

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Fortress Partners
DATE: June 29, 2010
SUBJECT: Dodd-Frank and the End of Community Banking?

This morning the *Wall Street Journal*, published a rather dour assessment by Sarah Wallace of the financial reform bill (the Dodd-Frank Act) under consideration in Congress. Ms. Wallace is a community bank executive and director from Ohio and the eye-catching title of her piece is "The End of Community Banking." While experience predisposes us to skepticism about the value and effectiveness of new regulation, we think the outlook is not so grim.

At the outset, it is important to note that what appeared to be a *fait accompli* just last week is now in doubt after one of the Dodd-Frank Act's supporters, Senator Robert Byrd, died yesterday and another, Senator Scott Brown, reversed his stance after a late insertion of a tax on the largest banks. Sen. Brown's move will presumably require the bill go back to the Senate-House conference committee. That said, Sen. Brown's objection to the bill appears to be predicated on his dislike of the bank tax; if that provision is removed, he may well vote yes. Just when we thought the uncertainty factor was behind us....

Even assuming that the bill does pass with all the other major provisions in place, we think community banks will fare just fine. Why? Not all community banks are created equal. Some are operated as family businesses intended to keep everyone employed and provide a decent dividend. If these institutions are too slow to respond to new regulations, they may well falter. Others—the kind that typically attract outside investors—are run as capital generating operations. They are nimble organizations and, with the encouragement of shareholders, they will more quickly adapt to the new environment.

The debate about whether the Dodd-Frank Act is a blow to community banking or just a bump in the road focuses primarily on the effect of regulating debit interchange fees—fees taken by banks to cover the costs of debit card transactions. It is not yet clear the extent to which the Fed will lower these fees, but the potential for harm to banks' fee income is not insignificant. One industry research group, PaymentsSource, projects an industry-wide decline in revenue of over \$5.6 billion. On the other hand, Congress's charge to the Fed is to limit debit interchange fees to a number "reasonable and proportional" to the processing costs. The vagueness of this directive presents an opportunity for cooler heads at the Fed to minimize the damage caused by the new regulation.

The more salient point, however, is that well-run community banks have it within their power to do all the necessary adapting to this new regulation. Many community banks are already oriented toward deposit and lending relationships with small businesses. The impact on these banks from debit interchange fee regulation will be small. Those well-run institutions that do have more substantial exposure to this regulation will shift the focus of their portfolios to minimize the effect. While debit interchange fees often do form a substantial portion of a bank's fee income, they are hardly the only source of revenue for a bank. Good community bankers will navigate their organizations around the regulation and continue to generate profits.

Another source of anxiety for community banks is something we discussed last month: the Collins Amendment. The Collins Amendment was designed to ensure that the capital of a bank holding company (BHC) be of the same quality as the capital of the BHC's subsidiary bank. As it currently stands, BHCs are permitted to issue preferred securities (TruPS) which, for tax purposes, are treated as debt; for purposes of the Tier 1 capital ratio, they are treated as equity. As a result of this favorable treatment, many community bank holding companies (large bank holding companies, too) issued TruPS to increase their capital. In its original form, the Collins Amendment stripped away this ability. After an outcry from the industry and the

application of common sense, the provision has been substantially softened. There is no effect on any banks until 2013. For banks with less than \$15 billion in assets at year-end 2009, their already existing TruPS will be grandfathered. For larger institutions, their TruPS will be converted from Tier 1 into Tier 2 capital over three years starting in 2013. Whatever we might think of the wisdom of this regulation, it will not kill community banks.

Community bankers have also been concerned about the establishment of the Consumer Financial Protection Agency (CFPA). This new agency will be housed at the Fed (though, apparently, completely outside of the Fed's authority—we understand this arrangement no better than you) and will be responsible for regulating banking products for banks with \$10 billion or more in assets. Smaller institutions will continue to be regulated by their current regulators. We believe this is a terrible idea and will result only in the tightening of credit for consumers. But again, this is unlikely to have any effect on community banks unless their current regulators take their cues from the CFPA. The CFPA will have no direct (if any) supervision of community banks.

So, is Dodd-Frank the end of community banking? Most of the new regulation—derivatives trading, the so-called Volcker Rule, etc.—focuses on much larger institutions. Though we are never happy to see Congress kick down the doors and start imposing new rules, the brunt of the harm from Dodd-Frank will be felt by money-center banks and larger regional institutions. Community banking continues to fulfill an important role in the American economy and nothing about Dodd-Frank will extinguish the need for these institutions.

Copyright 2010 Fortress Partners Capital Management, Ltd.

FORTRESS

PARTNERS

CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029

262-369-1095 (Jon Bruss and James Bruss)

www.fortresspartners.com

THIS COMMUNICATION IS NOT AN OFFER OF INTERESTS IN FORTRESS PARTNERS BANC VENTURES I, LP, FORTRESS PARTNERS BANC VENTURES II, LP, OR FOUNDATION FINANCIAL PARTNERS, LLC. PERFORMANCE INFORMATION IS HISTORICAL AND IS NOT INDICATIVE OF, NOR DOES IT GUARANTEE FUTURE RESULTS.