Change Accelerates for Alabama Banks

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Alabama bankers will either look back on this first decade of the 21st century as the time when our operating landscape caught up with that of the rest of the country, or as the time when the predictions of three decades about the future of Alabama banking finally came true.

With Alabama's banking landscape evolving to more closely resemble what is seen in much of the rest of the country, we can learn a lot from the pattern that change in banking has taken in other states:

First comes the urge to merge by home-grown but large local banks with equal or larger competitors, for a variety of reasons. Next comes the acquisition of large local banks by larger out of state banks, again for a variety of reasons. For example, in Texas in the late 1980's it was prospect of failure due to the oil price bust, and the buyers were large, out-of-state banks that left the state without a single major bank headquartered there.

Second comes an explosion of creativity and growth as

- new banks get started,
- smaller banks get bigger and
- the largest banks perfect their technology-based ability to deliver more and more products to their customers scattered across the globe.

This was illustrated in Florida a number of years ago when 25% of the banks in that state were less than three years old after many of their larger institutions were acquired by larger out of state banks.

As Alabama just finishes adjusting to the sale of SouthTrust to Wachovia, word comes that the long-rumored combination of AmSouth and Regions turns out to be true. The latter merger results in Alabama retaining a major role in banking as headquarters to one of the country's largest 10 banks. One effect of these two mergers is that it changes the physical and business patterns Alabama banking has gotten used to over the last 40 years.

So what lies ahead for Alabama bankers and what challenges and opportunities await them in the evolving banking landscape?

Bricks, Mortar, Deposits & Loans Changing Hands

Do you remember the predictions of even a few years ago that banking was on the way toward occupying an entirely "virtual" world? Apparently the prognosticators failed to consult consumers. Even with the increasing popularity of internet banking services, the continued flow of customers into our branches would seem to indicate that many of our customers still want their banks to have a brick and mortar presence.

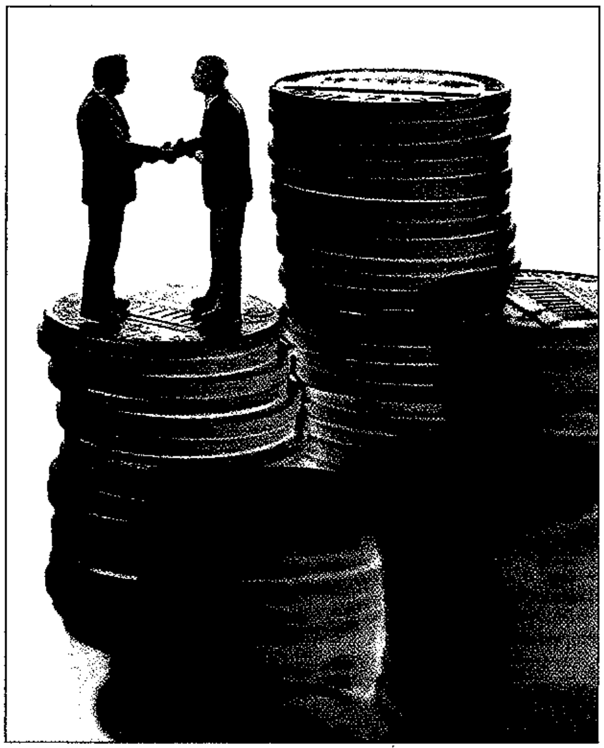
The merger of AmSouth and Regions will make available to the retail banking market a large number of bank locations and customer relationships. There are at least two reasons:

- The first reason for the influx of real estate and customer relationships into the market in certain areas will be the antitrust laws. Where the combined market share of deposits is so large as to be anti-competitive, the federal government will require that they divest not only brick and mortar facilities but also the deposit and other customer account relationships housed at those facilities. In Alabama, over $2 billion in deposits are expected to be made available primarily in Montgomery, Mobile, Tuscaloosa and Gadsden. The U.S. Department of Justice has shown itself willing to manage very closely the divestiture process in bank mergers.
- The second reason for bank real estate coming on to the market is that the two merging banks' branches are located so close to one another, often at the same intersection. One of the close-by branches will be sold as pure real estate, presumably the less attractive of the two either in terms of location, age or ownership (an owned location may often be more profitable to retain because of the absence of rental payments). The merging partners have stated publicly that they have 230 branches within a mile of a branch of the other bank.

Regions and AmSouth can be expected to sell the real estate and customer relationships in a highly disciplined manner, with possibly a view to have few purchasers rather than more. This has been the process followed by other similarly-situated banks such as Bank of America when it acquired Barnett in 1997and Wachovia when it acquired First Union in 2001.

To be a potential acquirer of assets which will be sold, bankers will have to have their teams of strategic planners, real estate advisors, financial analysts and lawyers ready to submit bids and negotiate terms with the sellers, and also to obtain the necessary regulatory approvals.

But for those who seek strategic expansions, the fact of these sales will provide an opportunity of a lifetime.



Talent Changing Chairs

Regions and AmSouth can be expected to retain as much talent as they can to produce the top line revenues they will need. However, with merger resulting in several thousands positions being eliminated, it offers other banks the opportunity to attract well qualified bankers. These may be individuals whose positions were duplicative or some who may choose to look for other career opportunities.

To compete for this talent pool, recruiting banks need to be ready with competitive pay plus the various types of compensation that larger organizations have offered. Recruiting banks should be looking not only at their base salaries, annual bonuses and health benefits to see if they are competitive, but also at long term incentive compensation and retirement benefits. Long term incentive compensation is typically stock-based, such as stock options, but need not be paid in stock if a bank does not wish to issue new shares. Senior banking professionals leaving larger organizations are by now familiar with such forms of long term incentive compensation as stock appreciation rights, restricted stock units and performance-based cash payments. These potential employees will also be looking for defined contribution retirement plans (401(k)) that at least approximate those available at larger organizations, perhaps with a matching contribution from the company. More senior employees will be looking for some sort of change in control protection. Banks that find themselves in the recruiting mode in a major way for the first time would be well-advised to obtain a survey of the current landscape of executive compensation and put in place competitive programs.

The needed team here includes executive compensation professionals, recruiters and lawyers to design the necessary plan documents.

An Increase in New Banks

Some bankers will take the extraordinary leap of creating their own new banks. Indeed, even before the Regions-AmSouth merger was announced, there were already more de novo banks in their organization stage or in their first three years of operation than at any other time in the history of the state. If history holds true, new banks will emerge from this transaction as well, directly or indirectly.

The lesson from other states is that these entities have a very good chance of being successful. Certainly, the history of start-up banks in Florida has been very successful. Studies by the FDIC have shown that to the extent that those de novo banks which are not successful can be explained largely by riskier real estate lending practices. It seems clear that banking regulators have learned from such mistakes and will be vigilant in their supervision of any de novo banks that emerge.

The needed team here includes your CPA firm, securities and bank lawyers, and a consultant to help navigate the practical aspects of starting a new business.

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Corporate Governance Expectations Changing

Alabama banks that decide to take advantage of the opportunities to grow by purchasing branches or branch real estate, or who recruit talent to expand or start lines of business, will face corporate governance challenges. With expansion in size comes a higher expectation from third parties for corporate governance:

- Compliance risk management expectations of banking regulators,
- Operational risk and interest rate risk management,
- Director expectations of governance sophistication, and
- Audit and insurer expectations and incentives.

The long-time head teller at a $100 million asset bank with three locations, for example, might be able to manage compliance and operational risk with help occasionally from her trade association, law firm and consultant. However, regulators will expect more as the organization grows in size and complexity. Those expectations will include increased sophistication and oversight of risk management at the level of the board of directors.

If you expect to grow and you do not already have a holding company, now might be the time to consider one. Holding companies provide several advantages for banks, such as facilitating the public offering of securities and permitting ownership of multiple banking entities. However, a holding company adds another layer of regulation that might not already be present, either by the Federal Reserve (if a bank is not a member of the Federal Reserve system) or by the Office of Thrift Supervision (which regulates not only thrifts but also their holding companies).

The team to ensure safe navigation of these waters needs to include persons knowledgeable in educating directors and executives in the governance demands of the 21st century, experts in compliance at the theoretical as well as the practical level, and tax and corporate law experts to help assess the wisdom of a holding company.

Capital Needs Will Change

Any bank desiring to expand in size will also have to deal with whether its capital is adequate for the new profile of its business. Capital can take the form of common stock equity or debt, and a variety of forms in between those two ends of the financial spectrum. For example, now might be the time to take a hard look at a new or additional issue of trust preferred securities. Trust preferred securities are the wonderful invention of investment bankers about a decade ago that are treated as permanent capital by regulators but also have some of the advantages of debt to their issuer. Regulators will be watching closely as loans increase to ensure that there is sufficient capital.

Banks will want to consult with their financial advisors and lawyers as they consider what additional forms of capital might be best for their growth plans.

Products Will Change

A major challenge for banks pursuing growth is to be competitive with larger institutions in terms of the array of product types and conveniences that these large competitors can offer. Just one trip through the internet banking website of a larger institution is most educational as to the expectations of sophisticated consumers.

Banks will want to work with their IT platform providers, strategic planners, lawyers and compliance professionals to ensure that they can meet the demands of the consumers whom they hope to attract.

Philosophy Remains the Same

The evolution underway in Alabama banking creates challenges and opportunities for banks of all size and individual bankers. While change can be unsettling, this is a time for banks to determine and communicate to their customers and potential customers how this evolution will allow them to better serve their needs.

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