



### Four Years On: Gramm-Leach-Bliley Revisited and the Future of the Community Bank

There are an estimated 350 million computers in use today. Yet at one point, there was a respectable contingent that could not envision anywhere near such mass acceptance of computers, especially not to the extent witnessed today. In fact, in arguably one of the *least* prescient remarks of the 20th century, Thomas Watson, then-chairman of IBM, hypothesized in 1943, “I think there is a world market for maybe five computers.” To be sure, this prognostication was made at a time when a single computer filled an entire room; indeed, in 1949, *Popular Mechanics* theorized that, “Computers in the future may weigh no more than 1.5 tons.” Yet, the profound incorrectness of this prediction remains.

Many bankers, advisors, consultants, and academics are making similarly profound guesses as to what the future holds for the independent community bank, especially as the constant reshaping of the banking landscape presses on. As amplified by recent merger announcements by Bank of America, JP Morgan, and Wachovia, the dynamic reshaping of the U.S. banking landscape is certainly not dormant. In our last *Industry Update* we summarized merger activity in 2003 and touched on what is shaping up to be a material uptick in M&A activity in 2004. Moreover, the fundamental industry shifts prompted by an updated basket of banking products and services, which was codified in October of 1999 by the Gramm-Leach-Bliley (“GLB”) Financial Services Modernization Act, continues to be defined. Accordingly, four years after GLB and in the midst of a significant round of industry consolidation, we feel that now is a particularly poignant time to ask: What is the future of the independent community bank?

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#### One-Armed Economists

Lacking a strong background in either finance or economics, as president, Harry Truman relied heavily on his economic advisors whom had largely been inherited from FDR. Following in the academic method championed by FDR, these advisors would commonly present both sides of a particular policy issue to Truman. “On the one hand [...]” they would begin; “...then again, on the other hand... [...]” Truman often joked that what he really needed to figure out the nation’s economic problems was a one-armed economist. When it comes to predicting the future role of the independent community bank, there appears to be a similar dichotomy. One camp espouses the success of the internet and technology in financial services, such as Bank of America’s electronic bill-payment and presentment, E\*Trade’s online bank, and the pure-play branchless bank ING Direct. This camp contends that consolidation in the banking industry will continue until a point of market-clearing equilibrium is reached, and this equilibrium will entail a significantly fewer number of banking institutions providing a substantially wider product set as facilitated by technology. On the other hand, there are those that contend that despite the advanced technology and engorged critical mass of the very largest institutions, the essential economic role played by community banks will remain, that the demand for local, independently-run sources of capital will persist, and that

mom, apple pie, and community banks will remain the trifecta of Americana well into the 21st century.

At the risk of walking the fence, we fall out somewhere in between. To be sure, industry consolidation, and the underlying factors driving such consolidation, is a very real and actual force to be reckoned with. This consolidation is a signal of a glut of banks in the United States and, given the current financial, operational, and growth challenges that many banks face, a market-driven decline in the number of banks will and must occur. From the perspective of shareholders and directors of institutions facing compressed margins, flat earnings, and limited loan growth, selling to another institution will rightfully appear as a very feasible strategic option, especially if the buyer's acquisition war chest has been buoyed by a stock with a strong P/E and cheap and easy cash, both of which would presumably facilitate a higher purchase price. Today's community banker faces a wealth of contemporary obstacles in addition to the challenges systemic to running a community bank in general. In light of the increased number of competitors in the financial services space as prompted by GLB, competition from financial supermarkets, the prohibitive costs of maintaining competitive technology, and the enhanced strength of the large banks as supported by acquisitions and *de novo* branching, many marginal community institutions will simply not survive.

However, "on the other hand," we would argue that on some level there *will always* be a role for the local community bank. For the foreseeable future, customer demand will persist for the higher levels of customer service, the local decision-making capabilities, and the community support efforts that are typically characteristic of the quintessential community bank. Moreover, anecdotally, in many communities across the U.S., community banks provide, if not the sole source, then one of a limited number of funding sources for many consumers and small businesses. As Comptroller of the Currency John Hawke noted in the OCC's most recent issue of its *Community Development* newsletter, "small businesses are the bedrock of the nation's economy, employing more than half of all private sector workers and generating as much as 80 percent of all new net jobs each year. [...] To do so, they [small businesses] must be able to obtain financing." Needless to say, community banks commonly represent that critical source of financing for small businesses, or those defined as having fewer than 500 employees. As such, in addition to their role in providing financing for many of the country's almost 6 million small

businesses, facilitating home ownership, and satisfying other critical social and economic needs, community banks as we now know them not only offer financial products but also represent a social good. Accordingly, the community bank does indeed seem to have a future in some capacity.

To be sure, to maintain continued successful independent operation, a community bank will need to effectively address competition from financial supermarkets, systemic and institution-specific obstacles, and the underlying market dynamics fueling the continued industry consolidation. And the truly successful community banks will need to avoid competing on a commodity basis but rather identifying and targeting a particular niche, whether that means a specified group of customers, a particular product or service set, or an unmet customer need.

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## Financial Supermarkets Redux

More than four years on, we can conclude that GLB did not ignite a radical revolution in the banking industry as some predicted, but rather a slow burn of measured, incremental reshaping of the industry. That this reshaping is a work in progress is clearly evinced by JP Morgan Chase's January announcement of the signing of a definitive agreement to acquire Bank One. At a total price tag of almost \$59 billion in JP Morgan Chase common stock, the transaction represents the third-largest bank transaction in history.

The high-level synergies of the transaction are apparent. JP Morgan Chase, whose retail exposure was limited by branch network concentration in the NY-NJ-CT and Texas markets, gained the fifth largest branch network in the country, as measured by total number of branches. Bank One, a retail bank with floundering earnings growth, will be buttressed by JP Morgan Chase's pending earnings recovery as well as Morgan's substantial wholesale, investment banking, and corporate lending operations.

On a *pro forma* basis, Morgan-Bank One is a financial supermarket in virtually every sense; the *pro forma* company will be a force to be reckoned with in virtually all areas of financial services. In terms of assets, the combined company will be the second U.S. institution to join the \$1 trillion club, ranking just below Citigroup. While total assets is certainly a telling metric, the true nature of Morgan-Bank One as a financial supermarket will be in its dominant market share in a variety of lines of business. For example, in terms of credit card lending, the combined company will have the number

one market share, as measured by total U.S. card receivables. Among U.S. banks, the combined company will capture the second highest amount of insurance revenues, after Wells Fargo. The combined company will secure a fourth place rank in total U.S. assets under management, just after Fidelity, State Street, and Barclays. And in the mortgage banking space, the combined company will rank fourth in both originations and servicing portfolio.

At least from a deposit-gathering perspective, many community bankers in the 25-state branch network of the combined company will find themselves competing with a financial supermarket with the ability to cross-sell a broad array of both interest-related and fee income products backed by the gargantuan expertise, balance sheet, and resources of the 2nd largest bank in the country.

The significance of this transaction, as well as the \$49 billion Bank of America-Fleet deal, has not escaped the watchful eye of regulators and lawmakers. As reported by the *American Banker*, a spokesman for Richard Shelby (R-AL), Chairman of the Senate Banking Committee, said of the Morgan-Bank One deal, "From a marketplace perspective, these are trends that we would intend to take a closer look at. Broader consolidation issues will be a part of a hearing we will hold this year on post Gramm-Leach-Bliley. This hearing, among other things, will look at the competitive landscape of the financial services industry."

The role of acquisitions in assembling a diversified financial services company remains important. Indeed, 2003 saw 81 insurance deals, 185 brokerage deals, and 140 asset management deals. The typical strategy for an acquirer after identifying its target geographic market is to identify a key agency, brokerage, or asset manager in that market with material scale, profitability and cross-sell potential. After this initial foray, additional, smaller-scale acquisitions are made in the same market area and rolled into the core target.

While several of the contemporary financial supermarkets have been built through a monumental merger (e.g., Citi-Travelers, JP Morgan Chase-Bank One), the paradigm for the future creation of such companies may be the organic development through internal growth offset with relatively minor acquisitions. Such is the model being followed by California-based E\*TRADE Financial. In its youth, E\*TRADE was a high-flying technology company that provided online brokerage accounts and internet-based trading. Now, in its adolescence, the company has transitioned into a more diversified financial services company. After acquiring an internet-only

bank several years ago, the company that began as an online brokerage now typically generates around 40% of revenues from traditional banking (37% of the company's 4th quarter 2003 revenues). Especially with the company's newly-launched Financial Sweep Deposits Account, the delineation between the banking and brokerage lines has become even more blurred. In fact, the company has made a point of emphasizing a strategic shift toward an emphasis on consumer lending (e.g., HELOCs) as well as a directive to attract more sources of recurring revenue. Notably, with the "internet bank and brokerage" company recently announcing plans to open 50 branches in select U.S. cities and announcing that deposits will still be accepted at its recently-divested network of more than 15,000 ATMs, several analysts have suggested that a retail bank acquisition announcement going forward would not be that surprising.

This discussion of the nation's largest institutions begs the question: on a practical level, why should a community banker be concerned with the iterations of financial supermarket evolution? This is certainly a valid question, and yet one with a simple answer. On multiple levels, both retail and commercial customers commonly outgrow the products and services of community banks. Demanding a level of product sophistication that is largely impossible for community banks to provide, customers - particularly small businesses - instead turn to these financial supermarkets. When it comes to losing cross-sell opportunities and the lifetime value of a profitable customer, community bankers would be wise to take heed of the 800-pound gorillas in the financial services jungle.

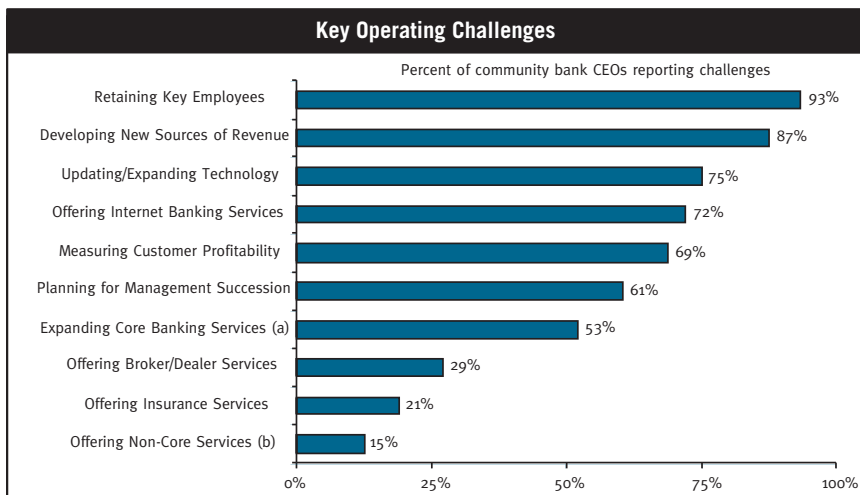
## Navigating the Gauntlet

No strangers to competitive threats, today's community bankers are facing an all new wave of systemic, economic, and market challenges.

In addition to challenges arising from capital constraints, generating loan and deposit growth, growing earnings, and finding and maintaining quality staff, the banking industry is beset with a myriad of unique issues and challenges:

### ***Decreasing popularity of banks as financial intermediaries: A shrinking pie***

There is an ever-increasing number of industry players chasing a piece of the banking pie. Exacerbating the effect of heightened competition is the fact that the overall pie is getting smaller. Indeed, the fraction of total individual financial assets that consumers



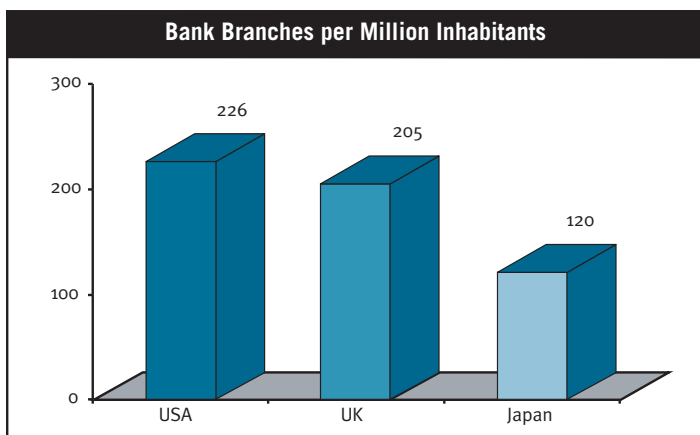
Source: Grant Thornton Annual Community Bank Executive Survey, 2003.  
 (a) Beyond traditional CD options, savings accounts, and loan options  
 (b) Leasing, travel agency, business advisory, check cashing, etc.

allocated to depository institutions has dropped from almost 25 percent in 1983 to just over 10 percent today. Largely attributable to the rising popularity of money market mutual funds over time, this trend is noteworthy nonetheless.

### Renewed deposit-gathering challenges: Smaller pieces of the pie

Recent FDIC data indicates that total domestic deposits have actually declined as compared to prior quarters, the first time since the first quarter of 1999. Especially in light of major *de novo* efforts of multiple national and regional institutions, a potential deposit crunch may be in the offing.

Bank of America has indicated that its announced acquisition of Fleet will generally not influence previous plans to build 550 new branches. Similarly, with the exception of its plans for Texas, JP Morgan Chase-Bank One has indicated that it will still proceed with its 100-branch *de novo* effort this year. Moreover, prior to its announced acquisitions of Alabama-based SouthTrust, retail giant Wachovia had announced a significant *de novo* strategy in Texas, with an eye toward 30 to 50



Source: Reserve Bank of Australia

new branches in the Lone Star state per year through 2010. And southeastern regionals AmSouth, Regions, and Compass have also embarked on aggressive *de novo* strategies in the faster-growing areas of their respective markets.

The *de novo* efforts of these and other regional institutions will only exacerbate what some have called the 'overbanked' nature of the U.S. banking industry.

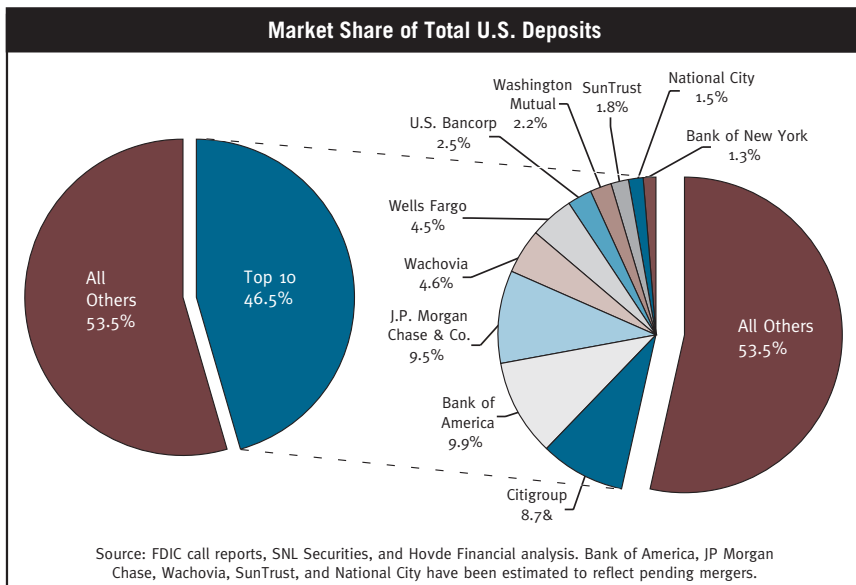
As the economy continues to generate steam and the corresponding demand for loanable funds grows, the list of challenges facing banks gathering deposits to fund new credits will not be limited to stiff competition. The deposit composition of

the average community bank suggests that many are generally not as well-positioned for a rate increase as would be hoped. While the conventional wisdom holds that rates will increase even further within the next 6 to 12 months, community banks could certainly be better leveraged for an increase. According to Call Report data, community banks have, on average, only 13% of their deposits in non-interest bearing accounts; conversely, CDs comprise almost 47% of total deposits. To be sure, the asset sensitive balance sheets of most institutions leave most well positioned for a rate increase in a broader sense. However, the benefits of such an increase will be somewhat mitigated by the current deposit base. And the ensuing competition for deposit funds will arguably only raise the cost of gathering incremental deposits.

### Market dominance

The ten largest bank holding companies have increased their share of total U.S. banking assets from approximately 30% 20 years ago to more than 75% today. In fact, with Bank of America's acquisition of Fleet, the *pro forma* company is flirting with the regulatory cap of 10% of all national deposits. Practically speaking, the concept of one institution controlling 1 out of every 10 deposit dollars in the U.S. is astounding. The top 10 now hold more than 45% of the total deposits in the country.

These large banks typically require a significant investment in personnel in order to achieve such scale. These high personnel costs would presumably play the foil to the benefits of the sheer scale realized. Yet, in terms of overall efficiency, the large banks do not appear to be suffering. According to FDIC Call Report data, despite an FTE-to-branches ratio of almost 886x, the efficiency ratio for banks with assets greater than

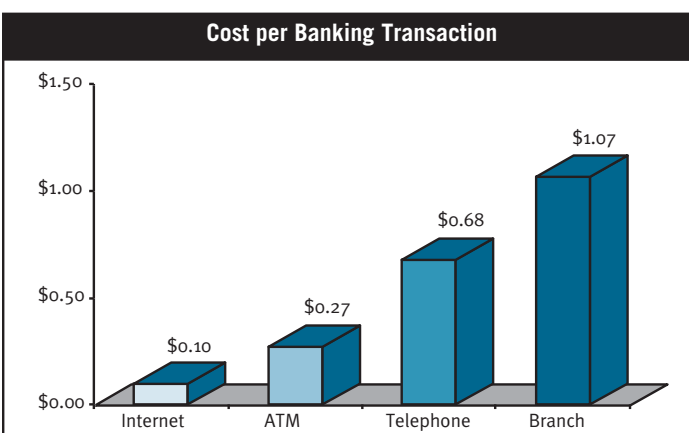


\$10 billion is 59%. This compares to an FTE-to-branches ratio for small community banks (assets less than \$100 million), medium community banks (assets between \$100 and \$500 million), and large community banks (\$500 million to \$1 billion) of 13x, 21x, and 31x, respectively. However, at 73%, 66%, and 61%, the efficiency ratios for small, medium, and large community banks, respectively, are still worse than that of the large banks. That said, the presence of diverse business lines admittedly limits the comparability of FTE-to-branch performance ratios.

### The prohibitive costs of competitive technology

Bankers are keenly aware of the financial burden of keeping abreast with current technology ranging from advancements in lending, processing, and servicing, to credit scoring, payments and account analysis. Yet, it is the largest banks that can more easily digest the significant costs associated with technology investments that benefit the most.

Bank of America, for example, has spent as much as \$45 million in recent years on marketing alone to



Source: Hovde Financial Internal Estimate

promote its online banking, payment, and e-billing functionality. The end result is that Bank of America has one of the most popular online banking sites with over 5.5 million customers banking online. The implicit benefits include a claim to 55% lower attrition for those customers who conduct online banking and 80% lower attrition for those banking customers who pay bills online. The company has also observed a 45% increase in the size of loan balances held with the bank for online bill-pay customers.

For the vast majority of community banks, however, it is both impractical and unfeasible to offer online functionality comparable to Bank of America's. But a basic online banking product is now virtually a requirement. For community bankers, online banking is viewed less as a means of gaining customers and more of a means of minimizing attrition and keeping up with the fray. The investment required to provide online banking, as well as a myriad of other back-office functions is daunting indeed.

Those institutions that are heavily or exclusively reliant on branches are at a natural cost disadvantage. Consider that the implied cost for a transaction conducted through an ATM is approximately one-fourth that of a branch transaction, while the cost of an internet transaction is less than one-tenth that of a branch transaction.

### "Everyday Low Interest Rates": Nonbank competition

Ironically, in our *Industry Update* discussing the Financial Services Modernization Act published four years ago, we compared the impending financial supermarket to the role Wal-Mart plays in the retail space. Now, however, Wal-Mart is campaigning to become a viable player in the banking space. Fresh from a legal victory against payment card associations Visa and MasterCard, Wal-Mart is increasingly an influential player in the banking industry. The company has attempted repeated forays into banking, capped off by its attempt to acquire an industrial bank in Orange County, California, in 2002. This attempt was ultimately stymied and for now, the extent of Wal-Mart's banking resides in a recently established in-store branching relationship with National Commerce Financial (recently acquired by SunTrust) and joining Fifth Third's EFT network. But few believe that this marks the end of Wal-Mart's efforts. After winning a decisive victory over the credit card associations, Wal-

Mart already plays a dominant role in the payments industry. Moreover, the nation's biggest retailer, which had already been offering money orders and money transfers, launched a check-cashing service at stores in 44 states this spring; licensing is pending in six additional states.

The company's efforts do not stop there. Indeed, Wal-Mart is lobbying hard to have Congress expand the power of obscure entities known as industrial loan companies, which would set up a nationwide banking system that could compete with commercial banks but operate under looser federal rules. As reported in *The Washington Post*, a Wal-Mart spokesman said changes in the industrial loan company rules are the retailer's best hope of getting into banking, given the other rules that bar it from owning a bank.

The prospect of Wal-Mart not only being a retail juggernaut but also a banking juggernaut is staggering. The company has 1,568 stores covering every state in the Union — as compared to the biggest footprint of any bank - *BofA* - touching only 25 states.

## Keys to Surviving

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### **1) Successfully identifying and competing in a niche**

Catering to the specific needs of the local community, Nashville's Third National Bank (now SunTrust) began a loan program designed for music industry professionals. Essentially, the bank generated loans to such professionals backed by future royalty income streams; rights to songs served as collateral. This niche-based program has proved to be extremely lucrative. The same SunTrust executive that began this program recently announced a similar private banking group focused exclusively on the motorsports industry, including NASCAR and Formula One teams.

Similarly, Tampa-based Pilot Bancshares, Inc. fills a demand for small aircraft financing. Through wholly-owned subsidiaries Terrace Bank and National Aircraft Finance Company, the bank finances small aircraft purchases for businesses and individuals for aircraft worth more than \$400,000. While this niche does not necessarily represent a substantial percentage of the loan portfolio, providing such financing serves a community need, enhances the bank's reputation, and generates strong, repeat-borrower relationships with aircraft owners.

Whether it be through providing unparalleled service to professional groups, the absolute best-in-class level of service, or filling a unique community need, identifying

and successfully competing in a niche is a sure route to differentiation.

### **2) Leveraging the utility of outsourcing**

Despite the prohibitive costs of offering certain products and maintaining technological functionality, there are ways for community banks to possess these competitive advantages. By way of example, it is often difficult for a community bank to provide an independent credit card product that can compete with those offered by major competitors touting such features as miles, cash back, charitable donations, and college savings. Through relationships with third-party providers and affiliations with agent bank programs, community banks can offer credit card products with just as much functionality as Citi and Bank One.

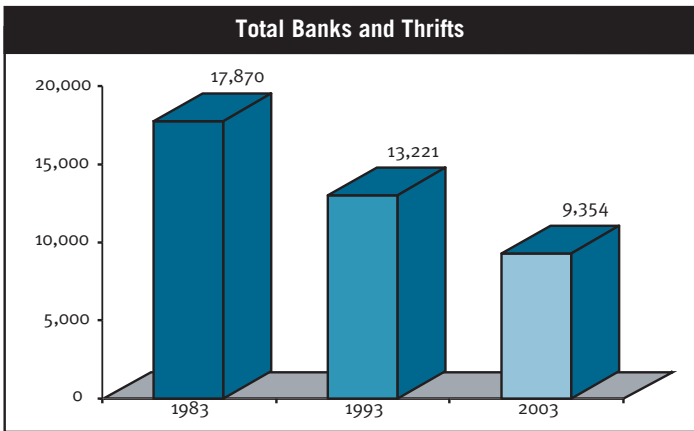
Similarly, third-party IT providers allow virtually a similar suite of customer functionality to be offered by a *de novo* bank as by a \$10 billion bank. Indeed, before it even opened for business, a California *de novo*, Redwood Capital Bank, already had "core processing, internet, ATM, network management, and item processing with branch image captures. [...] a fully integrated suite of core technologies, with all delivery channels," according to the bank's CFO, Fred Moore.

### **3) Remaining nimble and able to capitalize on missteps and run-offs from bigger players**

Once home to three regional banking giants, the city of Memphis has now seen two of its prominent native sons acquired. Moreover, three Memphis-based community banks with less than \$1 billion in assets have also been acquired, all within the space of the last nine months. The independent institutions that remain in the market have a rare and unique opportunity to attract portions of the deposit run-offs from these acquisitions as well as to hire key executives displaced by these transactions. However, as no banker can plan for such consolidation, the key to capturing any strategic advantages from similarly significant marketplace events is to have a strategic plan that allows management to remain nimble and agile from a tactical perspective.

### **Conclusion**

Due to underlying economic forces of supply and demand as well as the challenges described above and a myriad of others, consolidation in community banking remains a very real trend. In fact, the 9,354 institutions in operation at the end of 2003 represent approximately half of the total institutions in operation only twenty years earlier.



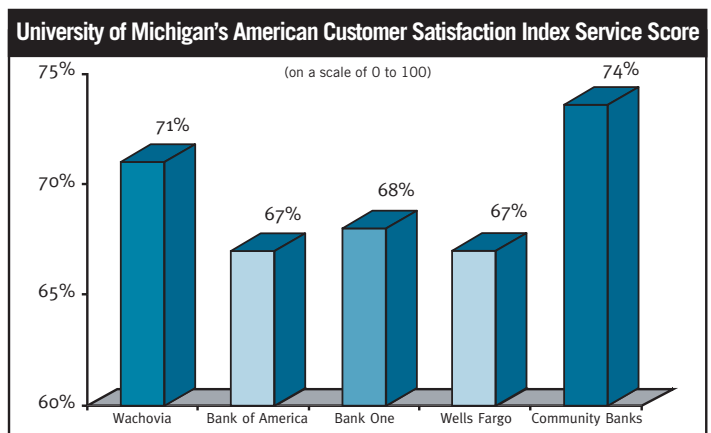
Source: SNL Securities Database

However, despite technology usurping many functions historically provided by the brick and mortar banking sector and the success of branchless internet banks, there is strong evidence that the death knell is nowhere close to sounding for the community bank. Even ING Direct, the most popular internet bank in the U.S. (by number of customers), relies on a “sweep” feature that facilitates the transfer of funds from a customer’s traditional account at another bank to that customer’s ING account. In essence, this “internet-only” bank model still relies heavily on the existence of traditional branch-based deposit accounts.

Recent research suggests that more than 75% of all checking transactions are branch-based, only approximately 13% are web-based, and the remaining 12% of such transactions are done via telephone banking or other miscellaneous channels. Yet many critics point to the success of branchless credit card companies and the exponential growth in debit card transaction volumes as a sign of an impending branchless industry. However, to get a true sense of the banking and payments landscape, and its implication for the community bank, one must more closely examine the evolution of the payments landscape. In a landmark study of the payments industry published in 2001, the Federal Reserve performed a comprehensive evaluation of retail payment transactions. While credit and debit cards are certainly realizing dramatic popularity and volume, the resilience of the paper check is clear: paper-based checks still comprise almost 60 percent of the more than 80 billion non-cash transactions that occur each year. And where there are paper checks and hard currency, traditional deposits will follow; so too will the branch-based deposit and lending function, the linchpin of community banking.

And the customer’s satisfaction with the higher-touch service of community banks is unmistakable, both

anecdotally and empirically. Even with the benefit of national or near-national retail coverage, large banks do not realize the same levels of customer satisfaction of a local community bank. *The American Customer Satisfaction Index*, a joint venture among the University of Michigan Business School, the American Society for Quality (ASQ), and the CFI Group, collects periodic data on customer satisfaction in a variety of industries and translates that data into a score between 1 to 100. The average scores over the last five years for retail giants Wachovia, Bank of America, Bank One, and Wells Fargo are 71, 67, 68, and 67, respectively. This compares to a five-year average score of 74 for the *Index’s* category of “All Other” banks, which is dominated by the nation’s community banks.



Source: University of Michigan

In 1977, Ken Olson, president, chairman and founder of Digital Equipment Corp., observed, “There is no reason anyone would want a computer in their home.” Time has overwhelmingly proved Mr. Olson wrong. While challenges abound for community banks, those asserting that there is no reason anyone would want an independent bank in their community may face a similar fate. [1]



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