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THE IB (INDUSTRIAL BANK) CONUNDRUM: GREAT PERFORMANCE VS. PUBLIC POLICY

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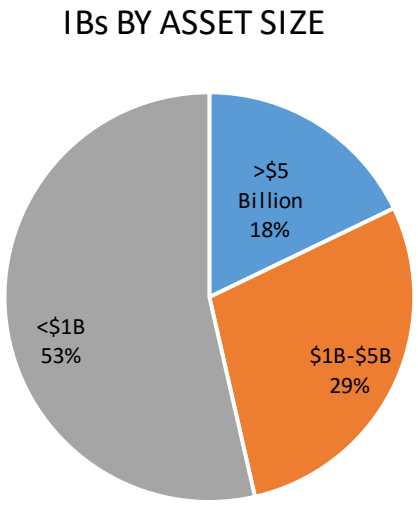
Industrial banks, or IBs are a small number of state chartered financial institutions that operate with generally the same powers as commercial banks. However, in addition to performance, IBs do differ from banks in one other characteristic—the type of companies that may own them. IBs meeting certain conditions may be owned and operated by firms engaged in commercial activities (avoiding the prohibitions on mixing banking and commerce that apply to all other depository institutions).

These small number of specialty banks represent $165.8 billion in assets as of Q1 2016. When considering the size of the US banking industry, their level of market share is minimal.

ASSET SIZE DISTRIBUTION



Also, IBs skew smaller, the majority (53%) have less than $1 billion in assets.

There were two things that caught my eye about IBs:

1. Financial performance
2. Political conundrum

FINANCIAL PERFORMANCE

IBs as a group materially outperform commercial banks. In most key measures it's not even close. One can identify multiple reason for their admirable performance. They do seem to operate in some ways in a non-traditional fashion. Here are a handful of factors to consider:

1. Customers skew to individuals with consumer-based needs (higher yield opportunities)
2. In many cases the owners have captive markets of target customers (potential for lower acquisition costs)
3. Primarily centralized operations (supports greater efficiency)
4. Non-traditional funding sources (may be more costly, but easier to manage and support, i.e. brokered deposits vs. traditional core deposits)

Overall, many IBs enjoy a very streamlined and efficient operating model and they do fill a specific void or need in the market.

POLITICAL/PUBLIC POLICY CONUNDRUM

Though this may be a somewhat dated issue, at the center of this controversy relates to whether commercial firms, retailers, manufacturers, and others—should be allowed to use IBs to get into banking and what would be the public policy implications of such entry?

Those opposing parties for instance, contend that IBs owned by commercial entities would face significant conflicts of interest. Such IBs, it is argued, would have strong incentives to lend to customers of the parent company on a favorable basis and without due regard for standards of creditworthiness.

These conflicts might thus be resolved to the detriment of the IB, its customers, or the deposit insurance system and other elements of the federal safety net. Another common argument (like when Wal-Mart was pursuing a charter) is that Wal-Mart and others might be able to exploit their size and existing customer relationships in a manner that would give them a dominant role in banking markets, thereby reducing financial competition.

In short, there have been concerns expressed with

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commercial entities owning banks (under IB charter). The key themes; safety and soundness, conflicts of interest, competitive effects (unfair advantage), and safety net concerns (serving multiple masters).

From a regulatory perspective, IB's are state chartered and FDIC insured. Most IBs are based (chartered) in the state of Utah. The unscientific observation based on feedback from industry insiders, is that the states are Pro-IB and the FDIC is neutral to anti-IB. The FDIC perception may partially be due to the public policy debates associated with Wal-Mart and Home Depot charter pursuits.

Considering that since 2008 there have only been three new charters issued (includes all charter types), FDIC and other agencies may be willing to change their stance on issuing new charters for IBs.

In the end, if there is an argument that wins the day, it is the fear arising from the competitive threat. As you will see in the research, IBs seem to have struck the right balance between risk and reward.

With that said, let's establish our research assumptions. For the purposes of this analysis we have selected IB banks with assets up to $5 billion (supports a better basis for comparative purposes). Additionally, to provide a broader perspective of performance, we included performance data from 2012 through Q1 2016. We also looked at medians and averages. The analysis compares IBs to banks between $3B-$5B and all banks under $5B. We added the $3B-$5B group to add a dimension or perspective to the value of size.

SUMMARY OF FINDINGS

The analysis indicates that IBs in aggregate dramatically outperform like sized commercial banks in the areas of growth, earnings, shareholder return, yields, operating efficiency, non-interest income and capital ratio levels.

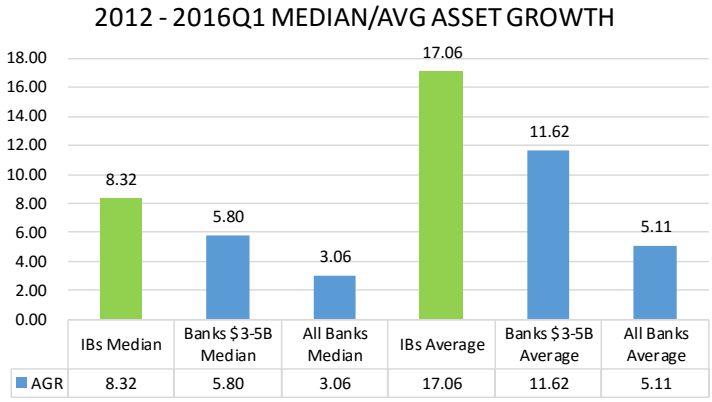
More specifically, the IB performance compared to their commercial bank counter parts reflects:

- Grew at a greater rate
- ROAA was higher
- ROAE was higher
- Net Interest Margin was higher
- Operating efficiency was lower
- Loan portfolio yield was higher
- Cost of funding was higher
- Non-interest income was higher
- Asset Quality (NPAs) was about the same
- Capital level was higher

Given this level of performance, you may conclude that the resistance to granting additional charters is more about a competitive advantage as opposed to elevated risk.

One additional observation (though not central to this study), the $3B -$5B bank group consistently outperformed the "All Bank" group.

MEDIAN & AVERAGE ASSET GROWTH



When analyzing the growth impact, the IB growth rate reflects a more robust trend post the Great Recession. This may also be tied to an increase in consumer spending. When viewing average growth vs. median, both the IBs and larger commercial banks enjoyed a

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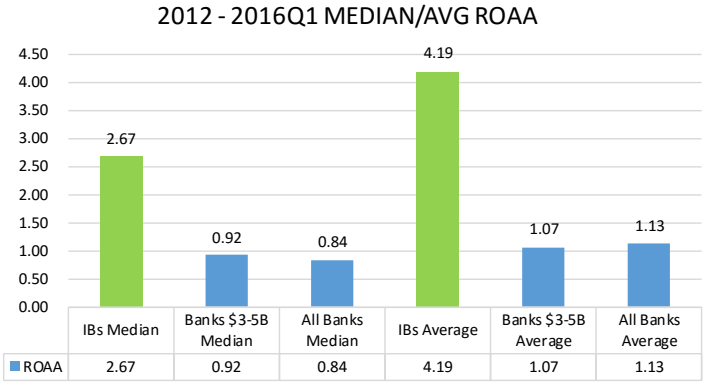
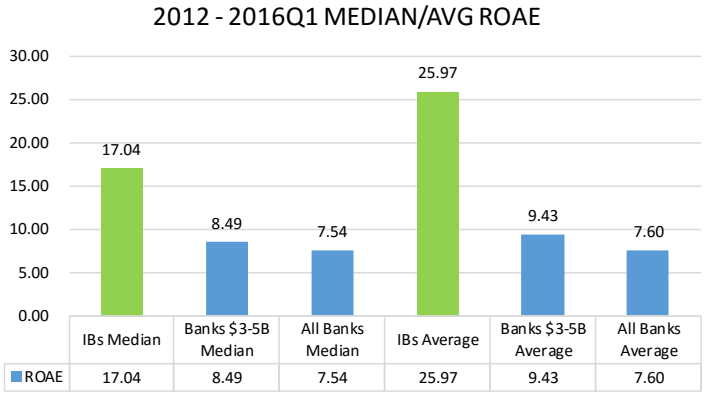
double digit growth rate over the performance period. The overall difference is great than 2 to 1.

MEDIAN & AVERAGE ROAA



When reviewing annual earnings comparison, the difference between the groups is dramatic. As mentioned earlier, you can attribute IB's performance to an overall higher yield on earning assets, greater efficiency, most likely attributed to a centralized environment and streamlined delivery and back office operations. The magnitude of difference ranges between 2.5-3.00 to 1.

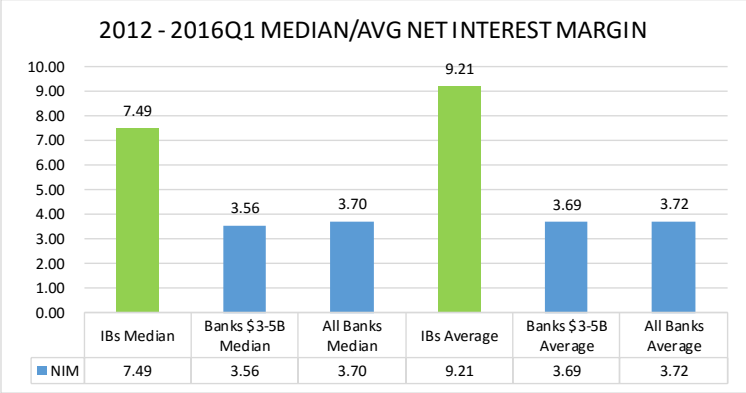
MEDIAN & AVERAGE ROAE



From a shareholder perspective, you can see why a commercial enterprise may want to own their own bank. Many IBs have been enjoying greater than a 15% - 20% ROAE over the last five years. Conversely, the industry in general is striving to return to a ten plus ROE. A level most banks have not achieved.

MEDIAN & AVERAGE NET INTEREST MARGIN

For the average banker, a net interest margin of 7% to 9% would be regarded as a "crazy" level of return, and one that most likely comes with a much higher risk profile. We will touch on portfolio composition for both credit and deposit under following charts, however, it is fair to say that a IB's NIM in this range typically comes with a majority of consumer/credit card business. Worth mentioning, is it may not necessarily carry materially higher risk. From a non-performing asset standpoint, the difference between IBs and commercial banks was insignificant



MEDIAN & AVERAGE EFFICIENCY RATIO

The average IB over the last five years has spent about 45 cents to make a dollar. For their commercial bank counter parts, it has been closer to 65-80 cents. Needless to say, there are multiple factors that can drive efficiency. A few key factors for IBs include: most

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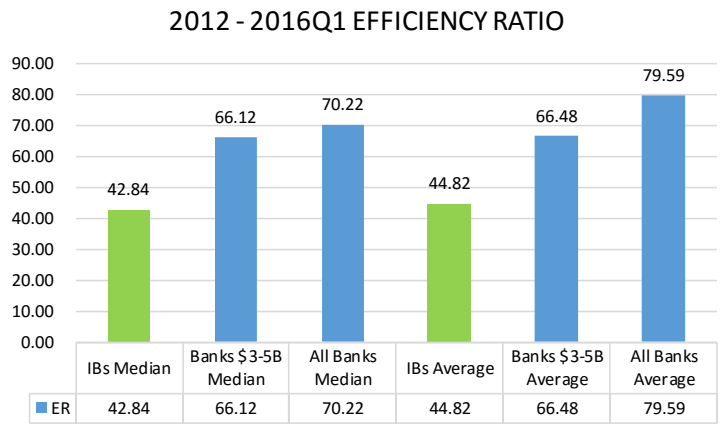
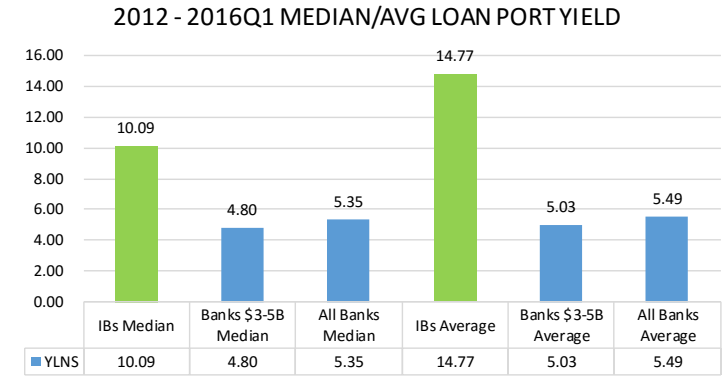
leverage a centralized operation, average net earnings per FTE is 10 times greater with an IB and they rely on a minimal number of branches.



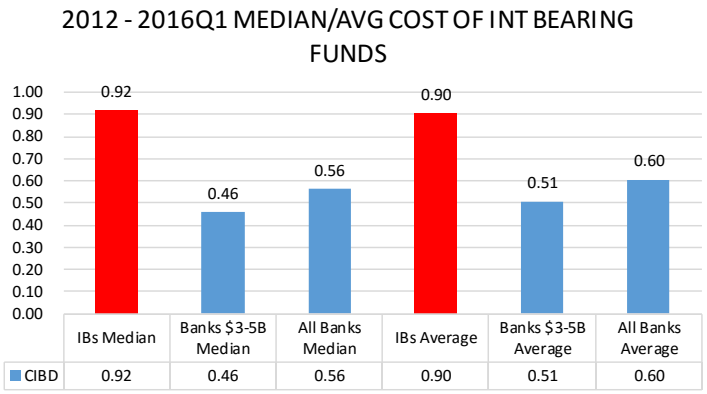
MEDIAN & AVERAGE LOAN PORTFOLIO YIELD



The two top loan types for IBs are Loans to Individuals and C&I. The average IB has 42% of their portfolio in Loans to Individuals vs. commercial banks at around 5%. These loan types will typically carry higher yields be they credit cards, direct or indirect loans. On the other hand, the average commercial bank's portfolios skew to CRE and 1-4 Family loan types (at 24% and 31% respectively). Neither loan type typically generates the types of yields reflected in the comparison chart above. IBs appear to enjoy a 2-3:1 advantage when it comes to yields. It is worth noting that IB's have the same CRA responsibilities as other banks, thus providing a tremendous asset to their communities.

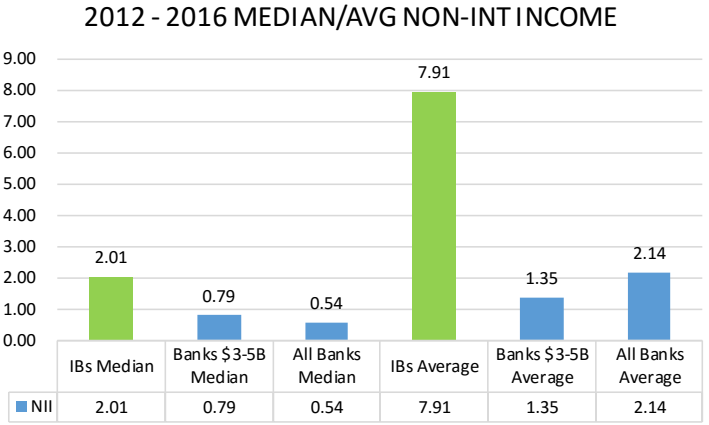
MEDIAN & AVERAGE COST INT BEARING FUNDS

The cost of interest bearing funds is one area where the IB did not perform as well as their commercial bank counterparts. For example, the average IB will have broker deposits making up 42% of their deposit portfolio (and some a lot higher), while the average bank will have just under 3%. However, with the option to rely on non-core deposits as a funding source, the IBs do not have to bear the expense of deposit product development, acquisition, and servicing costs at the level of a commercial bank. Many would argue the brokered deposits and commercial paper can be more effectively managed resulting in an overall lower risk profile than with



dealing with core deposits. An additional risk consideration is BD's allow a bank to expand and contract its balance sheet at a measured pace and the deposits are generally thought to be much more stable than deposits sourced online via high teaser rates.

MEDIAN & AVERAGE NON-INT INCOME



Non-interest income is a big differentiator for IBs. Many of their core products carry a significant non-interest income fee component. These fees can include, credit card service charges, origination fees, and other service related fees. Most of these fees need to reside within the consumer oriented business model. Comparable commercial bank models would include banks with a strong SBA group, trust services, wealth management or other specialty lending products. Deposit fee income can also contribute to this line item. However, in the end, IBs carry a 2-4:1 advantage.

MEDIAN & AVERAGE NON-PERFORMING ASSETS

Going into this section of the research, we expected to see greater disparity. Non-performing assets medians and averages were a modest number of basis points apart. Given portfolio yields and the assumption of some risk-based pricing the differences seem insignificant. We did dig deeper into 30-89 days past due, and did discover the average IB ran a 1.26% delinquency rate while the average bank group was 1.06%. the medians were even closer.

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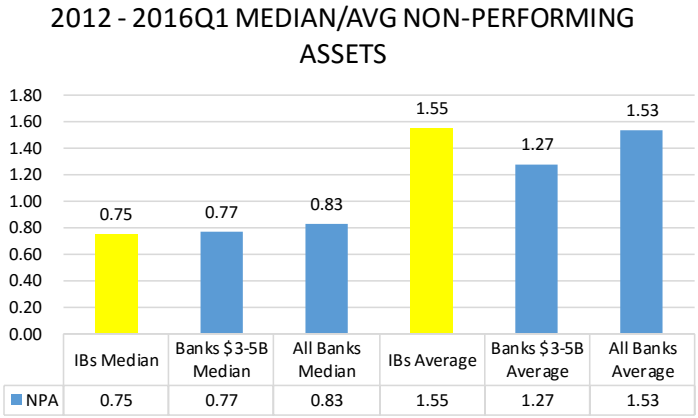
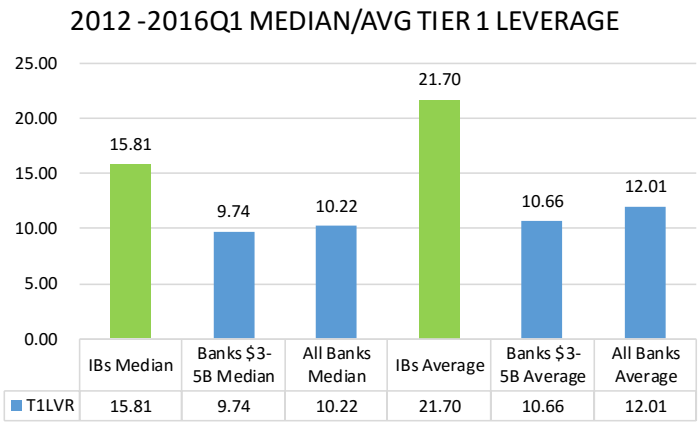


MEDIAN & AVERAGE TIER 1 LEVERAGE RATIO



Equity tends to represent the safety net for this federally insured industry. We selected the Tier 1 Leverage ratio for comparison purposes. If certain parties were worried about conflict of interest or other issues with commercial owners, it doesn't appear they are peeling off capital as a means to further enrichment.

CLOSING THOUGHTS

I think it is fair to say that IBs and their business models are very attractive. Based on our research, and review of early periods as well, IBs have maintained above average performance as a group, during good times and bad.

It will be interesting to see if IBs as an operating model, expand beyond their current market presence. In some respects, you could argue some look very similar to the emerging fintech models.

Perhaps an IB oversight model could serve as a vehicle to usher in regulatory oversight where currently none exists.

As far as the political/policy conundrum I mentioned at the opening of this study, there only seems to be one of the four concerns that may carry water.

It is the competitive threat. However, when you consider IB's do not pursue consumer or business deposits, and their lending activities are in most cases narrowly defined or specialized. I would argue from a community bank's perspective, IBs are not direct competitors. When assessing the competitive landscape of larger commercial banks, the lines may become a little less clear. In either case, in today's markets IBs do not compete for deposit relationships, which are central to most bank's strategies.

One might want to make an argument for conflict of interest (putting the commercial corporation interests before the interest of the regulated institution), but there is just nothing in the data that supports this view. On the contrary, I am sure that American Express, BMW, Harley Davidson and others would tell you their IBs are primary contributors to their strategic success.

As it relates to safety and soundness, and a capital safety net, the data dismisses these concerns. From a safety and soundness perspective, IBs as a group have a long standing track record that reflects sound performance in good times and bad. Regarding the safety net, IBs have maintained capital levels materially higher than their commercial bank counter parts.

It appears the future of IBs is still being written.