

# 2007 OUTLOOK THE SECOND HALF Anat Bird

Phone: (916) 797 2645 Cell: (916) 717 1710

Email: [anat@anatbird.com](mailto:anat@anatbird.com) Website: [www.anatbird.com](http://www.anatbird.com)

## 2007 Outlook

- Margin management: who knows where we're going
- The year of the deposit (continued)
- Credit is beginning to fray
- Secular changes in deposit mix and ownership
- The payments business opportunity: still underutilized
- The acquisition business: hot and heavy
- What's on the regulators' mind?
- What customers want
- Industry trends and The Street

## Margin Management

- The yield curve is still not normalizing
- Have we peaked yet?
- The spread game is NOT back
- Deposit pricing – no one is going long
- Who is doing something about it (dare I use the “D – derivatives” word)?
- Can you make money with a truly rate neutral balance sheet?

## Margin Behavior - Continued

- Wide range of bank responses to the declining rate environment—from heavy margin compression to great expansion
- Overall, margin dropped to a 17 year low in 3Q06
- Key lessons:
  - Core funding is always beautiful
  - Margin dependence is risky even if things are going your way
  - It might be time to activate a profit-capturing strategy
  - Market conditions make pricing more challenging than ever

## The Year of The Deposit - Continued

- Loan growth continues to outstrip deposit growth nationwide
- Deposit growth is there, but banks are not getting their fare share of the pie (system-wide bank deposits as a percent of total assets declined from 90% in 1950s to 60% today)
- We are teaching customers to shift funds from low cost to high cost accounts (assuming that, if we don't do it, THEY will)
- Acquisition will remain expensive as buyers vie for coveted deposit-rich sellers; while deals are heating up, the market will begin to rationalize in 2007

## The Year of The Deposit - Continued

- “Pretend” core accounts are getting costlier but stickier
- 2006 saw significant deposit growth, but mostly at the foreign-owned banks and branches (8.2% uninsured and large denominations vs. 1.2% insured deposit growth)
- Internet banks are sprouting and doing well
- Average balance of a small business account is 5-10 times larger than a retail account; small business deposit focus inconsistent with average loan size growth
- Technology is on your side (remote capture; check 21)
- “Happy meals” pay off

## The Year of The Deposit - Continued

- Key lessons:
  - Competition intensifying from internet banks
  - The market for deposit growth is there
  - Focus your product offering
  - Focus your marketing on customer segments
  - Retail should include small business deposits

## Credit is Finally Getting Worse

- Credit will worsen as the cycle turns; liberalized terms, covenants and razor-thin pricing will come home to roost in late 2007 – budget for it; 3Q06 results show a directional change in credit quality
- Loan growth is robust in most places; C&I is growing as demand for CRE ebbs
- The regulators are flexing their muscles on CRE capital allocation requirements, which further supports CRE decline
- Construction loan exposure is significant for some banks
- Incenting lenders on C&I and deposit generation is productive, especially when coupled with effective sales management



## Credit (continued)

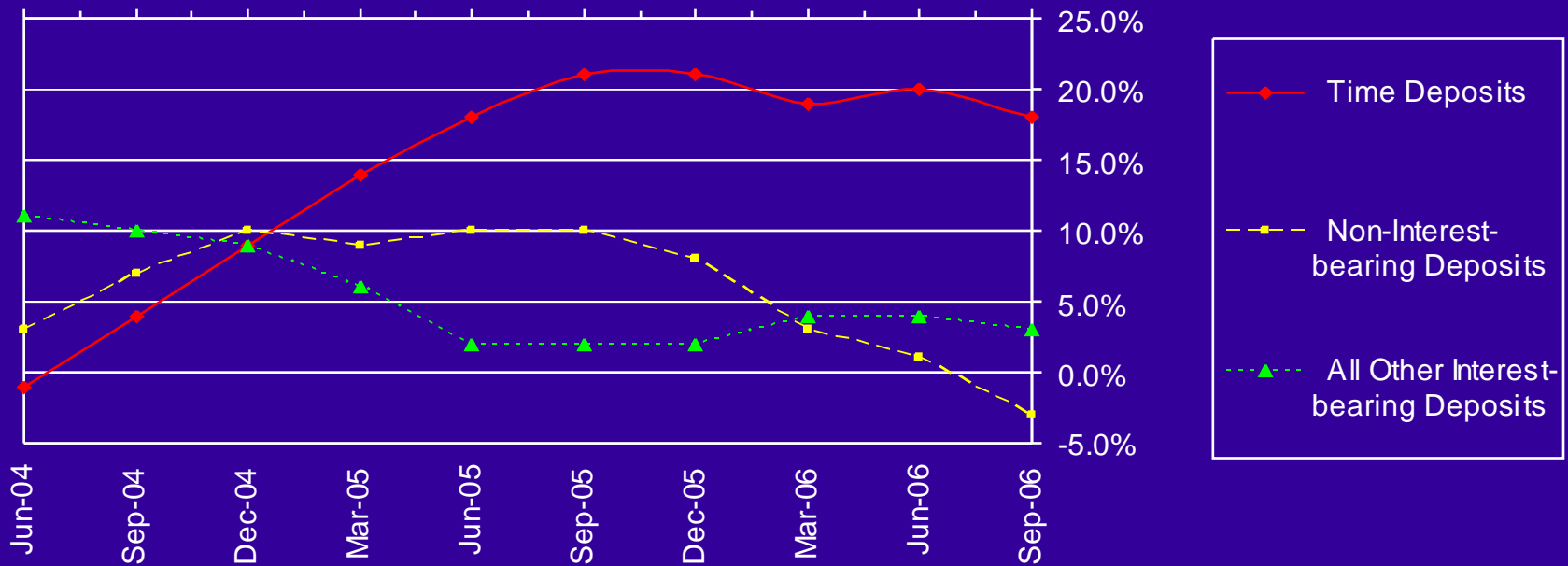
- Non-accrual loans up 8% system-wide
- This is the biggest increase in 6 years, mostly in residential mortgages
- Charge-offs declined in 2006, exclusively thanks to decline in credit card charge-offs
- No banks failed in '05 and '06 but one did in 2/07
- There is little risk-based pricing in the industry

## Credit (continued)

- Lessons learned:
  - What goes around comes around
  - Clear expectations from the lending sales force on both loan types and deposits will yield good results
  - Small business is still under-banked
  - Budgets need to incorporate credit deterioration in future years

# Secular Trends

## Domestic Deposits - Twelve-Month Growth Rates



Sources: FDIC Quarterly Banking Profile

Notes: Growth rate is based on deposits vs. the year ago quarter. See <http://www2.fdic.gov/qbp/grgraph.asp>

## Loyalists More Profitable

Loyal customers hold a greater share of their wallet and balances with their primary banking provider

### Variation in Balances Maintained at Primary Bank (relative to national average)

Checking	\$4,032	- 2%	- 5%	1%
Savings	\$6,587	6%	1%	- 3%
CDs	\$12,275	66%	0%	- 19%
MMDA	\$11,893	42%	- 10%	- 8%
<b>Total Deposits</b>	<b>\$16,112</b>	<b>24%</b>	<b>- 2%</b>	<b>- 7%</b>
Home Equity Loan	\$3,657	34%	17%	- 17%
Credit Card	\$1,431	- 5%	- 8%	2%
<b>Total Consumer Loans</b>	<b>\$1,873</b>	<b>-14%</b>	<b>9%</b>	<b>- 8%</b>

# What Customers Want

	Customer Experience Attributes	Customer Sacrifice Index Score	Customer 's Perception of Sacrifice
<p><b>HIGH</b></p> <p>CUSTOMER SACRIFICE</p> <p><b>LOW</b></p>	The bank rewards me for the size and length of my business	100	<p>Customers endure high levels of sacrifice. These experiences are extremely important to customers, but delivery by the bank falls far below expectations.</p>
	Branches are open evenings and weekends	99	
	Staff can negotiate certain fees and rates on their own	96	
	Decisions regarding my account are made locally	84	
	The bank offers me excellent in-person customer service	72	
	The staff at the branch has been there a long time	70	
	Branch staff are knowledgeable about all products, so I don't get handed off to specialists	68	
	The staff at the branch knows me	66	

## What Customers Want – Continued

	Customer Experience Attributes	Customer Sacrifice Index Score	Customer 's Perception of Sacrifice
HIGH  C U S T O M E R  S A C R I F I C E  LOW	The bank tailors products to my needs	63	Customers endure moderate levels of sacrifice. These experiences are important to customers, and the bank is meeting some expectations, but customers definitely want to receive more.
	Provides special education seminars (retirement, college savings, etc.) at the branch	57	
	Bank is very proactive in securing my financial information and preventing fraud	56	
	Offers superior interest rates on loans and deposits	48	
	Offers coffee, tea and other beverages at the branch	45	
	Staff asks about my needs and goals	45	
	Branch staff is warm, enthusiastic and friendly	40	
	One person coordinates efforts to resolve my problem	39	
	I'm greeted when entering the branch	37	
	Branch has large-screen TVs showing banking and financial news	35	
	Provides internet access at the branch	35	

## What Customers Want – Continued

	Customer Experience Attributes	Customer Sacrifice Index Score	Customer 's Perception of Sacrifice
<p><b>HIGH</b></p> <p>CUSTOMER SACRIFICE</p> <p><b>LOW</b></p>	Branch has a children's play area	29	Customers realizing low levels of sacrifice. These experiences are generally of moderate to low importance to customers and the level of delivery by the bank is fine.
	Staff conducts transactions in pods/desks	26	
	Warm and inviting branch environment	23	
	Branch staff takes time to chat with me	21	
	Access to specialists at the bank is easy and based on needs	20	
	The branch is a hub of activity in my community	20	
	Introduces new ways to banking to the market	13	
	Provides lounges and places to sit and read at the branch	12	
	Bank is locally owned	11	
	Provides bundled products addressing comprehensive needs (home-buying products, etc.)	6	

*Note: All of these Index scores reflect national averages. When viewed from a customer segment perspective, there are significant variations in some of these Index scores.*

*Source: BAI Research*

## Secular Trends

- Banks' share of household deposits continues to erode (from 30% in 1989 to 17% in 2004)
- The ten largest US banks hold nearly 40% of all domestic deposits and 51% of all industry assets



## The Payments Business Opportunity

- Debit card growth
- Credit card usage
- Remote Deposit capture
- Other remote banking tools are inching into acceptance (phone etc.)

## The Acquisition Business – Back in Business?

- The acquisition market is heating up at all bank sizes
- Pricing is better but still not rational
- Buying cash cows without “fixing” them isn’t a bad tactic for some
- Deposit franchises and high-growth market banks \$1B+ continue to be extremely pricy

## Acquisitions - Continued

- Lessons learned:
  - 2007 will be a big year for acquisitions
  - Competition will intensify as de novos slow down
  - Big year for aggregators
  - Deposits premiums will break 30%

## What's on The Regulators' Mind?

- BSA/AML – the never ending story
- Commercial real estate scrutiny is still a top concern (especially policies and procedures)
- Business continuity is back off the map
- Credit scrutiny will significantly intensify in 2007

# Money Market Relationship Packages

Requirements  
Checking with direct deposit or ACH  
(1<sup>st</sup> transaction within 45 days)

**Sapphire**  
\$1,000 daily minimum balance  
\$8/month fee if below minimum balance

**Diamond**  
\$5,000 monthly average minimum balance  
\$18/month fee if below minimum avg. balance

- Pick 2 of the following:
- Active online banking
  - Active bill pay (pay at least 1 bill every 30 days)
  - Active debit card (at least 3 transactions every 30 days)
  - Safe deposit box
  - Active credit card (at least 3 transactions every 30 days)
  - ACH (if Direct Deposit used for requirement)
  - Savings (passbook or statement)
  - Loan (any type with outstanding balance)

Get +50 bps on MMA  
standard relationship rate  
for 6 months

Get +75 bps on MMA  
standard relationship rate  
for 6 months

# CD Relationship Packages

Requirements  
Checking with direct deposit or ACH  
(1<sup>st</sup> transaction within 45 days)

**Sapphire**  
\$1,000 daily minimum balance  
\$8/month fee if below minimum balance

**Diamond**  
\$5,000 monthly average minimum balance  
\$18/month fee if below minimum avg. balance

- Pick 2 of the following:
- Active online banking
  - Active bill pay (pay at least 1 bill every 30 days)
  - Active debit card (at least 3 transactions every 30 days)
  - Safe deposit box
  - Active credit card (at least 3 transactions every 30 days)
  - ACH (if Direct Deposit used for requirement)
  - Savings (passbook or statement)
  - Loan (any type with outstanding balance)

Get +25 bps on standard relationship rate on any CD

Get +50 bps on standard relationship rate on any CD

## Industry Trends and The Street

- Overall, the industry continues to be profitable; 2006 was another record year (up 12bp. From 2005)
- The big banks are doing better than mid and small cap companies, primarily because they have more diversified revenue streams
- 191 de novo banks in 2006, the largest number since 2000
- More banks are experiencing profitability hiccups and margin pressure as the yield curve persists and as rates decline and credit deteriorates in some banks (out of 23 growth banks under one banker's coverage, only 6 beat the street, only seven met)
- More volatile earnings are expected in the future

