TRANSACTIONS

BOTTOM LINE NEWS TO USE

Fee Income: Revenues, Profits, Both, or Neither?

By Jeff Marsico, Vice President, The Kafafian Group, Inc.

I recently attended an annual meeting of a regional bank. As part of the presentation, a senior executive stated that their common stock was trading at a 19% discount to its peers. He hypothesized that the discount may be partly attributable to his bank's fee revenue, which was 20%-25% of total revenue. Peers were approximately 35%.

I tested his hypothesis and found that it had merit; similarly sized banks and thrifts with higher fee income to total revenues traded at a median 9% higher price-to-earnings ratio (for both bank and thrift groups, coincidentally). Not surprisingly, banks with a higher proportion of fee income also had higher returns on assets and equity than banks with lower proportions of fee income.

Thrifts with higher proportions of fee income, however, did not have better returns on assets or equity than their lower fee income counterparts. Part of the reason could be that the lower fee income thrifts had materially lower efficiency ratios. This may indicate that fee-generating thrifts weren't very profitable in their fee lines of businesses.

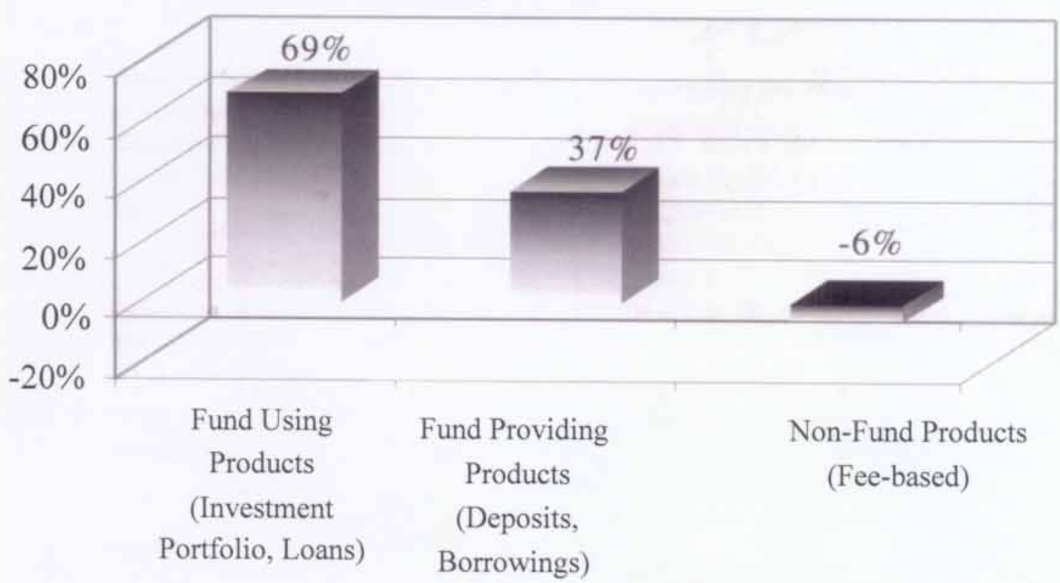
The banks in the preceding analysis were relatively large and I wanted to see how fee-based businesses were impacting profitability at community banks and thrifts ("community banks"). The Kafafian Group, Inc. ("TKG") profitability outsourcing service produces product profitability peer data that is more representative of PACB membership.

The accompanying chart shows the profitability components, broken down by product group, of the average community bank for the quarter ended December 31, 2002. The chart shows that fee-based product lines, on average, were not profitable during the fourth quarter.

The reasons why community banks make very little or no money on fee-based products are unique to each institution. However, exploring the genesis of these business lines may be helpful.

Some of these business lines are mature, such as the Trust business. For mature businesses such as Trust, community banks often lack the scale to make them profitable. Typically,

4QO2 Profitability Contribution



Source: The Kafafian Group, Inc.

the market dictates the price you can charge your customers. Therefore, for Trust, the only method to increase revenue is to increase assets under management.

The other side of profitability is expense. If your fee- based business is inefficient, perhaps you should implement what General Electric terms "workout," where the brightest talent throughout your organization, regardless of position, comes together to analyze processes and take work out of the system so you can reduce costs or increase volume. Another alternative is to outsource, taking advantage of another firm's scale for your benefit.

Other fee-based business lines are relatively new and building them takes commitment. To foster an atmosphere that produces results, these new businesses must be integrated into the bank's distribution channels. If your branch personnel refer business to your investment personnel only when they fail to put customers into a spread product, that business will not flourish.

Another part of commitment is building the brand. Are your customers proud to use your bank for investing or insurance or even think of you when those needs arise? Think of great brands such as Coke, Fidelity Funds, and JP Morgan. Community banks need only brand locally, not nationally or internationally. How are fee-based services included in your brand?

Another alternative to entering a fee-based business is to buy an existing one. This may give you scale but also presents the challenge of integrating an existing culture into your own. Of course, you may choose to exit or not enter certain fee-based businesses, given the challenges to running them profitably.

Community banks have been the benefactors of volatile markets, with new money coming into banks that was once invested in stocks and bonds. Maybe you remember that money when it flowed out of banks before. If community banks lack commitment to fee-based businesses, are you willing to watch it go again?

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