COMMUNITY BANKING
TRENDS AND PERSPECTIVES

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Chairman and Chief Executive Officer
StoneCastle Partners, LLC
StoneCastle invests exclusively in Community Banks – including 42 Iowa banks

Over the past 15 years we have grown to become one of the nation’s largest investors and depositors in Community Banks
StoneCastle Overview

Founded: 2003, 15 years of portfolio and risk management in bank sector

Capital: $13+ billion outstanding as of March 2018

Investments: 800+ Community Banks in all 50 states + Guam

StoneCastle Investment Footprint

1. As of 3/31/2018
The Banking Landscape
Starkly Different Profiles

Community Banks

- 5,555 banks (less than $10 billion of assets)
- Total Assets: $3 trillion
- Average Assets: $0.5 billion

Key Characteristics:
- Local relationship-based lending
- Locally funded through deposits
- High proportion of insider ownership
- Mostly prime borrowers

Global Money Center Banks

- 28 banks (over $100 billion of assets)
- Total Assets: $12 trillion
- Average Assets: $413 billion

Key Characteristics:
- Global and complex exposures
- Volatile trading activities
- Derivative exposures
- European and emerging markets

Source: FDIC – Statistics on Depository Institutions (12/31/2017)
The Informational Advantage

Local banks REALLY know local borrowers: loan size relative to personal guaranties means higher recoveries. Most community bank loans are 1st lien, senior secured and covenant heavy.

For 20+ years, Community Banks never suffered annual charge-offs exceeding those of larger peers.

1. Source: FDIC – Statistics on Depository Institutions, non-weighted averages
Large Banks Have a Funding Advantage

Community Banks can’t attract or secure large balance, stable pools of deposits

Wholesale (Brokered) Deposits as a % of Total Assets

1. Source: FDIC – Statistics on Depository Institutions, non-weighted averages
Superior Loan Performance/Risk Management During the Crisis

Percent of Institutions That Were Profitable

1. Source: FDIC – Statistics on Depository Institutions
Muted Reactions to 80 Years of Market Shocks

Over eight decades Community Banks have exhibited consistent resiliency

High-Yield Credit Default Rates\(^1\) vs. Bank Failure Rates\(^2\)

- Historically, Community Banks failed similarly to BBB-rated corporate credits\(^3\)

1. Source: Moody’s Investor Services - *Moody’s Annual Default Study Corporate Default and Recovery Rate 1920-2015*
2. Source: FDIC Data. StoneCastle Calculation: number failed banks in a year divided by total number of banks at the start of that year “Bank Failure Rates”
3. Source: StoneCastle comparison of BBB-rated corporate bond defaults according to Moody’s Investor Services and Bank Failure Rates
Important Role for Everyday Americans

Over 900 Counties rely exclusively on Community Banks for extension of local credit

Source: SNL Financial
Important Role for Everyday Americans

Community Banks grant everyday Americans cheap access to the financial system

Annual Costs: Unbanked vs. Banked Households

- Unbanked – prepaid card without direct deposit
- Unbanked – prepaid card with direct deposit
- Unbanked – cash only (no prepaid card)
- Banked – checking, no check cashing & average money orders

Modified by StoneCastle to remove marketing added by the source
AS OF 2014, THERE WERE 29.6 MILLION SMALL BUSINESSES IN THE US\textsuperscript{1}

\begin{itemize}
\item Community Banks represent 52% of all small business loans made by banks in the U.S.\textsuperscript{2}
\end{itemize}

\hspace{1cm} 

\textsuperscript{1} Source: SBA – “Frequently Asked Question about Small Business”
\textsuperscript{2} Source: FDIC – Statistics on Depository Institutions (12/31/2017)
Vital to Small Business

Small Businesses Provide 55% of Jobs & 65% of Net New Jobs Since the 1970s. –The SBA

The advantage that comes from close relationships with their customers and intimate knowledge of their communities that lie at the heart of community banking will continue to provide a powerful advantage in serving the vital banking needs of small businesses...

Fed Governor Lael Brainard

Source: Community Banking in the 21st Century, The Third Annual Community Banking Research and Policy Conference - Community Banks, Small Business Credit, and Online Lending

Emphasis provided by StoneCastle
Community Banks ARE Small Businesses

**AVERAGE**

- $545MM IN ASSETS
- 99 EMPLOYEES
- 7 LOCATIONS
- $66MM SMALL BIZ LOANS

**INDUSTRY**

- $3T IN ASSETS
- 551K EMPLOYEES
- 41K LOCATIONS
- $365B SMALL BIZ LOANS

Source: FDIC – Statistics on Depository Institutions (12/31/2017)
The Banking Landscape Has Changed Dramatically…

Total assets of the big have gotten bigger, while the small remain flat

Aggregate Assets\(^1\) (Inflation Adjusted\(^2\))

1. Source: FDIC – Statistics on Depository Institutions
2. Calculated using BLS CPI Inflation Calculator
However, Big Banks Are Not Loved

Results of recent bank customer survey

- Variety of financial services available: 80 (Big Four Banks), 86 (Community Banks)
- Ease of adding or making changes to accounts: 78 (Big Four Banks), 85 (Community Banks)
- Competitiveness of interest rates: 69 (Big Four Banks), 78 (Community Banks)
- Ease of understanding information about accounts: 79 (Big Four Banks), 84 (Community Banks)
- Courtesy and helpfulness of staff: 85 (Big Four Banks), 89 (Community Banks)
- Speed with which financial transaction was completed: 82 (Big Four Banks), 87 (Community Banks)
- Website satisfaction: 83 (Big Four Banks), 86 (Community Banks)
- Call center satisfaction: 79 (Big Four Banks), 82 (Community Banks)
- Number and location of branches: 68 (Big Four Banks), 78 (Community Banks)
- Number and location of ATMs: 74 (Big Four Banks), 78 (Community Banks)

Source: American Customer Satisfaction Index: Finance and Insurance Report
HOW ARE COMMUNITY BANKS DOING?
COMMUNITY BANKS NARROWED THE PRETAX ROA GAP WITH NON-COMMUNITY BANKS FROM 33 BASIS POINTS IN Q4 2016 TO 9 BASIS POINTS IN Q4 2017

Source: FDIC Quarterly Banking Profile, Community Bank Performance Fourth Quarter 2017
Q4 2017 noncurrent loans at the lowest level in over a decade.

Source: FDIC Quarterly Banking Profile, Community Bank Performance Fourth Quarter 2017
COMMUNITY BANKS INCREASED LOANS TO SMALL BUSINESSES AT MORE THAN 2X THE RATE OF NON-COMMUNITY BANKS IN 2017
...however, banking remains a highly regulated industry
REGULATIONS PROTECT THE BANKING INDUSTRY FROM OUTSIDE COMPETITION

Google
FDIC
Walmart
Amazon
Apple
PayPal
**Regulation loosens**: banking less competitive, differentiation easier to achieve
- More latitude to pursue differentiated banking strategies...sometimes bad ones

**Regulation tightens**: banking more competitive, differentiation more difficult to achieve
- Banking strategies restricted, making the businesses more commodity-like...focus becomes customer service
Banks are Always Subject to Dynamic Regulation

But bank consolidation has been regulation neutral

- **BHC Act**: 1956
- **FDIC Insurance**: 1934
- **Glass-Steagall**: 1933
- **DISMCA**: 1960
- **FIRREA**: 1989
- **Riegle-Neal**: 1994
- **Shadow Banking Boom**: 2007
- **Dodd-Frank**: 2010

**NUMBER OF BANKS**
- 15,000
- 10,000
- 5,000

**LEVEL OF REGULATION**
- Higher
- Lower

**Mass Bank Failures**: 1920

Graph is for illustrative purposes only
1. **Challenge:** Aging Management & Difficulty Developing Human Capital  
   **Solution:** Succession Planning

2. **Challenge:** Keeping Up in an Exponentially Evolving World  
   **Solution:** The Bank Tech Paradigm Shift
   - i. Rise of Digital Banking Channels
   - ii. Lack of Antiquated Physical Systems at Community Banks
   - iii. Vendor Competition & Outside Investment Bank Tech
   - iv. Constant Innovation & Simplification of Bank Tech

A. **Challenge:** Inefficiency Bringing Desirable Products to Market  
   **Solution:** Front-End Technology

B. **Challenge:** Losing Out on Gains in Operational Efficiency  
   **Solution:** Back-end Technology
Challenge:
Aging Management & Difficulty
Developing Human Capital

Solution:
Succession Planning
Aging Management…A *Growing* Concern

Source: Bank Director - 2017 Compensation Survey
EXECUTIVE MANAGEMENT

MIDDLE MANAGEMENT

EMPLOYEES

CEO, COO
& Chairman

CFO, CTO
& Vice Chair
CEO #1
- Successful 35-year track record
- Disclosed health issues
- Also serves as Chairman & COO

CEO #2
- Frequently discusses transition strategy
- Brings 44-year-old CFO to investor meetings
- Compliment each other while taking questions

CEO #3
- Occasionally confidentially discusses succession
- Plans to pursue talent as successor
- Familiar with recruiters to contact when needed
WHERE IS THE TALENT FOR COMMUNITY BANKING’S FUTURE COMING FROM?
Of the more than 4,000 higher education institutions in the U.S.,
Only 8 offer banking specialties

Undergraduate Programs (2)
- Texas A&M University
- Marquette University

Graduate Schools (6)
- Graduate School of Banking at Colorado
- Graduate School of Banking at University of Wisconsin
- Graduate School of Banking at Louisiana State University
- Pacific Coast Banking School
- North Carolina School of Banking
- SW Graduate School of Banking
Components of Solid Succession Planning

- Formally Documented & Made Visible to Key Staff
- Regularly Reviewed & Following Major Events
- Continually Enhanced With Input from Key Staff
Roadmap to a Solid Succession Plan

**Comprehensive Roadmap**

**Components of evaluation**

**ANALYSIS**
- Vision? Obstacles?
- Transparent & Objective

**DEVELOPMENT**
- Internal vs. External Formal Training

**SELECTION**
- Who is ready? Selection Process?

**TRANSITION**
- Executing year one; resources needed?

**STRATEGIC BUSINESS PLAN**

**KNOWN UNKNOWN (CONTINGENCY)**

**CURRENT BUSINESS MODEL**
Challenge:
Keeping Up In An Exponentially Evolving World

Solution:
The Bank Tech Paradigm Shift
The Principal of Moore’s Law

Technology improves and relative cost shrinks at an exponential rate.

![Graph showing exponential growth in technology improvement and cost reduction over time.]
Technology improves and relative cost shrinks at an exponential rate.

- **1900:** Teller counts money, stamps passbook, hands cash.
- **1925:**
- **1950:** Insert credit card, print receipt, dispenses cash ($20s).
- **1975:**
- **2000:** Load app on smartphone, tap “Send Money,” money settles “instantly.”
It says “Yes” 24 hours a day, every day.
It says “Yes” to $25, $50, even $100.
It says “Yes” at more locations around town than any other bank.

In a city that sometimes says “no,” Chemical Bank’s Cash Machines always say “yes.” They say “yes” twenty-four hours a day, seven days a week, all around the town. In fact, only Chemical Bank has twenty cash machine locations, a lot more than any other bank. And plenty of new ones are scheduled all over the New York area.

If you don’t have a Master Charge, or if you have one from another bank, you can still sign up at ChemBank.

And if you have a checking account with us, you have two different ways to sign up. You can get a Master Charge or a specially encoded ChemBank Card that works in any Chemical Cash Machine.

All it costs you is three dollars a year membership fee and twenty-five cents a transaction. And that also gets you protection, because only you and ChemBank will know your personal security number needed to operate the Cash Machine.

"Saying "Yes" is a full-time job. Remember, only ChemBank lets you get your hands on money all around New York, anytime you need it. Which seems logical, because saying "yes" is a twenty-four-hour-a-day, seven-day-a-week job."
Big Banks Capitalized on Their Size Advantage over the Years…

…but quite recently, the tides have turned

Source: FDIC - Ratios for Community and Noncommunity Banks
Is your bank leveraging available technologies?

How often do banks offer login through OAuth?
We Are Experiencing a Technological Renaissance for Banks

I. Rise of Digital Banking Channels

II. Lack of Antiquated Physical Systems at Community Banks

III. Vendor Competition & Outside Investment in Bank Tech

IV. Constant Innovation & Simplification of Bank Tech
Factor I. Rise of Digital Banking Channels

Real Bank Savings

<table>
<thead>
<tr>
<th>CHANNEL</th>
<th>AVG. COST PER TRANSACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch</td>
<td>$4.25</td>
</tr>
<tr>
<td>Call Center</td>
<td>$1.30</td>
</tr>
<tr>
<td>ATM</td>
<td>$1.25</td>
</tr>
<tr>
<td>Online Banking</td>
<td>$0.19</td>
</tr>
<tr>
<td>Mobile</td>
<td>$0.10</td>
</tr>
</tbody>
</table>

2. Source: Javelin Strategy & Research
A flexible core banking system is a significant contributor to a bank's ability to respond quickly to changing market conditions, including compliance and changing regulations\(^1\).

**Ages Ago, Big Banks Invested Billions of Dollars in Physical Plant\(^2\):**

<table>
<thead>
<tr>
<th>Outdated Systems</th>
<th>Constrained Tech Budget</th>
<th>No Complete, Real-time View</th>
<th>Real Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-40 YEARS OLD</td>
<td>75%</td>
<td></td>
<td>Some ancient AML systems have a 99% false positive rate. Each instance costs the bank as much as $50(^3)</td>
</tr>
</tbody>
</table>

Tech spending on system maintenance

**Community Banks Can Easily Move to Use Cloud Delivered Cores:**

- More Flexible
- Less Maintenance
- Cheaper to Update
- Easier to Evolve

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1. Source: Banking Exchange - *Core systems at a crossroads*
2. Source: American Banker - *BankThink Fintech’s future is in the back end*
3. Source: D+H – *Sanctions Screening & AML*
The big three core providers AREN’T in the innovation business, they’re in the business of maximizing their assets. Vendors continue to support legacy systems and upgrade them just to keep up with regulatory requirements, but won’t sunset them because they are cash cows.¹

¹ Source: Banking Exchange - Core systems at a crossroads
I’ve seen more banks willing to convert in the past 18 months than I’ve seen in the past 18 years. I see interest in banks with younger management teams who aren’t intimidated by technology and who recognize the need for technology to stay competitive.

—Copper River Group’s CEO Dan Fisher

Source: Source: CITI - Digital Disruption Report 2017
Historic\(^1\)

The big-three provided systems for transaction processing:

- Early systems were simple & effective
- Over time, a hodgepodge of ancillary systems evolved
- Decades later these systems are fractured & complex

These systems have been subject to term contracts, but are capable of being switched out in as little as 6 months\(^2\)

Present/Future\(^1\)

Growth of software as a services (SaaS) platforms offer:

- Real-time posting of transactions
- Cloud-hosted solutions
- Open architectures for integration of best-of-breed solutions from other 3\(^{rd}\) party solutions providers\(^1\)

Subscription-based, SaaS models often offer custom or pay-as-you-go pricing structures and are less expensive

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1. Source: Graphics from Q2 Holdings Investor Presentation
2. Source: American Banker - How core conversion spurred a community bank's explosive growth
For the 1st Time Since Adoption of the ATM Small Banks Have a Technology Advantage

• **Don’t compete with FinTech.** Use API’s that allow a bank to leverage solutions FinTech companies create every month!

• **APIs work behind the scenes.** Used to deliver best-in-class features to your customers through your channels, increasing customer loyalty.

• **Only pay for what you use!** Banks can pick and choose which features to add or remove quickly and at minimal cost, based on usage.

• **Instant utility.** Most existing core systems can utilize this tech immediately by adding features – such as mobile banking – seamlessly via API.

• **Software stays updated.** Nothing is in-house – maintenance and updates are outsourced too – so you can focus on customers!
Challenge:
Inefficiency Bringing Desirable Products to Market

Solution:
Front-end Technology
Devices Are Ever Evolving…

adding new features & functionality banks can leverage without CapEx
Array of Services Keeps Expanding…

…increasing the value that banking apps can deliver to customers
Customers Prefer Mobile

INCREASED
CUSTOMER SATISFACTION

A BRANCH VISIT IN THE U.S. IS 2.3X MORE LIKELY TO ANNOY THAN A MOBILE INTERACTION.

INCREASED
CUSTOMER RETENTION

FREQUENT MOBILE USERS IN THE U.S. ARE 40% LESS LIKELY TO SWITCH BANKS

Digital Growth Has Room to Run

Customer supplies the hardware – bank retains the customer data

U.S. lags in mobile adoption and millennials strongly prefer mobile

Challenge: Losing Out on Gains in Operational Efficiency

Solution: Back-end Technology
## Breaking Down the Back Office

### Challenges
- High variable costs
- Poor speed of service, human error
- Low staff morale and poor productivity
- Less innovation
- Not flexible or scalable
- Compliance processes and procedures

### Key Levers
1. **Relocate**
2. **Standardise**
3. **Optimise**
4. **Digitise**
5. **Automate**

### Examples
- Labor arbitrage
- Identify global process commonalities
- Define, simplify, and LEAN processes
- Deliver workflow, document management, self service, and data warehouse
- Implement robotic process automation

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2. Indicative % benefits estimate based on total cost base
“By reworking their IT architecture, banks can have much smaller operational units run value-adding tasks, including complex processes, such as deal origination, and activities that require human intervention, such as financial reviews.

By taking full advantage of this approach, banks can often generate an improvement of more than 50 percent in productivity and customer service.”

Source: McKinsey & Company - Automating the bank’s back office
Automation Does Not Mean Layoffs

Rather, automation empowers existing employees

ATMs Didn’t Reduce the Number of Tellers

Source: Richmond FRB - Depression-Era Bank Failures: The Great Contagion or the Great Shakeout?
### Automation Can Deliver Many Benefits

<table>
<thead>
<tr>
<th>Higher Quality</th>
<th>Productivity Boost</th>
<th>Cost Saver</th>
<th>Accelerates Implementation Speed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Human error eliminated</td>
<td>Average Handling</td>
<td>Processing costs</td>
<td>Fast implementation of new processes</td>
</tr>
<tr>
<td>Improved compliance</td>
<td>Times reduced</td>
<td>Reduced by up to 80%</td>
<td></td>
</tr>
<tr>
<td>Higher staff satisfaction</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capacity increase by robotics virtual workforce &amp; refocusing of staff on customer service</td>
<td>Payback in up to 3 months</td>
<td>Re-usuable process elements</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Source:** Accenture - *Benefits of robotic process automation extend beyond just cost savings for banks*
Automation Has Broad Applications

ONBOARDING
- New account entry across systems – moving data and doing multiple entries
- Client onboarding - documentation requirements check
- KYC – collection and analysis of basic identity information (CIP)
- AML – name matching against lists of known parties

BOOKKEEPING
- Account reconciliation – duplicating and moving data
- Accrual support – making and updating entries
- Notification of delinquent loans – emails and letters to clients
- Account cleansing – purging old data
- Cost accounting and Purchase Orders

REPORTING
- Audit support and validation
- Report generation across systems

RISK MANAGEMENT
- Fraud detection – customer risk to commit money laundering, terrorist finance, or identity theft
- Trend spotting – collection, aggregation and real-time collection & monitoring of “Big Data”
COMMUNITY BANKS SURVIVED OVER 100 YEARS THROUGH MANY MARKET & CREDIT CYCLES
TODAY,

THERE IS

NEW REASON FOR OPTIMISM...
Before the Internet, goods from far away were desirable.

But, today any good/service is attainable anywhere.
LOCAL

WHILE LARGE BANKS TRY TO PITCH IT...

COMMUNITY BANKS ARE UNIQUELY POSITIONED TO DELIVER IT...
BY CONTINUING TO DELIVER THEIR HALLMARKS

Fostering relationships & providing individual attention

Remaining active & visible in the local community
BY ACTING NOW TO INVEST IN THE FUTURE

Leveraging the technology available at your fingertips

Cultivating a pipeline of future leaders
Community banks have a vibrant future if they choose to “seize the day”
If your bank is considering raising capital or could use extra deposits give us a call!

StoneCastle

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