FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Ed Depenbrok
DATE: December 28, 2019
SUBJECT: How *Digital* is Your Bank? Part Two

The electronic ink was barely dry as we sent you our October Fortress Partners *E*-Memo, "How Digital is Your Bank?" when the **American Banker** in quick succession carried a piece by Ken McCarthy on November 10 entitled "Small banks resisting digital (yes, they exist) warned to wise up" and on November 13, Will Hernandez wrote "Tired of paying 'ransom' to core vendors, two small banks fund a new one".

We found both articles enlightening, but we concluded, based upon our recent strategic planning exercises with community banks, but while the subject of digitalization of community banks is a frequent discussion topic, most discussions do not seem to take the next step of setting Strategic Objectives around the issue Its almost as if everyone is waiting for someone else to solve the issue or at least provide the tools and direction.

In our October *E*-Memo we said we've been "noodling on this subject since we wrote our August *E*-Memo". It would be fair to say that more recently we been *brooding* on this subject. We think that Ken McCarthy's piece is a serious indictment of the mindset of community bankers as the survey we discuss below indicates. Mind you, we know that community bankers do not march lock-step to one theme or another—except perhaps when it comes to tilting at the windmill of credit unions.

Experts, according to McCarthy, say that "[b]anks that want to consider themselves full service institutions need to capture *all* (*E*-Memo italics) of a clients' wallet share, which is impossible without a strong digital presence." In his article McCarthy cited a recent survey by the Conference of State Bank Supervisors (CSBS) of 571 community banks from April and July of 2019 which indicated that 40% have no plans to accept online loan applications and 75% felt the same way about online loan closings. What? Really?

McCarthy writes, "Has the time come for community banks to say enough to allowing its clients to hold a Capital One credit card (one of us does), an American Express card and have a car loan from yet somewhere else?"

One of the panelists discussing the CSBS survey was asked whether we were at the point that every community bank needs a digital strategy. His response, "Do you think the internet is here to stay. . .[t]he entire economy is being built around companies using digital tools."

Another panelist responded by citing the example of a farmer who drives a tractor with an air-conditioned cab containing equipment allowing for a satellite feed telling him where to plant. So this farmer stops by his bank and sees his contact officer with a file folder containing some outdated pie charts rather than holding an iPad. The level of sophistication does not decline the smaller the town.

The internet is driving the banking experience folks currently being served by small banks are seeking. If they don't find it from their smaller bank, they will find it from the big banks.

According to McCarthy and the panelists it is industries like ours—banking—that are heavily regulated that get disintermediated last. We've been a protected class for a long, long time. Take a look at shareholder owned public utilities: were they first in the development of wind power or solar energy or methane gas generation from livestock waste or. . .?

Finally, we think a key to long term survival of community banks, the banks that we manage, the boards on which we serve, the banks in which we invest. is growth without adding to staff. Digitization—is the only answer to profitable growth.

So where do community banks go from here? API (Application Programming Interfaces) and the Cloud.

According to the ABA panelists: "The cloud has allowed the smallest community banks to use exactly the same technology as Bank of America or JPMorgan Chase. . .where the same technology can be deployed at a $1 billion-asset community bank as the big four."

And the really neat thing is that much of this technology is user based to you can get the level of sophistication used by the big banks but at a much lower price.

A stumbling block for community banks wanting get to the cloud has been, according to Will Hernandez's piece on November 13 in the **American Banker** is their current core processor**.**

We know how fed up community banks are with traditional core-systems vendors' cost and services. This frustration is not new. We know it is decades old as we have managed small banks for three decades and have personally lived those frustrations.

The solution may be as simple, according to Hernandez, as "taking a page from venture capitalists and financing an upstart core provider." The banks taking the proverbial bull by the horns are the $230 million asset State Bank of Wonder Lake, IL and $1 billion asset Provident Bank of Amesbury, MA.

What is needed according to Michelle Toll, CEO and President of State Bank of Wonder Lake is to "get our core provider to somehow scale the cost of adapting quicker to their new products, or be able to work a third party through an API (which allows two applications to talk to each other—*E*-Memo insert)". She cited two examples of State Bank's rationale for seeking and supporting an alternative to the bank's current core processor:

- A $10,000 charge for updating the lender's new logo on its mobile banking app.
- A $100,000 charge to upgrade an API that linked a third-party mobile banking provider to the bank's core system and online banking.

The legacy core providers have been created by mergers and acquistions of mom and pop type core processing companies. Their businesses are a hodge-podge of tiny companies acquired over the last 40+years that have never been integrated into a single homogenous platform. We believe this is the key reason legacy core providers can't be as nimble and quick as we as bankers and bank investors need them to be to enable us to compete with the largest of institutions many of which are operating and competing with us in our own backyards.

The upstart core provider in which Provident and State Bank are investros is Neocova. It was formed by founder and CEO, Sultan Meghji, and co-founders Kelsey Weaver, Chief Business Development Officer and Lindsay Lockhart, Chief Digitial Officer after extensive discussions with community banks, regulators and industry associations. What Meghji and his partners found in their discussions with the aforementioned groups that led them to move forward were: "outdated technology from traditional cores, unfair vendor contracts (discussed in our August 31, 2017 *E*-Memo, Community Bank Vendor Contracts—*Do Something Now Before It's Too Late!*) and increased market competition faced by small banks from the largest lenders and fintechs.

What is encouraging is that the American Bankers Association (ABA) is attempting to act as an intermediary to the cores on behalf its member banks. It recently published a set of principles for cores and the banking industry to follow as it relates to those relationships. The Hernandez article summarized the ABA's principles for cores and the banking industry to follow as it relates to those relationships. They are as follows:

- On-time, exception customer service
- Concise, easy-to-read billing statements
- Access to all bank data from cores through APIs
- Industry leading data protection and privacy
- Fair and transparent contracts

Without question, merely thinking about changing from a current core processor to a new core processor brings on memories of horror stories from the last changeover—with the same core. One can't begin to imagine the challenges in switching to a totally new core. I was told by the CEO of a bank we acquired 25 years ago that "Anybody can run a community bank. It's breaking up the knife fights in the backroom that requires real skill."

As Andrey Brozhko, head of ClauseMatch, wrote in a recent piece for BAI Banking Strategies, "Boring banking can be a good thing if it means a steady, measured approach that protects consumers and keeps the financial system on solid ground. But boring banking can have a downside if it means relying on outdated systems that ultimately don't work for customers, investors, employees, or even banks themselves.

We write this E-Memo, our last for 2019, realizing that becoming digital is a huge leap for many community banks and it is not a leap to be taken blindly. Digitalization needs to become top of mind for bank managers, bank boards and bank investors in 2020 to preclude the decline in shareholder value of the bank you manage or the bank in which you are invested in the upcoming decade.

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