

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & James Bruss
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SUBJECT: The Deposit Opportunity

Among the many headwinds facing community banks over the foreseeable future is the prospect of falling margins. The Fed's actions over the last couple years have kept rates so low that banks are struggling to lend money at even modestly attractive (to banks, not borrowers) rates. Net interest margins, in turn, have been compressed, hamstringing banks' efforts to earn their way past credit problems. These credit problems also continue to weigh on banks; non-performing loans are not paying interest, or paying less than originally agreed upon. Meanwhile, loan growth has leveled off (in some cases, it's actually declined) leaving banks without the revenues to boost their margins.

For obvious reasons, bank managers have had their heads buried in their loan portfolios most of the last three years. Too many loans soured, destroying capital and depleting revenue sources. Concerns about credit quality persist even if they are now more defined. Charge-offs at banks continue to be somewhat above normal, further straining both capital and earnings.

Bankers continue to complain that loan growth is anemic where it exists at all. This has several causes. Both regulators and investors have told community banks to reduce concentrations in commercial real estate loans. This is a salutary development, but it has the effect of cutting off a reliable source of borrowers. Businesses, for their part, have been very cautious resulting in tepid loan demand from those sources. Many bankers have been very successful at deleveraging themselves and now sit on piles of cash. They seem content to do that in the face of considerable uncertainties—whether concerns about the European sovereign debt crisis, the prospect of ever-increasing regulation and the imposition of growth-sapping taxes or general anxiety about the state of the economy.

As a result, among both community banks and the banking industry as a whole, outstanding bank credit was down modestly in the first half of 2011. During the same period, loans fell 0.35% at banks with less than \$1 billion in assets and only grew at just under 1% over the last 18 months. This compares to double digit growth in 2007 and 2008 and almost 6% growth in loans in 2009! Recall the world nearly ended in 2009 and the loan growth (or lack thereof) since then is even more remarkable. Bankers can be forgiven for their concern about loan growth and the prospects for growing profitability.

But profitability, as every banker knows, is a two-sided coin. One uncommonly bright spot over the past year has been growth in deposits. While loan growth is flat or even down, deposits are up. This is remarkable given the rates being paid by banks, but certainly reflects the relative safety of an FDIC-insured account. In the first half of 2011, for banks with less than \$1 billion in assets, deposits grew at an annual pace of just over 1%, compared to loan growth of -0.35%. Since 2009, deposits grew at an annual pace of almost 14%.

There is never a bad time for banks to focus on deposit generation. But given the lack of loan growth over the past 18 months in particular, deposit inflows offer banks the opportunity to pick and choose what kind of deposits they will accept. Gone are the days of funding strategies that rely heavily on brokered CDs. Shouldn't banks also eschew large, high-rate CDs generated in their existing customer base? Banks with less than \$1 billion in assets saw their cost of funds decline from 1.66% at Q4-2009 to 1.07% at Q2-2011. With this huge pool of liquidity, banks are now in the enviable position of being able

to accept only those deposits that further drive down their cost of funds and positively impact their net interest margins.

We are in an interest rate environment that requires a mindset significantly different than that of the past decade. In the past, banks faced a balancing act between a low cost of funds and a low cost for the operations needed to achieve that low cost of funds. With the inflow of low cost deposits, that balancing act is no longer as critical. Banks can pick and choose their depositors and achieve a low cost of funds at the same time shedding operating inefficiencies through branch staffing changes or branch consolidation, as an example. But we wonder with loan demand for the over 5,800 banks in this size category at nil, why some are piling on more of something they can't put to use and paying for it too boot?

Of course, lowering the cost of funds is a move toward greater profitability for banks. It is also an opportunity to build shareholder value by creating a stable, low-cost deposit franchise. Banks that recognize this unique moment will benefit with higher profits and improved franchise value. They will also be more prepared to capitalize on the economic rebound when it begins in earnest. We as bank investors will love it!

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