**Harland Clarke Webcast 09/21/16**
**The Retail Banking Challenge: Opportunity or Armageddon? TRANSCRIPT**

**Presenter:** Christine Ahlgren, Payments Marketing, Harland Clarke
**Presenter:** Doug Freeman, Former Chairman and CEO of Netbank and Other Senior Positions in US Retail Banks

**Jeb:** Good day, and welcome to Harland Clarke's speaker series The Informed Banker. Today's topic is The Retail Banking Challenge: Opportunity or Armageddon? This webcast is being recorded, and you will be sent a link for playback next week. If you have questions at any time during the broadcast, please use the chat box located in the webinar control panel. Your questions are private, and they're only seen by the presenters. I would now like to turn the call over to our host, Christine Ahlgren, with Harland Clarke Payments Marketing. Christine, you have the call.

**Christine:** Thank you, Jeb. We're really excited to bring you the fourth segment in our Harland Clarke Informed Banker Series today with industry authority Doug Freeman. Doug is going to talk to you about the challenges impacting retail banking today. If you've missed any of the previous sessions on topics like the challenges of managing social media in a highly regulated environment or implementing complex new banking technologies like EMV, please visit the Harland Clarke website, where you'll find recordings of those previous sessions. This session has been designed by you through your generous feedback on topics that are of interest to you. We are currently working on additional future sessions, and we'll notify you as soon as those are scheduled.

Let's move on to why you're here today. We are very proud to bring you the keen insights of Doug Freeman. Doug has held leadership roles in banking for 45 years and has made a career of advising banks that are facing tough strategic decisions. Doug is going to present his information now, and he's leaving a lot of room for questions, so please be ready to enter those questions in the Q&A panel on your screen. Doug, thank you again for being with us today. The floor is all yours.

**Doug:** Thanks, Christine. My format is I'm going to spend about half of the meeting going through some industry data, setting the challenge and what the industry has to do. Believe me, I'm on the board of a hedge fund, Second Curve Capital, that invests in financial institutions, and we have never seen a tougher environment for generating returns for the shareholders in our careers. I'm going to spend about half the time setting the stage and then about half the time answering your questions and giving some advice.

Let's talk about the profitability trends in retail banking. The first slide shows you what our spread and fee income has been over the last ten years or so. You can see that the industry, although ten years ago we made a certain amount of revenue, that's the same amount we make today. In a decade, there's been literally no revenue growth in the financial industry. Part of this is caused by our net interest margin, which, as you know, is a difference between what you generate on your loans and assets and what you pay on your deposits. Back in 1984, we were at 300 basis points; today, we're at 300 basis points. From '84 to 2016, which is 30 years, we've made zero progress in making our industry more profitable.

All the banks will tell you, "Wait until interest rates go up. We're going to see our margin go up." The fact of the matter is that's not true. In annual reports today, every financial institution has to disclose the impact on their margin of a 100-basis-point parallel shift in rates, and you can see that there are anywhere from 2.5% to about 6% gross growth in margin with interest rates. If people are sitting and waiting on interest rates to happen, and that's going to be their salvation, the math just tells you that's flat not true.

Part of the problem is if you look at the growth of bank deposits as a percentage of nominal

GDP, which is a really good way to think about it, the GDP is the industry's revenue, and what are the deposits as a percentage of that? You can see that we've had great growth since 2005 in deposits, but what's the problem? Look at the gap between deposit growth and loan growth, the red line being deposits and the blue line being loans. We currently have a $2.5 trillion deficit between the deposits and the financial system, and loans in the financial system. The fact of the matter is if we don't get loan growth going as an industry, we're never going to improve our profitability.

If you look at our fees, in between our Consumer Finance Protection Board and all of the regulations and all that are coming on, we see absolutely zero growth in fee income. As a matter of fact, most financial institutions are struggling just to maintain the current levels. As I used to say, it doesn't take the world's smartest bank analysts that went to the Midvale School of the Gifted to figure out that there's low to no revenue growth in our industry. Frankly, over the next five to ten years, I don't see it changing very much.

With that in mind, if you look at retail expenses in our industry, they are way too high. If you look at the first growth about US bank and thrift branch counts since 2000 to 2004, you can see that we grew. Compound growth of branches is 2% in the first part, and we're bringing it down some today, but not very much. Look at the number of FTE at banks. Between 1994 and 2004, we added 500,000 new bank employees, 500,000. That's a stunning number, and frankly, one the industry can't earn through anymore.

What do you do? Branches are still important, but their activity is in permanent decline. If you look at this slide, with the top line, blue, being branch banking, and the percentage of households who use it, you can see branch banking on a precipitous decline when compared to direct deposit and remote deposit capture, and mobile banking, and all that. Consumers are voting with their feet out of your branch system. Why is this? It's because our behaviors are changing. The world is getting more digital, and consumers are increasingly pursuing mobile and digital payment options that allow them to bank where they want to, when they want to, on the device that they would like to bank it on.

Now, many bankers that we consult with said, "Oh, that's just the young people doing this." Not true. If you look at this chart, this shows you by age count percentage of people that use primarily the mobile device to access the internet. You can see that, if you look at the 18-25 millennial position, a few years back 36% of them used mobile, and today 38% of 45-54 use mobile as their primary device. What happens is the older people are adopting the technology; it's just lagged a few years to the younger. If you want to know what it looks like in ten years, it's going to be a stunning reversal of where transactions are being performed.

With that being said, if branches are important but they are in permanent decline, and you say, "Okay, we're going to close some branches to save some money," it is a very difficult challenge because deposits are concentrated. If you look at this slide, over 90% of consumer and small-business deposits are held in the top two deciles. Twenty percent of the branch customers own over 90% of the deposits.

Unless that doesn't make you have an upset stomach, look at the next slide. Over 20%, 23%, of consumer and small-business balances are held by the top 1% of the customers in your branches. As we go about the process of whittling down branches and redoing distribution, if we lose any of the 23% or the 20%, we're dead in the industry. It's an extremely difficult challenge to figure out what do you do, where do you do it, and who do you do it to.

The next thing we have a challenge with is oppressive and inconsistent regulation. Every bank we talk to today is going crazy over things like Dodd-Frank. Just to give you a feel, in September of '15 we only had about two-thirds of the Dodd-Frank rules written. We only had about

another 10% or so that are being proposed. You all know how it works. When the regulators want to do something, they write a law and have regulations sent out to you for proposal, and we still have about 20% that they haven't even drafted what the regulation is going to be yet, and this is Dodd-Frank that has been there for ten years. From a regulation perspective, we are dying on the vine.

Then what really makes this challenging is customer-facing technology is more important every day, and banks flat are not winning. If you look at just this one chart, that shows you. The dark blue is the financial institutions and what their percentage of payments business is. It's been on an unbelievable decline against nonbanks.

With that being said, again, when we visit with CEOs and CFOs of banks and we talk about the challenges facing their organizations over the next three to five years, every one of them says, "We don't know where additional incremental revenue is coming from. Our expenses are extremely high. We don't know how we're going to cut the expenses we need to cut and not lose our most profitable customers in the process." With that being said, I would like to open it up for some questions from you all.

**Christine:** Hi, Doug. I'm taking a look at our question panel, and I have a few questions popping up I can start with. This first question says, "If cost savings are so important, what banks are doing the best job?"

**Doug:** I think there are a number of them who are doing a good job. I'll pick just some big ones and then I'll talk about some small ones. B of A, amazingly enough, four years, they had 108,000 employees in their retail bank. Today, they have 58,000, and they intend to take another 10,000 out over the next 12 months. Bank of America is doing a good job of cutting cost and replacing it with technology. I know Wells has been beaten up over other issues, but I think they have a wonderful retail platform that they're reengineering rapidly.

The big challenge is are they going to be able to keep up with financial institutions that never had the embedded base of branches, like internet-only banks and companies like Cap One, who did such a good job on the credit card side. From my perspective, in big banks, they're using technology to leverage. Then, on the small bank side, it's amazing that the smaller the bank, the more the CEO every day is aware of what the issues are, and it doesn't take them long to fix them. A lot of the smaller banks are more flexible. The challenge that they have is that their strategic positioning has always been customer centric, customer relationship driven. How do they balance using new technology with the past, which was their old values of customer intimacy?

**Christine:** Thanks, Doug.

**Jeb:** As a quick reminder, Christine, I thought I'd remind everyone that you can enter your questions in the chat panel. If you don't see the chat panel, you may have to pop it open, but it's at the bottom. Go to webinar control panel on the right, and those questions will come into our question panel. Thank you.

**Christine:** Thanks, Jeb. We have some more here. Doug, will the big banks abandon rural markets? That's an interesting question.

**Doug:** I'll give you a politician's answer. I remember back in NCNB, or Nationsbank, days, Hugh McColl, their CEO, made an infamous public comment that he didn't want his bank to be in every pig path in Georgia. Now, being a nonpolitician, that probably wasn't a bad statement. Being a politician, you could never get away with saying you don't want to be in every pig path. I'll also say that, from my perspective, I was with Barnett Bank for a while, and we had banks in big

cities and small cities. Predominantly, the small cities dominated the return on equity. They didn't dominate total return because their market potential was small, but they were able to be more efficient than banks in big cities.

I think that you will find people that have a niche that understand how to serve small and rural markets, and as long as they do that well, they'll succeed. If you took a JP Morgan Chase and put them on every pig path in Georgia, I don't think they would do well. I think that the secret sauce is knowing who you are as an organization, knowing what your skillset is, and then matching your market up against what you do well.

**Christine:** That makes sense. Thank you, Doug. Next question: What role will interactive teller machines play in the future?

**Doug:** What role will automated teller machines play in the future?

**Christine:** Interactive teller machines.

**Doug:** Oh, interactive ATMs. I think, a great role. If you think about it, it's putting an internet device in a mall for a customer to do their banking on. If you go back to the early days of ATMS, you all may not remember this, but the first ATMs you put in a card and they would give you a predetermined package of cash, like $20, four fives, or two tens, or whatever. You didn't even get to say what account and how much.

We've gone from there to where we have ATMs that talk to you; they take digital images of deposits, and all that. I think that they'll merge with technology to allow customers to do self-service shopping, investing, buying a share of stocks, looking at their investment accounts, and getting balances. I would say that is a substantially cheaper alternative than having people sit at a desk waiting on someone to queue up for a service.

**Christine:** That makes sense. What about, Doug, your thoughts on overdraft and NSF fees, and what the CFPB's view is?

**Doug:** It's amazing in the business world, and our industry took a major hit yesterday with Wells testifying, but it's amazing how politicians want to tell us how to run our business. Overdraft fees were one of the most primary sources of fee income in most banks. Did the industry probably go too far? Yes. Is the CSFP going too far? Yes.

I think the challenge for most of the banks isn't complying with the law, although that is in and of itself a challenge; the challenge is replacing the revenue. If you were covering 60% of your cost structure with NSF fees, wow, what do you do? You're not going to get the 60% anymore, so what are you going to do to do it? There's no option but to take expense out of the system, in my opinion.

**Christine:** Makes sense. Not so easily done, though. How about this? Do you think that the branches are ever going to actually become obsolete, where we're going to have an environment with no branches at some point?

**Doug:** I can remember back in 1980 we used to talk about the branchless world. Now, most of you all might not have been born in 1980, but we were convinced that by the year 2000 there would be no branches. Now the year is 2016, and you hear some soothsayers say by the year 2030 there will be no branches. I don't buy that.

I don't buy it because if you read customer surveys, I think the number is almost 85% of customers who open an account online with the bank go into the branch to fulfill it. Gosh, how

are we going to do that? Then you start looking at other internet companies like Amazon and all, and what customers rate their customer service, and what they don't like because they can't get to see a person. I think the balance is how do you architect a branch structure at a cost you can afford to be able to do what the customers want. I don't believe I will be alive when they close the world's last branch. It's going to be a while.

**Christine:** Thank you, Doug. Another question here: Why is your prediction of loan growth so low?

**Doug:** That's a good question. Let's go back to things like Dodd-Frank. I personally believe that regulation and things like Dodd-Frank are one of the biggest detractors of our economy today. If you look at historically, small business counts in the United States grew year after year, and they were the predominant hirer of employees. All job growth came out of small businesses. Today, small businesses are actually declining in count, and the jobs are not being filled. They're being let go from small businesses today. Why is that? Because small businesses can't put up with the regulation. Small banks can't put up with the regulation, and small banks were the dominant lender to small businesses.

I believe two things. I believe that the small business market has been decimated by overregulation. Then, conversely, you have a consumer out there who really doesn't feel very good about the economy. Other than auto loans, which have done very well, there's no borrowing for home equity. We're paying down credit cards and all that. To turn this thing around, we need the consumer feeling better about themselves and borrowing money, and then we need somehow to get the regulators out of small banks' hair. Let them start taking care of small businesses again.

**Christine:** No small feat.

**Doug:** Yep.

**Christine:** Doug, what do you think the Fed is going to do this year on interest rates?

**Doug:** I've said for the last 12 months they're not going to move. I've said they aren't going to move, and at 2:00 they decided they're not going to move. The reason is very simple. I've sat on Greenspan and Bernanke's advisory board for years, and if you look at the unemployment rate – and the rate you're being communicated today is not the real rate; it's not the way we used to report – and customer sentiment is not that good, business sentiment is not that good, so if you go raising interest rates, you have the very likely probability that you could choke off whatever spark of a recovery, as small as it is, that is coming. Factor into that international issues like Brexit and all that, I think it would be malpractice, in my opinion, for the Fed to raise rates now.

**Christine:** Okay, that's clear. What about the digital delivery? Who is doing well getting their business into a digital environment?

**Doug:** Again, I think Wells and B of A. I'll get to this when I summarize things. The challenge that most banks have today is how do you challenge Wells, and B of A, and JP Morgan, who have unlimited budgets to do all the bells and whistles in technology, and how do you do that if you're a $100 million community bank, or you're a $5 billion local bank, or something like that? I think if you look at the top three banks in terms of everything they're doing, it's not just the delivery of the technology; it's the mining of the data on the customers behind the delivery technology. They are, in my opinion, far above everybody else.

**Christine:** Okay. Thanks, Doug. We still have a few more questions. It looks like we have some time, so that's great. The next question is is there room for a person-to-person business model in, say, ten years.

**Doug:** I think there's room for a person-to-person business model in 110 years. A lot of the people who hawk technology to the detriment of everything else don't understand. If you look into the American psyche, they like their money, in many cases, more than their family. With that affinity to say I like and I want to control my money and I want it to be safe, I think there's always going to be a number of people that say, "I need to have a name I can talk to if I have a problem, or if I need to buy something, or I need advice," or whatever. I believe we can put all the kiosks out there want and have somebody in Bangladesh or whatever answer the phone and answer their questions; I don' t think that's going to replace the real business of person-to-person banking.

The higher up the spectrum of financial customers you go, the more you're going to see this. When we started small business banking 40 years ago and we surveyed customers, what do you want, they said I want a bank who knows me and knows my business. We did that same survey today; they want a bank who knows me, knows my business. That hasn't changed in half a century, and I don't think it'll change in another half a century for business. Then for the upper-end wealthy, again, it's a person-to-person business. We could get into some hashing of segments as you move your way down the food chain, but I believe there's always a model that one could run profitably if the revenues are in line with what it costs to deliver that.

**Christine:** It sounds like that supports your theory of the branch model not disappearing any time soon.

**Doug:** Yeah, I think it will change. All the branches are being closed today. Somebody asked me, "What do you think will happen to all those branches?" I said, "There are only so many take-out Chinese restaurants that one city needs," because that's the only thing I think you could do with one. What else would you put in there? A dry cleaner or a Chinese restaurant. That's all I can think of. I think we have some issues we have to work through.

**Christine:** I know you've touched on this today, Doug, but can you specifically talk about what the industry can do to improve fee income?

**Doug:** Yeah. I think that we have to do a number of things. Number one, we have to make sure that our product balance is appropriate. For instance, merchant credit card fees are a nice source of income from small businesses. You can still do some overdraft fees. You can more accurately price your maintenance and per-check charges on products. I think that Harland has a number of solutions, like get everybody to buy their checks from you. It's my understanding, isn't this right, that less than 50% of bank customers buy their checks from a bank?

**Christine:** Correct.

**Doug:** Gosh, look at all the money there we're leaving on the table. I think we just need to, instead of taking a blunderbuss to it, use a microscope and a scalpel and figure out customer by customer what does that customer need and how can we figure out how to handle it. Again, I think the business mix factors into this. The better your corporate C&I mix to retail, the more fees you're going to have. The higher your retail to C&I, the lower your fees you're going to have. There's still plenty of value banks add; they just have to figure out how to charge for it.

**Christine:** It's 2:26 right now. We have time for maybe one or two questions, so if anyone has any last-minute questions, please submit them now. Right now, I do have a question for you, Doug, and that's is there a chance that we'll get some regulatory relief.

**Doug:** No. I don't know if you all watched John Stumpf being I want to say interviewed, but a better verb is grilled yesterday. It's against that backdrop that banks are persona non grata. When I went into banking, I would walk down the street and I was proud to be a banker. Today, I walk

down the street and pretend I'm a real estate salesman or something. Our industry has just fallen on disfavor in Washington. They don't trust us. They think that we're a bunch of bad people up to bad stuff, which is 180 degrees from the truth.

Until we can get our credibility rebuilt, and the Wells thing went a long way to setting us back two or three years, unfortunately, I see little hope that we're going to have regulatory relief. I actually am worried that we're going to have more regulations. Believe you me, the CFPB will put out regulations against cross-selling. Now, I don't know what it's going to look like, but there's going to be something that comes out against cross-selling.

**Christine:** Doug, you mentioned reputation. This is the last question of the day. Hopefully, there's some solution, some magic trick to help banks move that reputation or repair it more quickly. Is there something banks should be doing right now to help with that? We know what they shouldn't be doing.

**Doug:** I think, like all problems, the first thing, if you find yourself in a hole, stop digging. We as an industry have to stop digging. Then what we have to do is we have to win our reputation back a customer at a time. I wish it was easier. I wish there were direct-mail campaigns or digital marketing campaigns, or whatever.

Some of that may be apropos for certain segments, but at the end of the day, if I was running a financial institution today, I would make sure at every touchpoint, every time a customer touched us, we shined and we would begin growing our trust with that customer back. That's hard work, but that's what the industry has got to do. Each of your financial institutions on the line, that's what you all have to do. If we don't, that customer is gone. They'll go somewhere else and take their money with them.

**Christine:** That sounds like a perfect endpoint, Doug.

**Doug:** I've got my summary to tell them what we're investing in at Second Curve, if I have another second.

**Christine:** Sure. Go right ahead.

**Doug:** With all that being said, who are we investing in today? They're going to be some winners that maximize the whole way of banking through superior execution. There are a number of community banks and credit unions who are superior at this. Some will try to win with a niche focus, like a Cap One, and some will capitalize on the tremendous change in economies of scale, like Wells and B of A.

Who don't we like? We are not fans of $100 billion banks or bigger with no focus because we think if you're not focused on what your strategy is, and your game plan, you're going to get crushed by the people that do. Most of the consolidators, banks who buy other banks, we short them because we think that model has run its course. With that being said, thank you very much for your time.

**Christine:** Thank you, Doug. For all those on the phone, as a follow-up to today's program, you can expect an email from Harland Clarke with a follow-up survey along with some links to the recording of today's presentation. Please feel free to share that recording with any of your colleagues who may have had to miss today's session. Doug, thank you again for your valuable insight, and thank you to all the participants who made it a priority to be with us today. Jeb, do you have any closing comments?

**Jeb:** Yes. First of all, thank you, Doug. Just a clarification, please do take a moment and answer that

survey that will be coming in email. You'll get another email next week which has the recording. We actually have to do it. It take us a little time to bake it, so watch for two emails, one today with the survey and then one next week with the replay and a copy of the deck. Thank you all for attending this audiocast. This concludes today's webinar.