THE BALTIMORE SUN
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SUNDAY, DECEMBER 25, 2011

BUSINESS & JOBS

THE INTERVIEW: ANITA NEWCOMB, BANKING CONSULT

Big changes coming for small banks

Regulations, economy will increase pressure to merge

By Jay Hancock
The Baltimore Sun

In coming years your community bank may be merging with a rival, closing branches and redesigning the interiors of branches that remain, says Columbia-based banking consultant Anita G. Newcomb. With nearly three decades of experience running banks, handling bank mergers and advising banks on strategy, Newcomb sees smaller lending institutions combining in a manner similar to what happened to the industry after the financial collapse of the late 1980s.

All banks are pressured by new red tape, fee limits and interest rate squeezes. But small banks — especially those with less than $500 million in assets — will have an especially tough time, she says. Even as they face new limits on overdraft fees, for example, they don't have enough employees to handle the complex new regulations.

Newcomb has advised perhaps 20 Maryland banking companies and many more up and down the East Coast and across the country.

She is also a board member of the Baltimore branch of the Federal Reserve Bank of Richmond. She sat down with The Baltimore Sun to discuss what's next for the industry.

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Anita Gentle Newcomb, president and managing director of A.G. Newcomb & Co., financial and strategic advisory consultants, works with community banks.

Community bankers I know are very unhappy that the public confuses them with the Wall Street institutions that caused the financial crisis. Can't say I blame them.

There's this perception out there in the general market that all banks are created equal. And unfortunately, because of some infamous comments about fat-cat banks, community banks have sort of been lumped into that category. People don't understand there's a difference between a mortgage bank and a commercial bank and an investment bank. And even within the commercial banks, there are national banks or money center banks and there are regional banks and there are community banks.

The community banks have been painted with the same broad brush. They were not the lenders in the subprime market. That's just not the typical community bank business model. Yet they seem to have gotten the same backlash associated with that.

How is the 2010 Dodd-Frank reform act affecting community banks?

There are about 5,500 pages of new regulations coming down the pike associated with banks in general, including community banks. The reality is that the cost to comply is going to go up significantly. … A Maryland banker recently did a poll of his employees and 25 percent of their time … is spent on compliance training.

And this is training for new regulations that are coming on?

Yes. New regulations. We also have new mortgage regulations that have come down the pike. We have regulations around overdrafts that I'm sure you've heard a lot about, and all this is coming down with regards to Dodd-Frank. What lawmakers don't realize is that continued regulation of an industry that's already very regulated just continues to put the burden on the smaller banks. The larger banks, they have the scale to deal with it. The smaller banks don't.

Community banks are also getting pressure on the fee income side in the form of regulations around overdraft and legislation dealing with interchange fees [collected on debit card transactions]. So they're getting pressure on the expense side.

They're getting pressure on the fee income side. And because of this challenging environment, the regulators have begun to require higher levels of capital. Community banks don't have access to the capital markets like the regionals or the money centers. And many of these banks are going to have to raise capital.

You just described about five different forces that make scale an advantage and smallness a disadvantage. Does the future have room for the community bank with $200 million in assets?

Probably not the $200 million bank. When you look at the breakdown of banks in this country by size, you have 2,622 banks that are under $100 million. You've got 4,368 that are between $100 million and $1 billion.

My belief is that it's going to be almost impossible for a $100 million bank to compete in this new era, unless you're serving a rural market where there's very little competition or unless you have some real specialized niche. I think you're going to need to be closer to $500 million to really be able to effectively compete.

So you expect consolidation?

There's going to be huge consolidation in our industry.

What will the timetable look like?

Probably in the next year and a half to two years we're going to see the merger and acquisition activity pick up. The consolidation will be in the smaller-bank range. I tell my clients who are small and need to begin to think about merger partners to think about a merger of equals. For investment banks they're almost impossible to do — mergers of equals. But in this new environment, that's the more likely scenario [for community banks] — a $250 million bank teaming with another $250 million bank to create a $500 million bank so it can compete.

And how are these $500 million banks going to make money and pay all those compliance costs?

I would say that banks, all in all, have not been successful in fully monetizing their customer relationships. … They've not been successful in instilling a needs-based selling culture in their banks to fully monetize these long-term relationships they have with their core customers.

And that's part of what they need to do now?

Yes. They also have got to be much better about pricing. They've got to build pricing models that take into consideration risk and relationship. You've got to be much more deliberate and thoughtful in how you price your product, whether it's a loan or a deposit relationship or treasury services.

> ***"My belief is that it's going to be almost impossible for a $100 million bank to compete."***
>
> *Anita G. Newcomb*

Give me an example of a product that's badly priced now.

On the loan side, it's endemic across the industry that they price competitively but not necessarily pricing for risk.

It seems like the last few years are an example of that!

Yes. And relationship. When you look at the relationship of the average small business to a bank, the profitability of that relationship is primarily driven from the deposit relationship. But the focus always seems to be on the loan side. The smarter banks have finally figured out that to underwrite a loan, to appropriately price it, they are required to also have that deposit relationship. Because in the banker's mind, they want the entire financial wallet.

So we could shave a little off the loan for the right customer?

If you give us the deposit relationship. Yes, banks are saying that.

Banks also need to do a better job of bundling products. The industry is in major transformation. Not only because of Dodd-Frank. Not only because of the financial crisis. Consumer behavior has changed dramatically in the last 20 years. But we still have our basic line of products. We call it a checking account when in reality check usage is down significantly. Now debit card usage exceeds checks written in this country. It seems to me that these macro factors are coming together to a point where banks need to think about redesigning their product.

What can banking customers expect to see in the next five years?

First of all, they'll see some of their community banks merge with other community banks. You're going to see an acceleration of consolidation. They're going to see basically over the next 10 years a redesign of products that better meet their needs. They'll begin to see changes in how their branch is designed. Traffic — transaction activity in branches — is on the decline. People are opting to bank electronically. Activities are shifting from transaction activities and the need for tellers to more complex activities such as sales of products or complex resolutions of issues. You'll see redesign of the branches and probably not as many branches as there were before.

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