FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Ed Depenbrok
DATE: February 16, 2019
SUBJECT: Free Markets, Community Banks and Their Regulators

In a few weeks we will be *celebrating* the 10th anniversary of the March 9, 2009 turnaround of the financial markets. We remember that day because it coincides with the date when Barney Frank's Financial Services Committee annound a hearing with the Financial Accounting Standards Board (FASB) on this really dumb accounting rule, FAS 157, a/k/a mark-to-market accounting which was designed to force banks to take a few bids from the marketplace and use those bids to value assets. Cash flow didn't matter, neither did underlying asset value. The results were disasterous. Markets for loans froze and assets that were still paying on time were sold at bottom of the barrel prices. So banks under FAS 157 were forced to take the "bid", reflect it on their income statements and subtract the losses from capital. The result was that there was no willingness to invest in banks because at any time they could be wiped out by mark-to-market losses. FAS 157 which applied to all asset classes actually exacerbated the subprime crisis (according to over 600 news articles).

When this hearing was announced, the financial markets were prescient (without the benefit of Artifical Intelligence) and realized that change was coming. The market (S&P 500) is up 300% (through 1/31/2019), banks were healed, asset values rose and a so-called normal recovery began.

The government-led version of history reflects that it was *Quantitative Easing* (QE) which began in September 2008 that lifted the stock market and according to Hank Paulson and others, it was the *Troubled Asset Relief Plan* (TARP) pushed into law that saved the banks. Neither could be further from the truth. The market continued to fall through 2008 and until March 9, 2009 when the financial markets realized the change was coming. The S&P 500 fell an additional 40% after TARP and QE, and bank stocks fell 73%!

FAS 157 was amended April of 2009 and the rest is history. Point being, it wasn't government that engineered the turnaround, it was the *free market*—a market that was loosed from the shackles of FAS 157 by the FASB itself on April 2, 2009.

It is clear to us that the election of Donald Trump in November 2016 also contributed towards the sustained stock market rally, particulary for bank stocks, as the S & P 500 and the SNL Micro Cap US Bank Index have both increased by +26.4% and +30.9% respectively since election day. We believe that the markets rallied sharply after the election and have held most of their gains due to belief that the President would deliver regulatory relief. Nowhere was relief needed more than at community banks.

Last week we attended the Wisconsin Bankers Association's Annual Bank Executives Conference. We had the opportunity to sit in on a Q & A session with Jelena McWilliams, Chairman of the Federal Deposit Insurance Corporation. Among her remarks was her very clear acknowledgment that "[c]ommunity banks are key economic drivers in smaller towns. . ." and a straight-forward statement that the "regulators are tyring to simplify the rules for them while making sure they maintain standards for financial strength. . ."

She went on to say that her "whole approach at the FDIC is that community banks are not complex, and we shouldn't try to regulate as if they were complex financial institutions. . .[and that] the FDIC is working to simplify capital requirements for non-mega banks"

Further on the subject of capital and in response to a question about the paucity of new banks she stated that the industry is operating under the impression that bank organizers need to raise at least $20 million to start a bank. "Actually, the capital raised could be much less than that, depending on the banks business plan," and went on to say "the FDIC needs to do a better job working with potential bank founders before they apply for FDIC insurance so the process can go faster once an application is filed."

Every person we talked with about Chairman McWilliams agreed that she was a "breath of fresh air" in the regulatory world in which we live.

In a meeting McWilliams had with reporters before her Q & A session, she said that when "the community bank closes down, so does the local barber shop and the diner, and it has a trickle-down effect on the revenue stream for the city and schools and everything else."[1] We personally observed this happen with the Fortress Bank of Westby:

In 1992 Fortress Bancshares, Inc. was formed to acquire the $55 million asset Westby-Coon Valley State Bank. In November 2002, Fortress Bancshares had grown to almost $220 million in assets organically and by acquisition; Fortress Bank of Westby had become a $111 million asset bank serving its markets in Westby (population 2,200), Coon Valley (population 784), Chaseburg (population 296) and West Salem (population 5,026). In that year, the company was sold to the $1.5 billion asset Milwaukee bank, Merchants and Manufactuers Bancorporation, Inc. which in turn was sold to Bank of Montreal (BMO) in Febraury 2008. Shortly thereafter, BMO Harris, shuttered each of the offices and apparently merged the deposits with its office in LaCrosse—26 miles to the west of Westby.

". . . [A]nd it has a trickle-down effect on the revenue stream for the city and schools and everything else."

Earlier this week at an American Bankers Association Community Banking Conference in San Diego, newly appointed Federal Reserve Board Governor, Michelle Bowman spoke.[2] She made it clear that bank "regulators have a duty to make sure policies are suited to the particular profile of community banks [because] the straightforward nature of community banking, regulators have an obligation to develop and refine approaches to supervision that fit the smaller size and less -complex risk profiles of these banks."

According to the *American Banker*, Governor Bowman pointed out that community banks play a vital role in providing financial services to small communities while posing little if any risk to the financial system at large. "This role puts the onus on the Fed and other regulators to ensure that its rules and regulations are not harming these institutions", she added.

She was a former Kansas Commissioner of Banking and a 5th generation banker who also served as vice president of the Council Grove, Kansas, $180 million asset Farmers & Drovers Bank. With her appointment by President Trump and approval by the Senate in November of 2018, she is the first to fill a spot required under the Federal Reserve Act (amended in 2014) for someone with community banking experience and, is in our view another breath of fresh air in Washington in support of community banks.

So there we have it—two new regulators, both with banking experience; Chairman McWilliams an executive at Fifth Third Bank who is talking the talk and hopefully walking the walk on behalf of community banks which make up the great majority of the banks insured and regulated by the FDIC and Governor Bowman, 5th generation community banker and former Kansas Banking Commissioner who has lived in and with

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[1] Source: The writers and "FDIC trying to tailor rules for community banks, chairman says in Milwaukee", Paul Gores, *Milwaukee Journal Sentinel*, February 5, 2019

[2] Source: "It's rerulators' job to tailor rules for small banks: Fed's Bowman", John Heitman, *The American Banker*, February 11, 2019

community banks in her career, a regulatory duo, one representing (by law) and both advocating for community banks, something we've never seen during our lengthy careers in banking.

We believe that these two regulators may well represent a new era for community banking, an era in which the regulatory environment will be redesigned and implemented in the field to fit the "particular profile of community banks". We see the possibility of the easing of administrative burdens on community banks and bankers such as the possible shortening of the length of the quarterly call reports, the quarter financial statement required of banks by regulation. Also of great importance to us as bank investors is a continued flow of new banks managed by competent and experienced bankers to provide loanable funds to unserved and underserved communities and markets throughout the nation. We see Chairman McWilliams efforts to align capital requirements to fit the business plans and markets of *de novo* (start-up) banks.

What we heard and read in the last week from regulators reinforces the Fortress Partners' mantra (www.fortresspartners.com) "The Foundation of a strong, free economy is a diverse and competitive banking system. We interested, proactive shareholders promote efficiency and good performance, while fostering a healthy banking and economic system."

We believe this with every fiber of our being. We hope you do as well.

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