Harland Clarke Webcast
The Informed Banker – The Retail Banking Challenge: Opportunity or Armageddon?

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

Nathan: Good day, and welcome to Harland Clarke's Speaker Series of 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, as well as a PDF of the slides. If you have questions, please use the chat box located in the webinar control panel. Your questions are private and are only seen by the presenters. I will now turn the call over to our host, Christine Ahlgren, with Harland Clarke, Payments Marketing. Christine, you have the call.

Christine: Thank you, Nathan, and welcome to everyone who has joined us today for this encore presentation of The Retail Banking Challenge: Opportunity or Armageddon? with industry authority Doug Freeman. We had such a strong response following the September installment of the program that we've invited Doug back to present this important content to those of you who may not have been able to join us for the last session. Doug will speak to you today about the challenges impacting retail banking today. The Informed Banker Series as a whole has been designed by you through your generous feedback and direction on topics that are important to you. Please join us again on January 25 for the next topic, which will be Attracting and Engaging the Young Adult Gen Z Market.

Let's move on to why we're here today. We're very proud to bring to you the keen insights of Doug Freeman once again. 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 will present his information now, and leave a lot of room for questions. Please be ready to enter those questions in the chat panel on your screen as Nathan just mentioned. Doug, thank you again for being with us today. Take it away.

Doug: Thank you, Christine. I look forward to spending the next 30 minutes with you all, and what I intend to do is spend about 10 or 15 minutes or so going through a setting of the stage of what we see going on in bank earnings today. When I say we, I'm on the board of Second Curve Capital that's an active investor in bank stock. We spend our days consulting with CEO's and boards and reviewing financial statement of banks trying to understand trends and what banks are trying to do to solve them. My topic today is Retail Banking: Opportunity or Armageddon? I will say, in my career, I've never seen a climate like this. It's so

challenging for bankers and bank investors.

What I'd like to do is set the stage, and first off, I'd like to talk about some profitability trends in retail banking. First, if you look at our net interest spread and our fee income, if you look at quarterly noninterest income, which are fees over the past ten years, they've been flat as an industry. Then if you look at our net interest income, which is our margin, you'll see that that's literally been flat for the last ten years, so there's been no growth in either spread or fee income in the bank. The reason for that is, if you look at our quarterly net interest margin, which is a difference in what we achieved on our assets versus pay on our liabilities, the industry is at 300 basis points or 3%. That's the same number we were at in 1984. If you think about 1984 to 2015, there's been zero growth in net interest margin. It's really a tip-off on why banks are having a tremendous revenue problem these days.

Then you talk to banks, and banks will say, well, when interest rates go up, we're going to solve this net interest margin problem. The answer is that's not really true. All banks today have to report in their annual report what happens to their net interest margin if there's a 100 basis point parallel shift in interest rates. If interest rates go up 100 basis points, BB&T's, Branch Banking and Trust margin will go up 2.5%. At the end of the day, there's really nothing that banks can count on to speak of of a rising rate environment to help the revenue problem. What's causing the problem? If you look at U.S. Bank deposits as a percentage of nominal GDP, which is a way a lot of analysts look at it, which answers the question have we had good deposit growth over the last few years? The answer is we've had stunning good deposit growth since 2005 to 2015.

What's the problem? The problem is loan growth. On this slide, what you see is there's a $2.5 trillion difference between deposit growth and loan growth. Stated another way, if you look back at 2007 to 2009, the growth in deposits and growth in loans in the banking system tracked each other. Starting around 2010, we've had a really substantial downward pressure on lending by U.S. Banks relative to the amount of deposits that they generate, and if we don't fix this, I think that our margin is going to suffer for a long time. You then look at the fee income side, and between the Consumer Financial Protection Board and the regulations on NSF and things like that, the fact of the matter are that we really don't have fee income. It doesn't take the smartest bank analyst for Midvale School of the Gifted to know that, from our perspective, there's literally no growth in the economy, so there's low to no revenue growth.

The next challenge we have in the industry is our retail delivery expenses are just way too high. If you have no growth in revenue, either fees or spread, then the only way you're going to generate more money to pay more salaries to your

employees or reward shareholders is by controlling and cutting expenses, and today, retail delivery expenses are way too high. If you look at U.S. Bank and Thrift Count, the reason we have such high expenses is back from 2000 to 2009 we grew branches like there was no tomorrow. We grew 15,000 branch and delivery points in that 10 years, and today, although they're coming down, they're not coming down very quickly. If you look at fulltime employees at banks from 1934 to 2014, in 1934, there were about 200,000 employees in banking. Then with the recession, it went down, but let's look at 1994 to 2014. In 1994, there were about 1,500,000 employees in banks, and we grew by 500,000 employees over the next 10 years, 500,000 employees. Those were generally retail employees. If you think about it, the challenge that we have is that branches are still important but activity in branches are in permanent decline.

If you look at the channel penetration, with the dark blue line at the top of the page being branch banking, you see that starting in about the year 2000 we've undertaken a pretty precipitous drop in terms of how many – what percentage of the households are using branch banking. Compare that against direct deposit, or ATM, or remote deposit capture, or mobile banking, those kinds of things, all the other channels are growing substantially while the branch channel is actually shrinking. Why is our behavior changing? It's changing because of the increasing digitalness. A lot of English professors have told me that's not a word, but I'm going to use it anyway. Consumers are increasingly using mobile and digital payment options. Whether it's Apple Pay, or Samsung Pay, or Google Wallet, Visa Checkout, I mean, customers are moving quickly, quickly away from yesterday's payment system to tomorrow.

A lot of people will then – a lot of CEOs and boards will say, well, Doug that's only for millennials who are doing this kind of behavior, and in this slide, it's stark. If you look on the left side of the chart, you'll find that people from 18 to 25, back 3 or 4 years ago, 36% were using digital mobile devices to do their banking. Then if you look at the 45 to 54, the getting to be a senior citizen, a scant 3 years later, 38% of them are using mobile devices to do their banking. If you think about it, today's 50-year-old is a 20-year-old 3 years ago. What's that going to look like three years from now? You're going to have millennials at 90% and old people at 80%. You can't discount the trends across, and blame it on the young people are doing it, but the old people aren't. They all are using it.

The next challenge we have – when we talk to banks about we need to close some of these banks, the challenge is how deposit balances are concentrated, and some of these charts just leap off the page in terms of how relevant they are. In deposit balances, over 90% of consumer and small business deposit balances are held in the top two deciles. In other words, 2 out of 10 customers owe 90% of the deposits in our branches, stunningly concentrated. If you think

that's unbelievable, in the next slide, 23% of our deposits are held by the top 1% of our customers in our branch system. As we begin the process of trying to scale back branches, if we make any of these 23%, or 90%, or whatever move, the people with the balances leave, and we're left with the other 90% that have no balances, literally. It's one of the most challenging exercises that we work with banks on today.

The next challenge we have is that customers and employees are self-selecting out of larger bank networks. What we see is a lot of banks, a lot of the larger banks, are losing customers and losing employees to smaller banks. Then the last challenge we have is our regulation, and regulation today is driving us crazy. You all may know this, but here's Dodd-Frank Progress Report. Just to remind you of how it works. When they pass a law, they propose rules. They have a law. They then propose how they want to implement the law and finalize the rules, so in 2011, less than 10% of Dodd-Frank was finalized. In 2015, two-thirds are finalized, but the other 30% are either in proposed rules, or they haven't even thought them up yet. If you think about it, the regulatory burden is stunning today. It's a huge challenge for banks.

Then the last thing is, in terms of customer-facing technology, the internet, the mobile, the FinTech, and all that, I would like to say that our industry is winning, but I don't believe they are. I believe that the smaller, the mobile, the FinTechs are really beginning to eat our lunch here. If you look at this chart, the dark blue line is the depository institution in terms of their share of financial intermediation. Look at the other financials. They eclipsed us back in 1990, and we and the insurance companies are going down. We really do as an industry have a huge challenge. Everybody's going mobile. Everybody's going internet. Everybody's going electronic transactions, and we're not winning that war.

With that being said, we have about 15, a little over 15 minutes, and I'd be glad to take your questions.

Christine: Doug, this is Christine. I will read the answers from the panel of questions that are being asked from the group here. One is you just mentioned Dodd-Frank. Do you see a delay in moving the proposed rules into a final rule state given the results of the election?

Doug: I'll give you two answers. The answer I hope, which is yes. The answers I expect, which is probably not. Just to remind you all how this would work. You would not only have to have the executive, but you'd have to have the legislative branches go with you in terms of pruning back some of those regulations. It hasn't been long ago that banks got a black eye for our practices, and then we weren't helped a month or so ago with Wells Fargo and their sales practices. I'd like to say that, when I walk down the sidewalk in a city, I'm proud to say I'm a

banker, but I actually hide my nametag in my pocket.

Christine: Okay. Thank you. Let me grab another question here for you. If cost savings are so important, what banks do you see that are doing the best job, Doug, and what is it they're doing and why?

Doug: I'll take two slices of it. First, the big banks and I'll take Bank of America for a minute. I worked there for a number of years. Bank of America had 108,000 employees in their retail bank 5 years ago, and now they have 58,000. They have announced that they'll go to 48,000 in the next 12 months. Think about that number for a minute. Make the math easy, 110,000 to – they've let over half the employees in the retail bank go, and they're not even at their quest yet, at their goal yet. The big banks who are applying technology, whether it be ATMs, and Smart ATMs, and mobile, and all that, they're doing a good job.

Then on the small end of the spectrum, you have smaller banks that are doing a much, much better job of aligning distribution to their customers. I would say that the real challenge are the people who are in the middle who aren't big enough to buy the technology, but yet, aren't small enough to really understand and control retail delivery cost. Those are the ones with the biggest challenge.

Christine: Yeah, makes sense. Okay. Next question, where do you see specific opportunities for banks in the digital space over the next two to three years?

Doug: I think the biggest thing – and I won't use the word cross-sell because that's a dirty word today, but I will use the term about harvesting the profit potential of your customer. I think that very, very few banks are doing what I call a spectacular job of getting 60, 70, or 80% of a financial customer's wallet. Most of them are 10, 20, 30%. The odds of a bank going out there and tripling their market share to be able to react to that I think are very, very low. The odds of someone going from 30% profit penetration to 50 or 60% profit penetration, I've seen that done before, so you can double your revenue just by that.

I will say in one quick deal before the question is asked. Wells Fargo got in trouble because they paid people for volume. Not profitability. We have an expression. Volume is vanity. Profits are sanity. You pay for what you want, and what you want from a customer is a piece of the profitability of that customer. Don't pay for widgets. Don't track widgets. Track how much of a customer's wallet that your bank is getting.

Then the question underneath that is how can we get more wallet? I haven't seen very many banks do a really good job on fee income yet. Having my buddies at Harland on the phone, I mean, how many of your customers are

buying their checks through you, and you get the margin? The answer is a very small percentage relative to what it could be, and the number goes up and up and up from there. How many people have a car loan that don't have their car loan from you? I think the really holy grail for banks tomorrow is saying, listen, if we have a customer, we're going to – we want to own that customer, and we want to sell the customer products they need. We're both going to win in the process.

Christine: Doug, to follow up on that question, do you see any example of digital delivery that is best in class at this point that people should be looking at?

Doug: Yeah. I'll give Wells kudos. I think they're excellent at what they do, and when I was there years and years ago, we were probably one of the best at ATMs in the U.S. They have captured that and moved it forward. Now, they have an advantage. They're headquartered in San Francisco, and Silicon Valley is between 30 minutes and 3 hours away, depending on the traffic to the airport. At the end of the day, they're in the hotbed of that. I'd say they have done a good job be it they – because of their clout has done a good job. Yeah. There are people who've figured it out, and then for the smaller institutions, what they need to do is figure out they tap into that through their vendors, or collective buying arrangements, or whatever to get that technology.

Christine: Yeah. That makes a lot of sense. A new topic, so are there any areas that you see for opportunities for additional fee income that we haven't discussed?

Doug: I think, again, if you look at fee income, things like brokerage, and investment products, and financial planning and all that are loaded with fees, and the banks don't do that very well. Things like annuities are very, very good fee generators, and banks don't do a very good job at that. Although customers buy lots of annuities, generally, they buy them from insurance companies. Not from banks. I think that there are probably no homeruns. We certainly are going to be challenged to offset our loss in NSF income with other sorts of fee income, but that we must do. I mean, we must find a way to do that. I think that it's just there are no homeruns. It's hitting singles, and getting the entire organization to understand what you need to do and mobilize to do that.

Christine: Thanks, Doug. Back to the regulatory environment, I think you've answered this, but just to make sure. Do you see a chance for any regulatory relief? I didn't hear that in what you said so far, but just to be sure.

Doug: Very low probability. I just think that, again, bankers aren't – we don't have the best brand and reputation on the Hill. Elizabeth Warren is certainly not going to back off very much. The hope we may have is that the CFPB was ruled unconstitutional because of the way they're funded and no accountability and

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all that. There may be a crease. I don't see a single person in Washington saying the best thing for me to do is start defending big banks in front of the public. I just don't know that we're going to see that. I hate it, buy I don't think we'll be seeing it.

Christine: Wait and see, right?

Doug: Right.

Christine: Okay. Without banks increasing their NIN or fee incomes, do banks have to find wins where they can in niche markets or opportunities? Is it more important than ever to define your ideal customer? It's a great question.

Doug: I think that's exactly what you should be doing. I mean, in the old days, what we talked about in banking was how many customers we have, and how many products we sold that customer. That's yesterday's thinking. Tomorrow's thinking is what customers do I want to bank and why, right? That's a very different exercise. You're saying that, at the end of the day, there's some customers who have very different profit profiles than others. Good banks that I see are the ones that say who do I want to bank and why, and what do they buy? What do we sell that could meet their needs, and how good a job am I doing selling into those needs?

I think that selecting your customer and the word we use is relentlessly focusing on that customer is a way to succeed. To try to be Walmart or Kmart of the financial industry, I don't see it. Matter of fact, I think both Walmart and Kmart are going to have a very difficult time in the future because they're indiscriminate in terms of customer focus. To me, step one, who do you want to do business with and why?

Christine: We heard you speak earlier, Doug, about this 500,000 influx of additional employees in the banking space, and then it dwindling down again. What's the end state of a branch network look like? Is there a potential for branches to become obsolete over time?

Doug: Yeah. Let me give you one. In case you all would like a little bit of information, SNL puts out a report, and what they do every quarter is they go in and look at bank branch closures. When you close a branch, you have to file and notify people and all that. In the first quarter of this year, 337 branches were closed throughout the United States. Second quarter, it was 481. Third quarter, it was 732. Now, you don't have to be a math major to look at that trend, and you go it's doubled in six months. I suspect it will be well over 1,000 in the fourth quarter. I think what you're going to see banks doing is cutting the number of branches down.

Now, why do I start my discussion of the branch future there? You have to free up the money to do what I think you have to do in a branch, which is make them more relevant. What does that mean? It means that the banks of the future have to have better technology, better trained employees. I truly believe that there's always going to be a place for someone to go down and talk to somebody, and get some advice about buying a new product, or solving a problem, or whatever. In terms of online banking account applications, if I'm not mistaken, the number is over 90% fulfill. They open it on the internet, but they fulfill in the branch. There are always going to be opportunities to be able to exploit that. The challenge is how do I get the low value transactions out of the branch, and how do I take that money and reinvest it in smarter employees, better trained employees, better technology, better customer communication, better products? That's where I think branches are going. Short answer is, in my lifetime, they'll always be branches, but they're going to look a heck of lot different than the average branch today.

Christine: Things like a branch café or all kinds of new business models that are popping up.

Doug: Yeah, I mean, that being like Starbucks. If you think about what Borders Books tried to do was they said the solution to my problem is I'm going to put Starbucks in there. It didn't help them, but it was a great idea.

Christine: I just want let everyone know on a call alert. We have a few minutes left. If you have any last questions, please get them in now. We still have a few in here that I can ask, but just to let you all know this is running down to the wire here. Let us know if you have any questions. Doug, what do you think the Feds going to do on interest rates this year? Is it predictable at this point or not?

Doug: Yeah. On the last call, I said they wouldn't move at the next meeting, and I was right. This time, I'm going to predict a 25 basis point increase. The reason I am is the markets believe in their hearts that Yellen's going to go up 25 basis points. The new President has talked about how rates need to go up a little bit, so I think that all of the arrows are pointing to a 25 basis point increase. You go back to my slide, though. Let you not think that that's going to help you with your earnings issues. It will not.

Christine: With that change, is there any change to the loan growth prediction that you showed us? It looked pretty low. Is that going to affect that in any way?

Doug: It's really challenging. People ask me why is loan growth so bad? I'll go back to Dodd-Frank and some of those things. If you're a small community bank today and your bread and butter forever has been small business lending, the

regulatory paperwork and requirements are such that they almost do no loans anymore. Consequently, no small businesses can get loans, so they're not expanding, and hiring people, and all that kind of stuff. I don't really see small business loan growing. The one bright spot has been auto lending, but the losses are starting to mount up. Most of the banks that we work with are cutting back, throttling back on indirect and direct auto volume. Home equity is tepid today.

When we were on the Fed Board, the economist said if you cut an interest rate, businesses will borrow. I said you're all wrong. They said why? I said business aren't sitting around saying I can borrow money because interest rates are low. They borrow money because they have more customers. They need to put in a factory line. They need another distribution point. They need to add employees and all that is based on economic growth. Not based on interest rates. Until we get GDP north of 1.8%, I don't think you're going to see a lot of loan growth.

Christine: Okay. Doug, one last question, a few minutes we have remaining. I like this one. It's interesting. Do you see big banks abandoning rural markets?

Doug: There was a gentleman, Hugh McColl, who was the Chairman, CEO of Bank of America years and years ago, and he made a statement that he was going to leave every pig path in Georgia. That didn't make him very popular in rural Georgia. The whole concept was if BofA didn't know how to make money in Hahira, Georgia, for instance, and, consequently, they abandon a market because they didn't have a model. They only had one model, which is big city model, which had no applicability in the small town. I see a bunch of banks, and some West Coast banks, and Umpqua Bank, and banks like that who are really good at having multiple models. I think that it's going to depend on how elegant and good the management team is. The more eloquent they are in terms of having defining strategies for multiple market points, you make good money.

The Barnett Bank in Florida, which was one of the best banks in managing rural areas, our most profitable bank was in Okeechobee, Florida. The reason is that there wasn't a lot of competition. It was efficiently run. All of the banks in the small areas had a higher return on equity than the big areas. I think that it's all going to depend on the quality and how elegant people manage.

Christine: Thanks, Doug. That is all we have time for today. Thank you again, Doug, for your valuable insight. Thanks to all the participants who made it a priority to be with us today. Nathan, do you have any closing notes?

Nathan: I just want to thank everyone, again, for attending, and you will receive an email survey today. We appreciate your feedback to help us inform future webcasts. Also, be on the lookout for the playback link and the slides next

week. This concludes the webcast. Have a good day.