Industry ROUNDTABLE

PRESENTED BY: Hodgson Russ LLP ATTORNEYS

BANKING

How much will the next president affect regulations on the banking industry? Will we see more banks merge? What is the state of banking in the Capital Region? Law firm Hodgson Russ and *Albany Business Review* recently convened a panel of seven industry leaders to answer these questions and more. Cindy Applebaum, market president and publisher of *Albany Business Review*, moderated the discussion.

How do you describe the state of banking today in the Capital Region, and is the overall business growing or is the pie being cut into even smaller slices?

RUTH MAHONEY: The economy here in the Capital Region is a good one. And our banks, our financial institutions seem like they're all prospering. It's great to see new banks coming into the market that we haven't had in the past. I think that's a great sign for us.

ROBERT DAVEY: I think that we're very fortunate in this area to have such a mix of banks. If you're a business, there's a bank that probably has the culture and skills and products to fit. In general, our businesses are a little conservative, which I think is good. We don't have people going off and trying to do crazy things, so it makes our portfolios clean, which allows us to be active.

CHRIS DOWD: I think the strength of the system was really highlighted during the financial crisis. I think you saw other parts of the country where the financial infrastructure tightened up in lending stock. I don't think that occurred to the same degree in this region.

What is it about this area that makes community banks thrive while they decline in other markets?

JOHN BUHRMASTER: I think what's happening is you're seeing mergers of community banks. New York was strong through the recession and it was because of the strength of lending. Yet, pressures of interest rate, regulatory pressures, those are causing some banks to consolidate.

MARIO MARTINEZ: There's a lot of competition. That's OK, because there's a lot of business to be had, and we work very well together with most of the banks anyway. We can go to our other markets and take a very close look and see we're not growing there. It's not because we're not growing; the market's not growing.

KEVIN TIMMONS: The top 10 banks in this market have about an 85 percent market share. So 15 percent amongst all community banks in the market is a pretty significant chunk. Take a look at a lot of markets around the country and those top 10 banks are going to have 95 percent, and even more in some cases. It is somewhat unusual that we've got that significant amount of market share divided among at least several dozen small, healthy community banks.

Interest rates for borrowers and savers have been low for many years. How has that affected your business?

BUHRMASTER: Thirty years ago, we were working off 4.5, 5 percent margins. Now, our car loans are in the 2-percent range. It's a little hard to make a 4 percent margin on a 2 percent car loan, so you have to do things differently in the bank. And yet the competition is just as strong as it was 20, 25 years ago. So it's not that the competition is any fiercer because the interest rates are lower, it's just that our ability to make a profit is reduced because of the lower rates.

DOWD: The margins have compressed rather significantly over the last seven, eight years with the decline in the interest rates from when they were over 4 percent some years ago. We had to adjust our business model as a result of that to capitalize on different opportunities that we saw in the marketplace and achieve the growth goals that we set for ourselves.

MARTINEZ: It puts pressure on us, because all of a sudden, our assets are growing. And the investment market is terrible. That's why we keep pushing our loan portfolios. At least in the commercial real estate side, which is 95 percent of our business, you can make a decent rate. It's still not great. We're not going to make a 4-, 5-percent spread. We're lucky if we make 3-1/2 these days. And even paying zero, people are still putting money in the bank.

MAHONEY: Consumers have accumulated a lot of cash, and that's what we're seeing. There are times we want our deposits to grow, and this is certainly a good time to do that. It's made us be more creative and it's made us be better bankers, because we have to find other ways to generate revenue.

SCOTT HOUGHTALING: That's driven us to look at wealth management, which is a non-interest margin item, non-interest income. We'll continue to look at those non-interest income revenue streams to diversify and take pressure off of the margins.

TIMMONS: We're prepared to focus on residential mortgage lending more than the business lending. We're still making mortgage loans, demand is reasonably good, and the rates we've been asking for and getting have been in the high 3s to 4 percent. As a mortgage lender, we've always operated with less margin than a commercial bank has operated.

So with interest rates so low, how do you differentiate yourselves in a very competitive commercial lending market?

HOUGHTALING: It is hard to differentiate yourself. Every single one of us can serve a commercial client and can bring capital to the table. But maybe how it's delivered and the ideas and what we can bring to the table are the intangibles that separate us.

MAHONEY: We try to take an enterprise approach to commercial banking clients. It's listening to the clients and then trying to figure out how you can bring different parts of the organization to play with that client that makes sense.

BUHRMASTER: Speaking for the smaller banks, I don't see low interest rates making our competitive environment any different than they were when we were doing 7 percent or 9 percent commercial mortgages. Where the real competition comes from is how fast can we get it done, your creativity, your flexibility. Because you're getting people with unique situations now. There are different types of couples, there are different types of family relationships, there are different types of businesses that are sometimes hard to understand.

DAVEY: You really have to know who you are and where you fit in the puzzle of the Capital District and financing. If you're true to that, and the market knows it, then I think you also have that little edge.

To what extent are you competing with credit unions for commercial loans?

BUHRMASTER: Rates. They have a 40 percent advantage. When you look at what we put aside for taxes, we're paying a 40 percent-plus tax rate that they don't

(Back row, left) Chris Dowd, John Buhrmaster, Scott Houghtaling, Kevin Timmons, (front row, left) Robert Davey, Ruth Mahoney, Mario Martinez

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have to worry about. So they have more flexibility to compete for commercial loans.

MARTINEZ: Our bank does a lot of business with credit unions. We decided, instead of trying to fight them, we'll just join them. It works for us.

? The popularity of online banking continues to grow in the U.S., yet new branches continue to be built. Why? Could banks save a lot of money by looking more toward technology and not growing branches?

TIMMONS: In our situation, we've opened a lot of branches over the past 10 years, partly by moving into new markets. We find our particular breed of customers want to have personal service, or at least have the ability to have personal service. They certainly want the online banking as well, but they very much want to be able to come in and sit down and talk to somebody if they should refinance.

BUHRMASTER: If you look at the profile of the customers you're serving right now, they have their banker. But they don't necessarily want to be in the branch all the time. They'd like to pick up their phone and do everything they possibly can. Branches are going to continue to be an important part of banking, but one of your branches is going to be your phone. It's a mobile society. We all have snowbirds that go to Florida, but don't want to lose their accounts, so I sign them up with mobile banking and I still have their accounts.

MARTINEZ: Technology has allowed us to spread out. We invested a lot of money in technology and in our network.

MAHONEY: The branch of the future is a very different branch than what we've all seen. And some companies have already experimented in terms of having virtual tellers in branches. There's a lot of different ways that companies are trying to figure that model out.

BUHRMASTER: My daughter is working for the bank, just out of college, and she's saying, "I'm being asked to do everything." I said, "Actually, you are the new breed of teller. You're going to cash checks, you're going to open accounts, and you're going to learn how to take a loan application because we're going to have less people in the branch and everybody will have to have more skills."

MARTINEZ: We don't have these distinct roles anymore. We spread it out so you're not so dependent on one person. You know, one person's out to lunch, you can't open a new account. That's ridiculous.

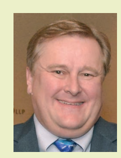
? How will the opening of the Schenectady casino affect your ability to attract and retain tellers?

TIMMONS: We have not lost anybody to a casino yet. Historically, casinos tend to hire somewhat – a little bit older and more mature people. And our workforce on the teller line generally is pretty young. So I'm not sure we're necessarily going to be a target that casinos are looking for.

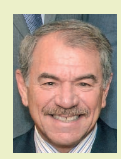
DOWD: It's going to impact our bank. We know it. We need to respond to it as time goes on. We invest a tremendous amount of money, time, training, and you have to have training programs that are robust. And we're losing tellers, losing new staff to industries like the casinos. But we have those industries today. The insurance industry, health insurance industry is going through waves of hiring and we're losing people to that. That is a factor in our business and you have to manage successfully for it.

? To what extent is your bank automating services, and how will this grow in coming years? Will tellers become extinct in 10 years or so?

▸ MEET THE PANEL



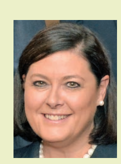
JOHN BUHRMASTER
Title: President and CEO
Company: 1st National Bank of Scotia



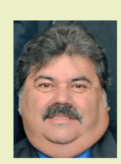
ROBERT DAVEY
Title: Regional vice president
Company: TD Bank

CHRIS DOWD
Title: President and CEO
Company: Ballston Spa National Bank

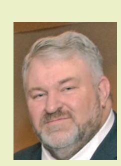
SCOTT HOUGHTALING
Title: Executive vice president, commercial banking regional executive
Company: Berkshire Bank



RUTH MAHONEY
Title: Market President
Company: KeyBank



MARIO L. MARTINEZ
Title: Chairman and CEO
Company: Catskill Hudson Bank



KEVIN TIMMONS
Title: Vice president and treasurer
Company: Trustco Bank

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MAHONEY: They're the people that greet our clients when they come into the branch. I would say they're a very critical and important part of our business. I value them in terms of what they do. I believe they're going to be around for a very long time.

BUHRMASTER: I think what you're going to see is a continued differentiation in business models. Certain banks are transaction based; certain banks are relational based.

DAVEY: I think relationship is everything, whether you're on the community level or you're on the upper end of the scale in terms of the size of your bank. Relationship is a very big part of banking in general, servicing your clients. So I think anybody that's in the transaction business is actually in trouble unless you're a virtual bank.

We're a little over two weeks into the Key and First Niagara merger. How's it going?

MAHONEY: Things are actually going very well. This was a very significant transaction for Key. In fact, it's one of the largest acquisitions since the financial crisis. It means a million new clients to KeyBank and thousands of new employees. So clearly, it's going to take us time to absorb this huge company. Our teams have done an amazing job, everyone's been working very hard to solve for any issues that clients have had. I'm very proud of what we've tried to do to make it right. It doesn't mean we've fixed every challenge, but we're certainly working very hard on it.

What surprised you the most about the process?

MAHONEY: The people and their dedication, their commitment to try and get this right. You know, certainly in the Capital Region, we have great bankers. Their dedication to clients, their dedication to try and solve for issues as they come up, the amount of hours that people have put in to make this all go smoothly has been amazing.

We would like to hear from everybody, if you think that this region will continue to see more mergers, and why? If not, why not?

DOWD: I think the environment that we're operating in would indicate that you're going to see more mergers. That said, I think we have well-established institutions in this region that are well-capitalized, well-run. So I'm not convinced that you're going to see more merger activity in this region, though factors would indicate that you are.

DAVEY: I think you have to ask the regulators, too. They're a big part of this.

MAHONEY: I think we will see more activity. I know from our experience, the regulators were very supportive and positive of this happening.

DAVEY: We spend a lot of time actually talking to our customers about the impacts of regulations. People tend to think that all the decisions are decisions that the bank gets to make, especially on the larger side. A lot of our decisions are being driven by what the regulators, what's the flavor of the day and what they're pushing.

BUHRMASTER: There is a tremendous amount of regulatory fatigue, especially in mid-sized community banks across the country. And I agree with Chris. I don't see a lot of potential merger activity in the Capital Region. However, I do see across the country that this is going to continue, and you're going to see banks who are suffering from that regulatory fatigue just say, "It's time."

Why would this region sort of be insulated from the mergers that you think will probably occur more nationally?

BUHRMASTER: For me, personally, I think the remaining community banks here are banks with strong local roots, strong local ownership. There are some pretty strong and dedicated families and communities that want to keep their community banks.

TIMMONS: Also, the financial performance of a lot of the community banks around New York state is pretty strong. In terms of equity or in terms of assets, the banks in upstate New York are superior to what you see in many parts of the country.

You've all referenced regulatory things that hold you back. Is that more on the state or federal level? And if you could impact one regulation, what would it be?

MAHONEY: That's a loaded question.

MARTINEZ: The issue we have is that the government really is asking a lot of the banks. For a small bank, we have three full-time people in the [Bank Secrecy Act] department. Believe me, it's money I'd rather be putting into marketing or new branches or technology or something else.

DOWD: I think it's the pace or the frequency of regulatory change that is very challenging. Every time there's a change in regulation – and many times it's not valuable to the consumer on the other end of the equation, or the financial institution in terms of the safety and soundness – it costs us money.

TIMMONS: For our folks in residential mortgage lending, we've been in the position for the last five years where we have had to turn down loans that we would have historically made, not because we don't think they're going to pay us back, but because they don't fit within certain regulations that we now have to abide by.

BUHRMASTER: There are people that we've been doing these odd loans for generations. That's one thing we've always specialized in. Now, because of the high cost mortgage rules and the escrow rules, it becomes nearly impossible to do these mortgages under $50,000. And that's directly affected home ownership in this nation.

Catskill Hudson Bank is fairly new to this market. What were the advantages of expanding into the Albany area, and why was the timing right?

MARTINEZ: We started in the Catskill region, and the economic growth in that area is not rapid. So in order for us to grow our loan portfolio, we started expanding out of that area. We went into Orange County, Dutchess County, and even that did not suffice. I live in Saratoga, so I'm very familiar with the area. I saw what's been going on here for the last 10 years. So we did that about 2 1/2 years ago with our first branch in Malta, and then our second branch in Halfmoon. And right now, the Capital Region and Saratoga represents about 25 percent of our loan portfolio, 80 percent of our pipeline on new loans coming in, and I predict in a year or two, it will be 50 percent of our portfolio.

Chris, Ballston Spa National Bank opened an office in Albany County for the first time. Why did you choose the location on Route 7?

DOWD: We've been doing business in Albany County for a number of years, and we needed to develop a branch in that location to solidify our commitments, our presence and create additional visibility. That branch is 1,500 square feet, I believe. We staffed it with about four people. I think it's been a very effective model for us. I would say we're going to replicate that with additional branches in the near future.

Are there any areas in the Capital Region that you feel are under-served?

BUHRMASTER: I think Fulton County probably. If you look at Fulton, Montgomery, that area, you have very few banks there. So there is opportunity.

This year's annual survey of community banks by the Federal Reserve Conference of State Bank Supervisors found small business lending grew more than 7 percent in 2015, and mortgage lending grew by 6 percent. How do those numbers line up with your bank?

TIMMONS: We've actually let our commercial portfolio diminish a little bit. What we've seen in pricing commercial has been that there's been some erosion in pricing power. So as you get lower prices, and you have higher credit than we have in our traditional mortgage lending, we'd rather concentrate on that.

DOWD: On the commercial side, we had a very good year in 2015. 2016 looks very good as we sit right now. We were up over 20 percent in '15, and we're tracking about the same number in 2016. Residential side wasn't as good. I think 6 percent was the number on the residential side. We had some staffing turnover.

MARTINEZ: In the last couple years for us on the commercial side, which is all we're really doing, we've seen about a 15 percent growth by design. We could grow faster, but credit quality is the most important issue to us rather than the growth size.

BUHRMASTER: We've been quite successful in the commercial business. Probably, to just start as a base, 2013, up 60 percent, up another 40 percent another year, and we'll probably match last year again this year.

HOUGHTALING: When we break out small business, we put a focus on SBA lending. Our growth there would exceed what the survey says. For commercial lending, we control it. We grow that 7 to 8 percent each year.

The survey also found that regulatory burdens were the top reason why community banks exited or curtailed certain lines of business, such as fixed rate mortgages for single family homes. Is your bank planning similar steps because of federal regulations? And how have your costs increased because of the regulations?

MAHONEY: It's nothing new to us. We have staffed up significantly in all of our institutions to accommodate all the demands and the requirements that are put on us. Whatever angle you look at it, the regulators are our friends.

HOUGHTALING: It comes up on every [earnings] call: What are our plans, what is our process, and the dollars in some of the budget planning for the next year of spending. It's an alarming amount spent on compliance. But I don't think there's any way around it. We have to embrace it.

BUHRMASTER: A wise banker once told me when I was complaining about the regulatory burden many years ago that you're in a regulated business. It doesn't mean we can't become active and try to rally against them. We are speaking for our shareholders because most of us are public companies. In the end, we're speaking for our customers because the cost of these regulations is landing on the laps of our customers.

This presidential election has certainly been impactful on a local, regional and national level. Do you feel that whichever administration gets in there will be more willing to listen to the concerns that the banking industry has with regulations and how they are really hurting the consumer?

BUHRMASTER: Having testified several times before Congress, the House and the Senate, I can tell you that I really don't think who is elected president makes a difference on the regulatory burden that we face. It's the gridlock that occurs at the committee level in Congress that prevent common sense solutions from being found.

DOWD: I would agree. I don't think either candidate can bring that common sense to the equation that allows us to move forward in a better way.

TIMMONS: There's a generic taint from the collapse and the big banking issues that occurred in 2007 and 2008 that certain legislators are still very much focused on. Overcoming that sentiment is still going to be very difficult.

Wells Fargo Chairman and CEO John Stumpf retired earlier this month after being criticized by lawmakers over a scandal in which up to 2 million accounts were created without customer authorization. What are your feelings about the Wells Fargo handling of the crisis, and what steps do you take to ensure that wrongdoing doesn't occur in your banks?

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BUHRMASTER: If I had 5,300 people fired under me and I thought it was immaterial, my board would fire me. That's the difference between the community bank and a large bank like that. There is an insulation at the top, and it's natural because it is a larger corporation. But unfortunately, this is going to trickle down to those of us in the room. Every one of us in the room is now going to have to deal with additional regulations.

MAHONEY: At Key, we think about and we have the approach of talking to our clients about financial wellness. And it really boils down to a great relationship approach.

DAVEY: I think it's fair to say that was a cultural breakdown when it's that widespread. Competing against the people in this room, I know there's a very different culture here than what existed in the field for the Wells folks.

MARTINEZ: It also comes from the top. The tone that is set at the top filters all the way through, especially in a small bank.

MAHONEY: In a large bank, I think it's even more important. That's a symptom of what we've seen.

HOUGHTALING: We have in our culture that if you have a complaint, it has to be logged, it has to be addressed, and we want it resolved in 24 hours to avoid losing that trust. Obviously, they've lost trust.

Final thoughts or predictions for 2016 as it relates to banking and the Capital Region?

TIMMONS: A lot of it boils down to the economy. We're at the cusp of potential significant change. It will affect all of us to one degree or another.

DAVEY: I'm very optimistic. We're attracting people from outside of the area, we're making investments, and we're keeping young people. That's a dynamic combination. Hopefully we continue to have good leadership in this area so we can address some of the other issues that we have.

HOUGHTALING: I am also upbeat. There is a major disruption with First Niagara coming out of the equation. It's probably the largest event in banking in this market in 10 years or longer, and that will continue to have ripple effects probably for the next several years.

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