

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss and James Bruss  
**DATE:** July 29, 2011  
**SUBJECT:** Have Community Banks Lost the Battle for Survival?

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*The report of my death was an exaggeration. – Mark Twain*

We think not! Community banks are here to stay. After the ill-treatment by regulators over the last three-plus years and the passage of Dodd-Frank, that may sound like an overly optimistic claim. But having served in the community bank industry for several decades, we are too aware of the dynamism and necessity of community banks to allow ourselves to get caught up in the conventional wisdom. Congress might not like them and regulators may treat them with contempt or worse, but community banks are the lifeblood of the economy's entrepreneurial ethos and will continue to be unless that ethos is killed off.

The battle began in 2007 when commercial banks, investment banks and Wall Street were conflated by the media (it is so much easier to say "bank" than "commercial bank" or "investment bank" or "community bank", isn't it?). And who cares, they all do the same thing—or so the thinking went. Sooner than imaginable, the pols were mimicking the media as were key cabinet officials like the Treasury secretary who was shortly joined by the chairman of the Federal Reserve and top bank regulators. We expected these types to know better.

The culminating event, Dodd-Frank, is a clear cut example of legislation in search of a rationale. Why? When the push for reform began, Congress set out to eliminate the real crux of the financial crisis, too-big-to-fail. The result of the sausage-making did nothing, however, to achieve that goal. Instead, today many of those institutions at the source of the financial meltdown still exist in substantially the same form (e.g., Fannie Mae and Freddie Mac). One of them, Bank of America, closed 2010 50% larger than at yearend 2006. The one reform that was needed—shrinking the major financial institutions—was jettisoned in favor of . . . growing those same institutions. With reform like that . . . .

So, if Dodd-Frank did little to address the too-big-to-fail problem, did it not at least address the problems facing community banks? No. It did, however, impose new burdens on them in the form of growing regulatory oversight. If micromanagement was what Congress wanted, it was very successful. But we've argued in this space and elsewhere that the new regulatory regime won't break the backs of many community banks. Again, the dynamism in the community banking sector, the sheer demand for community banking services from small business, and the increasing availability of technology (including software that facilitates compliance) will significantly offset any competitive disadvantage community banks face in this regard.

In addition, there is the very real possibility market conditions will force the largest financial institutions to shrink. Citigroup has already begun the process, spinning off its consumer finance division. Meanwhile, the major banks are saddled with the low earnings multiples that investment banks get. Exacerbating the problems of the financial crisis was the inability of management at major financial institutions (not to mention the analytical community) to understand the various business lines of their own companies. That's no way to run a company, much less build value. We expect the market will respond positively to streamlined and more focused banking enterprises.

More to the point, we think smaller is simply better. All of the arguments we've used to promote and encourage community banking in these pages over the past eight years are just as cogent today as they

were when we first listed them. We first stated then and we believe even more so today, the foundation of a strong, free economy is its diverse and competitive banking system. Community banks have been and remain:

- **Locally oriented**—Deposits are generated and invested locally, generally in small businesses that are the engines of growth for the US economy. Community banks provide the fuel that enables small businesses to expand.
- **Nimble**—Small banks can more quickly respond to market and customer needs than the staff in branch #1655 of the too-big-to-fail bank.
- **Accessible**—CEOs and senior loan officers of community banks are readily available to meet with clients to provide advice and counsel as required.
- **Knowledgeable**—Community bank CEOs generally have an equity interest in their banks, similar to that held by their small business clients, and therefore have a business perspective not found in the staff and lenders at large banks.

As we view the world of community banking today, Congress and their regulatory acolytes have perhaps inadvertently (a very positive spin) tried to stymie community banks. They've pumped scores of billions of dollars into the likes of AIG, GMAC (now known as Ally Bank), Citi and many others. Goldman Sachs and others were indirect beneficiaries of AIG's bailout. Meanwhile, regulators have beat up on community banks trying to do their job, and then let them bleed to death.

But community banks are a resilient bunch. There are more than 6,000 (more than 80% of all US banks) with less than \$5 billion in assets; 80% of those have less than \$500 million in assets. Some will go away (whether through consolidation or failure), but the community bank sector will be here long after we are gone. Community banks are a powerful economic force just now regaining their luster, just now overcoming the generic "bank" epithet thrown at them by politicians and the media, and set for a rally the likes of which will create fortunes.

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