Tired of Giving It Away?
5 Keys to Payments Profitability

CBAI’s 37th Annual Convention

September 23, 2011
Executive Briefing

Speaker

• Brad Smith – President, Abound Resources
  – 20 years experience helping financial institutions achieve their business goals by integrating strategy, sales/marketing, operations and technology
  – 500+ vendor evaluation projects in de novos to multi-billion dollar institutions
  – Lead negotiator representing community financial institutions on 200+ software, hardware and outsourcing contracts valued at $150+ million
  – Former Manager of Deloitte & Touche’s Community Bank Technology Consulting Practice
  – Advisor to several community financial trade associations
  – Instructor at several financial schools

512-351-3700
bsmith@AboundResources.com
Who We Are

- Management consulting firm for the Community Financial Institution (CFI) industry
- We empower community financial institutions to achieve their goals. “Goals achieved. Guaranteed.”™
- Based in Austin, TX; clients in 40+ states
- Founded in 1997 by former bankers and Big 5 consultants
- 500+ software evaluations
- Vendor neutral
- Advisors average 20+ years in CFI management; lending, cash management, risk management, operations and IT
- Endorsed by IBAT, ICBM and CUNA

What We Do

Goals achieved. Guaranteed.™

Improve your revenues from PAYMENTS

- Develop consumer bundles and packaging
- Develop small business and commercial programs
- Select product and payments vendors
- Negotiate vendor contracts
- Mystery shopping competitor’s consumer and commercial fees
You may be concerned about declining fee income, low rates, tepid loan demand and the regulatory assault.

Main Entry: **anxious**

Pronunciation: /ˈæŋkəs/ (key: **a** is a long A sound)

Function: **adjective**

Etymology: Latin *anxius*: akin to Latin *angere* to strangle, distress — more at **ANGER**

Date: circa 1616

1. characterized by extreme uneasiness of mind or brooding fear about some contingency: **WORRIED** <anxious parents>

2. characterized by, resulting from, or causing anxiety: **WORRYING** <an anxious night>

3. ardent or earnestly wishing <anxious to learn more>
And There’s Good Reason to Be Concerned

Declining core earnings
Legislative assault on fees
Repeal of Reg Q will increase COF, lack of commercial fees leaves you very exposed
Increased compliance costs
Decrease in CRE, increase in C&I, requires cash management

Growing Fee Income is a Big Part of the Solution

• Grow fee income
• Diversify fee income

Bank Operating Revenue as % of Avg Assets

-2.0% CAGR
-3.6% CAGR
-2.9% CAGR

More than $1B
$1B - $10B
$100MM - $1B

02 03 04 05 06 07 08 09 10 11

9/27/2011
You want to grow fee income, while minimizing risk and positioning yourself for the future.

Options for Improving Fee Income

• Keep what you’ve already earned
• Raise prices and/or add service charges
• Encourage behavioral changes to drive payments (and walletshare)
• New/expanded lines of business
  – Trust
  – Wealth management
  – Insurance
  – Mortgage origination
  – Correspondent services
  – Consumer cards and payments
  – Cash management and commercial payments

Best Practice Benchmarks

<table>
<thead>
<tr>
<th>Business Line</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust</td>
<td>.076% of assets</td>
</tr>
<tr>
<td>Investment</td>
<td>.056% of assets</td>
</tr>
<tr>
<td>Insurance</td>
<td>.023% of assets</td>
</tr>
<tr>
<td>Deposit service charges</td>
<td>.324% of assets</td>
</tr>
<tr>
<td>Commercial fee income</td>
<td>&gt;20% of fees</td>
</tr>
</tbody>
</table>

Source: CMPG, Abound Resources
Today’s Payments System is Evolving Rapidly

Changes in Rules and Regulations
Migration to Electronic Payments
Increasing Non-Bank/non-traditional Competition
Continued Decline in Check Volume
Shifting Demographics

Growth in Internet Payments
Consumer & Merchant Preferences
Technology Advances & Cross-Channel Access
Increased Risks

The Future of Payments

Source: Federal Reserve

Source: Nilson, Federal Reserve bank, Mckinsey, Mercator Advisory Group

*Evolving US Payment Systems and Bank Delivery Channels: Death of the Teller...Again?* Mccater; December 2009
Business vs Consumer Check and Card Usage

<table>
<thead>
<tr>
<th></th>
<th>Consumer</th>
<th>Small Business</th>
<th>Large Commercial</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checks</td>
<td>16%</td>
<td>48%</td>
<td>65%</td>
</tr>
<tr>
<td>Cards</td>
<td>44%</td>
<td>27%</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: AFP, Visa, Federal Reserve

US Payments Industry Revenue

$282 billion business in 2007

<table>
<thead>
<tr>
<th>Payments</th>
<th>% of Total</th>
<th>Approx Revenue Split (NII/Fee Income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer credit card issuing</td>
<td>39%</td>
<td>65/35</td>
</tr>
<tr>
<td>Consumer DDA</td>
<td>34%</td>
<td>46/54</td>
</tr>
<tr>
<td>Commercial DDA</td>
<td>11%</td>
<td>32/68</td>
</tr>
<tr>
<td>Commercial Credit Card</td>
<td>7%</td>
<td>24/76</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
<td>5/95</td>
</tr>
<tr>
<td>Acquiring</td>
<td>4%</td>
<td>0/100</td>
</tr>
</tbody>
</table>

Source: McKinsey
Future Payments Landscape

• Payments will continue their march towards electronics
  – Driven largely by consumers today, but business demand is increasing
  – Banks share of payments pie will continue to decline
• Card payments will continue to lead volume growth among electronic instruments. Will debit growth be replaced with credit card?
• Merging of mobile and e-commerce will drive future innovation
• New types of fraud and other security threats will need to be addressed to maintain consumer confidence
• Consumers coming of age prefer to transact business in ways that banks have failed to fully exploit (Internet) or embrace (mobile)
• Banks risk becoming the holder for deposits – all of the servicing costs with little non-interest income

Source: Federal Reserve, American Banker

Debit and Credit Cards

• Debit
  – Is NOT dead in community banks
  – Interchange rates may actually go up for community banks
  – Remains most important consumer DDA payment product (1.15% interchange income, $37 avg ticket)
  – Need to expand to small business (2.34% for signature, avg ticket 2-3x)
• Credit
  – Generally, 1% interchange if issuing. 0.2-0.4% if agent.
  – Don’t give up interchange income!
  – Need to expand to small business (1.89% for rewards, avg. monthly spend ~$3,000)
  – Only 18% of small businesses borrow on card. Avg outstanding for those is ~$6,500
What is a payroll card?
- Works like an ATM/debit card, but without checking account
- Funds loaded directly to the card and instantly available to cardholders
- Reloadable

Commercial customer benefit
- Lower processing costs – as much as $11 savings per check
- Eliminate escheatment administrative burden and cost
- Eliminate remote office admin

Bank benefit
- Commercial customer program fees
- Interchange fees
- Divert non-customer branch traffic
- Part of emerging market/unbanked strategy

Employee benefit
- Savings - unbanked/underbanked employees spend 1.5%-10% of every paycheck on check cashing fees
- Convenience
- Security
Pre-Paid Cards for Unbanked

Corporate Purchasing Cards (p-cards)

- Commercial customer benefits
  - Rebates typically 25% of interchange
  - Helps automate companies’ purchasing process
  - Helps manage spending controls
  - Greater visibility and reporting, integration with accounting systems
  - Most often used to pay for travel, fleet and small dollar maintenance, repair and operations

- Bank benefits
  - Account acquisition and/or monthly maintenance fees
  - Interchange income
  - Retention/Stickiness

- Trends
  - Larger dollar transactions
  - Supplier or ghost cards
P-Cards - Fastest Growing Cash Management Product

Revenue Growth Rates for Cash Management Products

- Rule of thumb $50/mo. in net fee income per merchant
- Considerations: acceptance, service, equipment, revenue share, risk
- Don’t forget mobile credit card acceptance and mobile remote deposit
Mobile Banking

- Smartphones expected to outsell PCs in 2012
- Cell phones will be most common device used for browsing the web by 2013 (Gartner)
- 30 million Americans used their mobile phones to access financial accounts in Q4 2010 - up 54% from Q4 2009

Source: Gartner

iPhone Update

- 500,000+ iPhone apps
  (15B+ app downloads)
- Ultra-personalization
  – Your phone evolves
  – Changes what you can do with a mobile device and what you expect from a mobile device

Source: ProfitStars
Payments

Give your smartphone some credit
Tap your phone to pay with the virtual credit cards stored on your Google Wallet.

Google Wallet supports two kinds of cards:
- Citi® MasterCard® credit cards,
- and the Google Prepaid Card

We aim to eventually support all the payment cards you keep in your leather wallet today. So the only plastic you’ll need is your phone.

Paying with Google Wallet is quick and easy
Business & Mobile Banking

- 73% of small businesses currently bank online
  - One-third likely to use mobile banking.
  - 15% willing to pay $5-10/month
- Mobile phones accept card payments
  - Intuit’s GoPayment
  - Square
  - iPhone and Android apps

Source: NSBA, ProfitStars

Mobile Banking: Considerations and Keys to Success

- Do you need it to be a mobile application or just viewable on smartphone?
- Differences between mobile app and mobile access:
  - Mobile RDC
  - P2P payments
  - Mobile alerts
  - Mobile financial apps
- Can you use commercial to subsidize retail?
- Is it foundation for mobile payments?
- What features are important? Do you have the right balance of features and usability?
- How are you going to educate and market to your customers?
- Have you nailed security?
- Does the technology work network?
Payments Profitability Key #1: Strategize/Prioritize Based on Your Customers

- Step back and evaluate what your customers need, but don’t be limited by their lack of awareness
- Evaluate how your existing products and services meet those needs
- Explore new products/service options to plug any gaps
  - Attempt to build payment services into those products
  - Explore sales/marketing, training, operations/process, technical, customer impact and risk management issues
  - Perform cost/benefit/risk analysis
- Launch or relaunch

Example: Customer View of Payments/Products

<table>
<thead>
<tr>
<th>Target Customer</th>
<th>Physician Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Set</td>
<td></td>
</tr>
<tr>
<td>• Business</td>
<td>Commercial DDA on Analysis</td>
</tr>
<tr>
<td></td>
<td>Business credit card with individual limits</td>
</tr>
<tr>
<td></td>
<td>Medical lockbox/OB</td>
</tr>
<tr>
<td></td>
<td>Merchant services</td>
</tr>
<tr>
<td></td>
<td>Payroll</td>
</tr>
<tr>
<td></td>
<td>Internet banking</td>
</tr>
<tr>
<td></td>
<td>Equipment leasing</td>
</tr>
<tr>
<td>• Personal</td>
<td>Premier Consumer DDA joint account</td>
</tr>
<tr>
<td></td>
<td>Internet banking with bill pay (seamless with business)</td>
</tr>
<tr>
<td></td>
<td>Personal debit and credit cards</td>
</tr>
<tr>
<td></td>
<td>Jumbo mortgage</td>
</tr>
<tr>
<td></td>
<td>Personal line of credit</td>
</tr>
<tr>
<td></td>
<td>Personal sweep</td>
</tr>
<tr>
<td></td>
<td>Wealth management</td>
</tr>
<tr>
<td></td>
<td>Enterprise rewards or relationship pricing</td>
</tr>
</tbody>
</table>

Relationship Officer: Healthcare Banker
Payments Profitability Key #2: Use Bundles and Premium a La Carte Payments to Drive DDA Profitability and Retention

- Bundle payments – debit and credit cards with DDAs, bill pay with Internet banking, etc. AND set targets
- Bundle related products – remote deposit capture with merchant services, ACH positive pay with ACH origination, mobile payments with mobile banking, etc.
- Promote a la carte upsells on basic products. Ideal targets are those with a 33%+ hit rate – positive pay, premium rewards, etc.
- Bundle discounts – discounts on other business or personal products
- Variable pricing – vary price according to usage, balances, market and/or risk

Example Bundle Strategy and Fee Targets

<table>
<thead>
<tr>
<th></th>
<th>Small Business $0-100K</th>
<th>Medium Business $100K - $3MM</th>
<th>Large Business &gt;$3MM</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of Cust Base</td>
<td>30%</td>
<td>45%</td>
<td>25%</td>
</tr>
<tr>
<td>Target Commercial Balance</td>
<td>$3,500</td>
<td>$75,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Target Annual Commercial Fee/Equiv</td>
<td>$150</td>
<td>$750</td>
<td>$3,500</td>
</tr>
<tr>
<td>Target Avg Credit Outstanding</td>
<td>$1,200</td>
<td>$10,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Product Strategy</td>
<td>Basic Business Bundle (checking, debit and credit card) plus personal account with enterprise rewards</td>
<td>Same as Small Business with basic cash management products</td>
<td>Expanded cash management, account Analysis and relationship pricing</td>
</tr>
<tr>
<td>Account Officer</td>
<td>Branch Manager</td>
<td>Business Banker</td>
<td>Commercial Banker</td>
</tr>
</tbody>
</table>

The bank for businesses and business owners
Payments Profitability Key #3: Fee Discipline and Product Management

• Fee Discipline
  • Tracking – do you track all fees? Fees waived by officer, business line and branch? Fees collected by officer, business line and branch?
  • Visibility – who’s watching it?
  • Accountability – who owns it? how are you incenting or disincenting them?

• Product Management
  • Committee role
  • Benefits language – if your people can explain the 3 bullet point benefits, you’ve got a problem
  • Research/survey new solutions
  • Quality focus
  • Technology/vendor utilization
  • Sales support
  • Cost containment – one offs need to be automated!

Payments Profitability Key #4: Restructure Vendor Contracts for Better Revenue Sharing

• Compare features, service, gross revenue, costs, fraud experience and net revenue

• More options available today
  – Ex. Can own all or a portion of liability on business credit cards but have issuer own all consumer liability.

• Most opportunity today is in credit cards and merchant services
Payments Profitability Key #5: Minimize fraud

Types of Fraud Banks Experienced in 2010

- Credit/debit card: 82%
- Check: 63%
- Phishing/vishing: 48%
- ACH/wire (account takeover): 37%
- Third-Party POS skimming: 32%

Payments Profitability Key #5: Minimize fraud

- What to do
  - Layered approach to security. Can’t rely solely on multi factor or FFIEC compliance.
  - Tie into peer networks and databases to kill fraudulent items before they’re processed
  - Turn customers’ fraud management into revenue generating service (eg, positive pay, Iron Key). Address customers’ security concerns.
  - Educate your customers, maintain your trust
  - Processes
    - Integration – eventually see daily aggregate exposure to single customer across payments channels
  - Risk assessment
  - Tight legal agreements
You may be concerned about declining fee income, low rates, tepid loan demand and the regulatory assault.

Main Entry: anxious
Pronunciation: ‘an(zh)(ə)s
Function: adjective
Etymology: Latin anxius; akin to Latin angere to strangle, distress — more at ANGER
Date: circa 1616

1 : characterized by extreme uneasiness of mind or brooding fear about some contingency: WORRIED <anxious parents>
2 : characterized by, resulting from, or causing anxiety: WORRYING <an anxious night>
3 : ardent or earnestly wishing <anxious to learn more>

You want to grow fee income, while minimizing risk and positioning yourself for the future.

Succeed

Business goals
Customer needs
Ops/IT infrastructure
Risk management
Takeaway: Payments Should be Driven by
Market Opportunity and Customer Needs

Bank’s Strategic Plan → Customer and Product Plans

Commercial Services Plan
Consumer Services Plan

Sales and Service Programs
Products & Payments
Organizational Impact

Channels
Processes
Technology
Risk Management

Ready for the Hard Questions?