experience in strategy formulation, strategic planning process design and board-management relations. See Joe's bio at <http://www.capitalperform.com/our-professionals>.

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