

Addressing the Threats of *Real* Disintermediation

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MERCATUS

Discussion Agenda

- **Thinking About Disintermediation**
- **The *Real* Threats to Traditional Franchises**
- **What Might the Future Look Like**
- **Adopting a Proactive Stance**

Banking Disintermediation Has Traditionally Mapped Across Three Dimensions

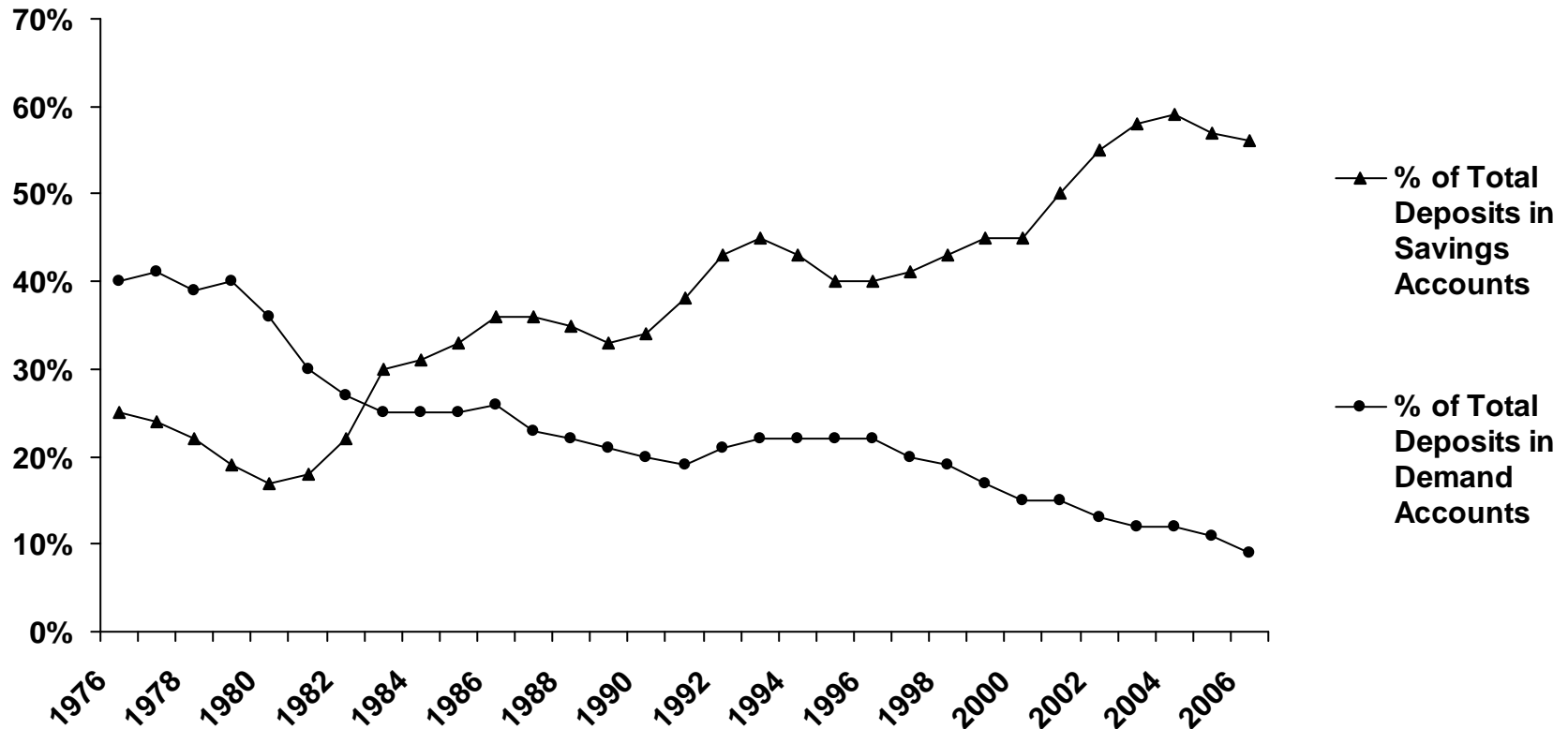
Product: MMDA vs. Savings

Channel: ATM vs. Branch

Payments: Electronic vs. Check

Over Time, Product Disintermediation Has Dramatically Reshaped Banks' Balance Sheets

Change in Deposit Mix Over Time, 1976 – 2006

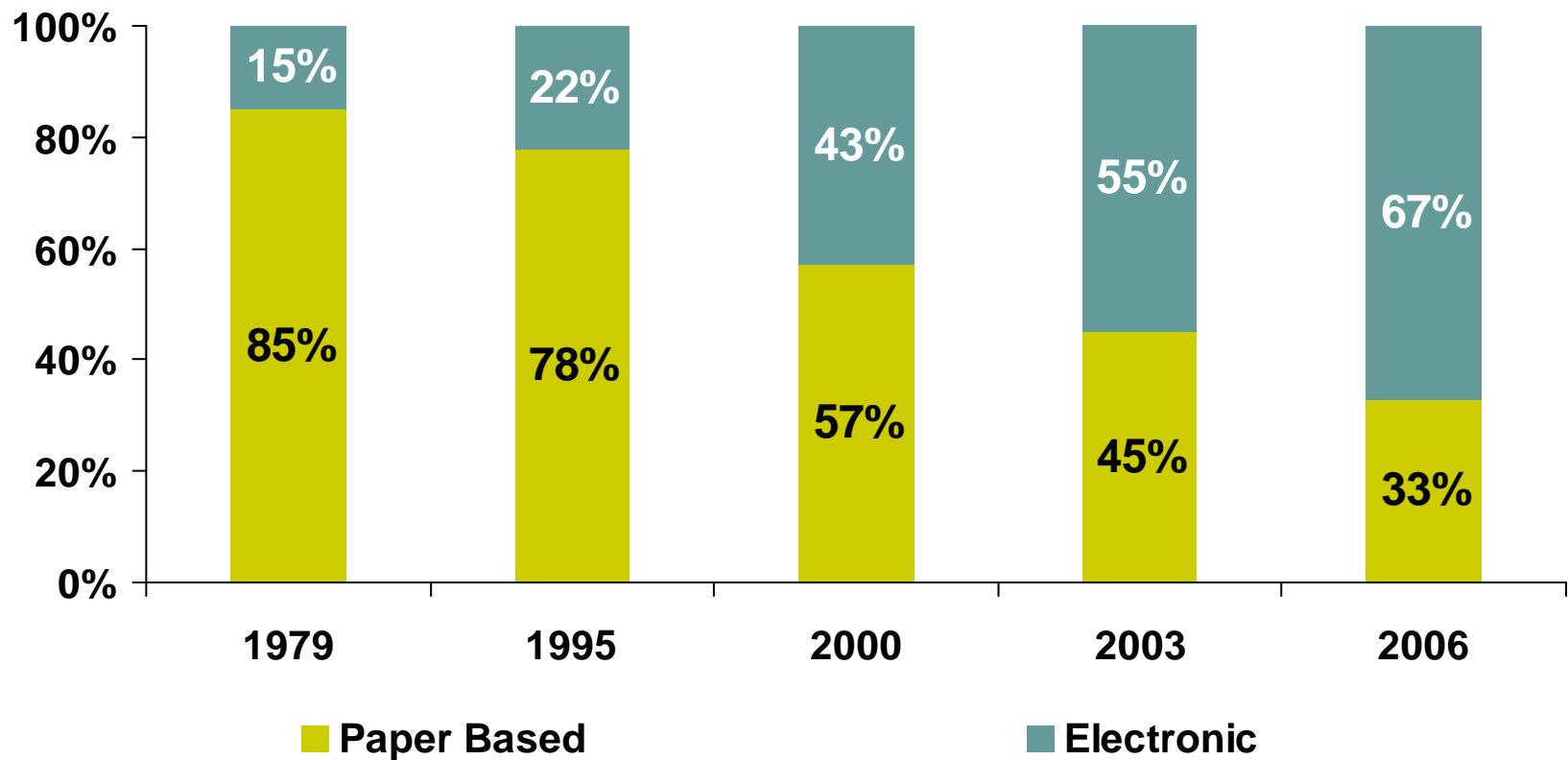


Note: Excludes time deposits

Source: FDIC 2007

Looking Across Three Decades, the Payments Disintermediation Has Also Been Real

Percent of Electronic Versus Paper Payment Transactions Over Time, 1979 – 2006

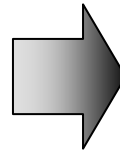


Source: Federal Reserve Payments Study, 2004, 2007

While Some Predictions May Initially Sound Silly, They Risk Being True

**“Banks are dinosaurs.
We can bypass them.”**

–Bill Gates, 1994



**“Suddenly, the long
ballyhooed check-less
society seems
visible.”**

–Rich Oliver, Federal Reserve,
2005

And the Ongoing Shifting of the Payment Mix Has Created a Litany of New Threats for Bank Executives to Worry About

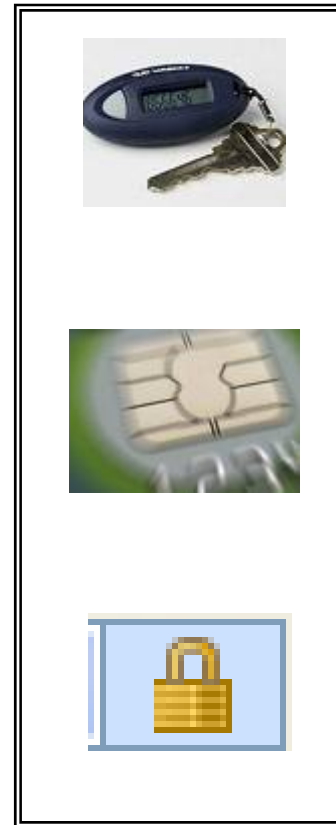
Contactless



Biometrics



Security



Cash/Check Replacement



But What Risks Should We Focus On?

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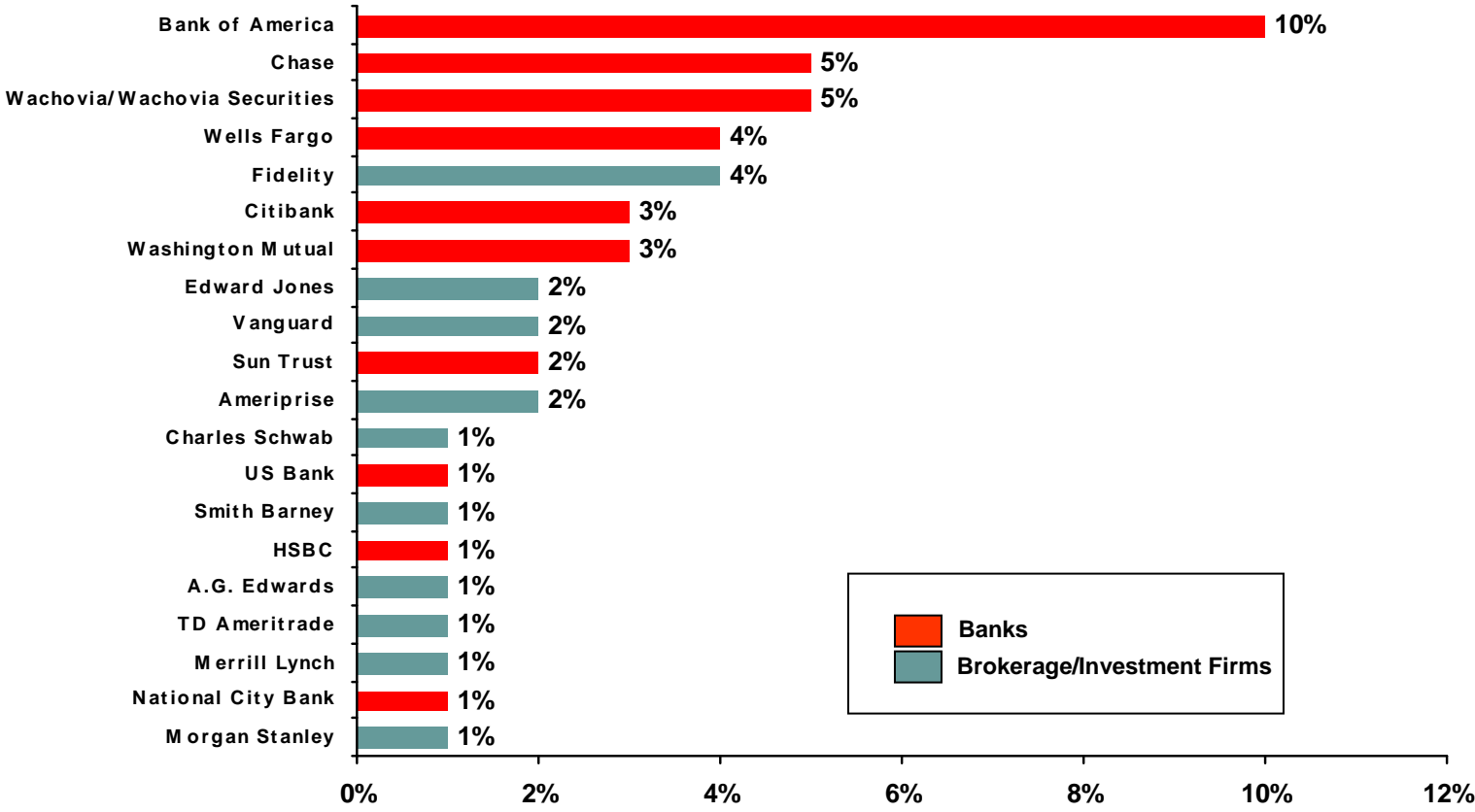
While we are here today to discuss payments, today's environment poses far more dangerous threats to traditional bank franchises.

The Three “Most Dangerous” Threats

- **Threat #1: Competitive Irrelevance**

To be a Bank, You Don't Need to be a Bank

Top 20 "Primary Banking" Services Providers
Percent of Respondents











Source: BAI/Mercatus 2007 US Retirement Preparedness Study

Question: (S3) With which of the following financial services firms do you have your primary banking relationship? (Options: Select one firm out of an option of 34 firms, other, none, or decline to answer)

Large Strategic Commitments Have Been Made to Provide Banking Services


Threat #1:
Competitive
Irrelevance

	 Charles Schwab	 E*TRADE Financial	 Ameriprise Financial	 Edward Jones <small>Member SIPC • Member NYSE</small>	 Merrill Lynch	 Fidelity Investments	 Vanguard	 TD AMERITRADE
CASH MANAGEMENT								
<i>Checking</i>	●	●	●	●	●	●	●	●
<i>ATM/Debit Card</i>	●	●	●	●	●	●	●	●
<i>Rebate/ATM surcharges</i>	●	●	●	●	●	●	●	●
<i>Online bill pay</i>	●	●	●	●	●	●	●	●
<i>Overdraft protection</i>	●	●	●	●	●	●	●	●
<i>Account transfers</i>	●	●	●	●	●	●	●	●
<i>Recurring payments</i>	●	●	●	●	●	●	●	●
CREDIT CARDS								
<i>Credit Card</i>	●	●	●	●	●	●	●	●
<i>Point loyalty</i>	●	●	●	●	●	●	●	●
SAVINGS								
<i>Savings accounts</i>	●	●	●	●	●	●	●	●
REAL ESTATE FINANCING								
<i>Home equity loan</i>	●	●	●	●	●	●	●	●
<i>Home equity line</i>	●	●	●	●	●	●	●	●

● Available ● Not Available

Source: Company websites

The Banking Offers Are Very Compelling

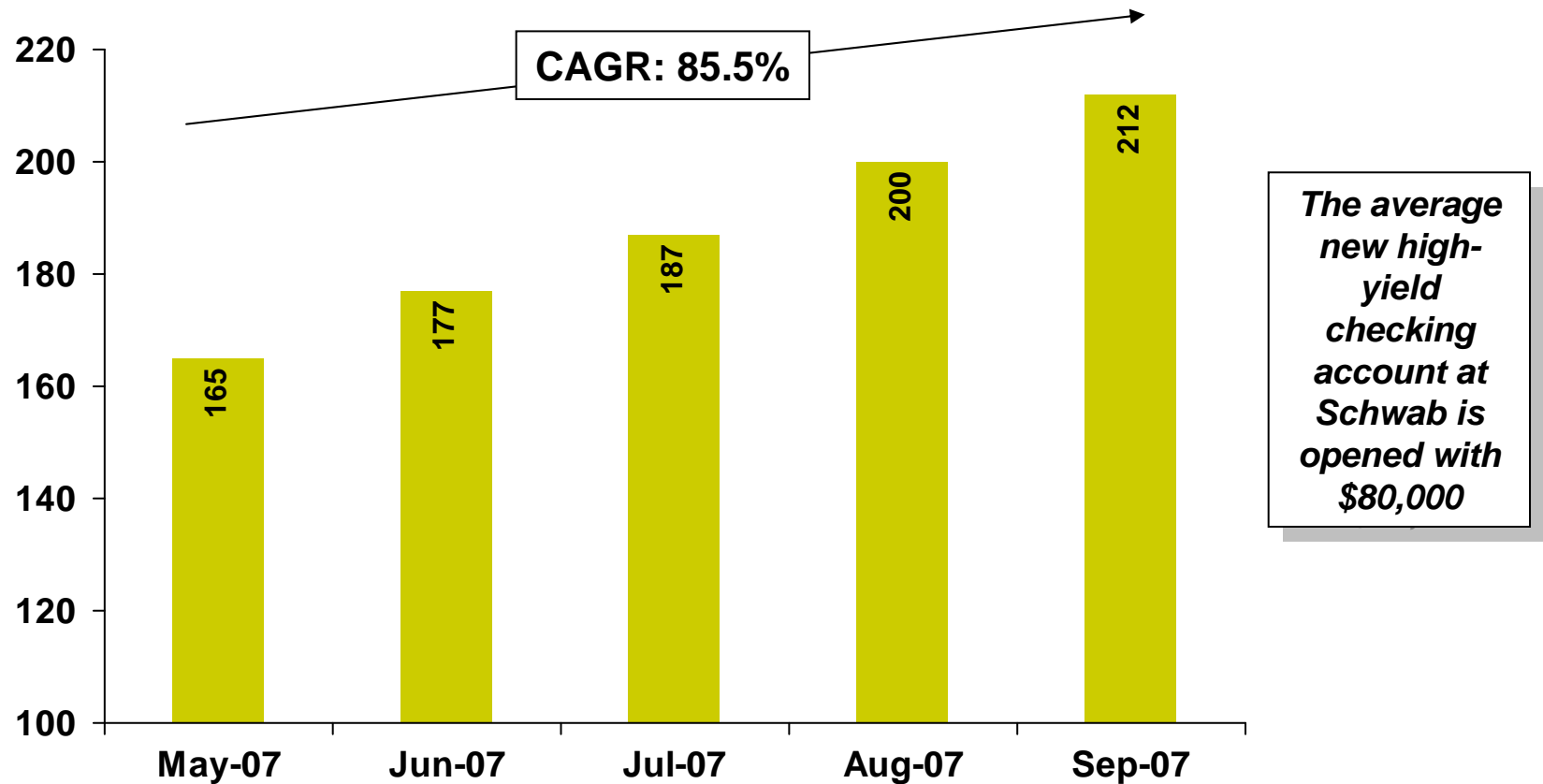
	 mySmart Cash Account	<i>charles</i> SCHWAB High Yield Checking
Introduced:	<ul style="list-style-type: none"> ▪ August 2007 	<ul style="list-style-type: none"> ▪ April 2007
Rate/Minimum Balance:	<ul style="list-style-type: none"> ▪ 3.00% APY with no minimum balance requirements and no monthly fees (as of 1/18/07) 	<ul style="list-style-type: none"> ▪ 4.00% APY with no minimum balance requirements and no monthly fees (as of 1/18/07)
ATM Card/Fees:	<ul style="list-style-type: none"> ▪ No ATM fees ▪ Automatic rebate of any ATM fee charged by any bank 	<ul style="list-style-type: none"> ▪ No ATM fees ▪ Automatic rebate of any ATM fee charged by any bank
Online Bill Pay:	Free	Free
Account Transfers:	Free	Free
Overdraft Protection:	<ul style="list-style-type: none"> ▪ Yes, with linked brokerage account 	<ul style="list-style-type: none"> ▪ Yes, with linked brokerage account
Checkbook:	Free	Free

Brokerage firms are taking direct aim at traditional bank services.

Schwab's High-Yield Checking Account Is Driving Dramatic Growth

Threat #1:
Competitive
Irrelevance

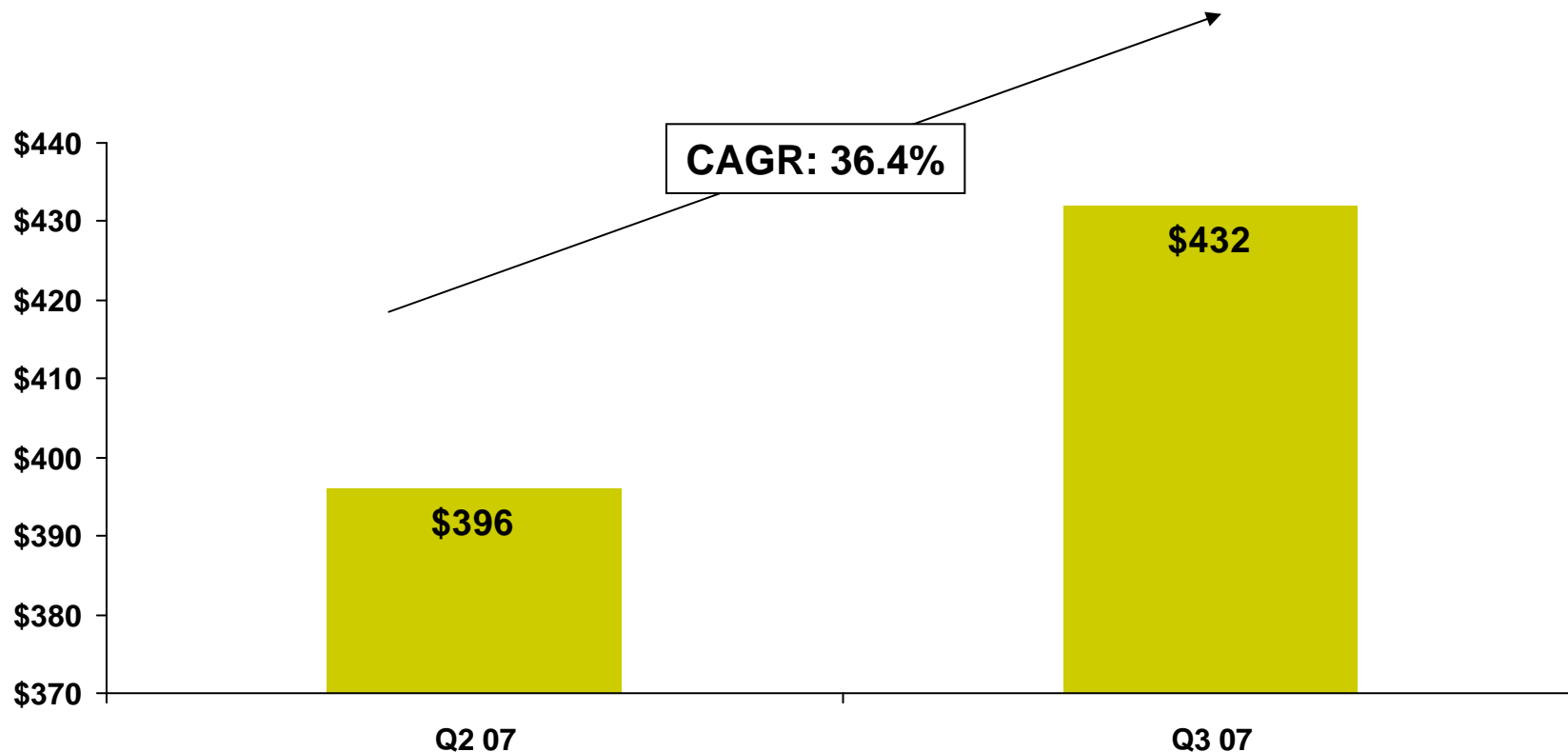
Number of Schwab Bank Account Clients at Month End, 9/06 – 9/07
Thousands of Clients



Source: The Charles Schwab Corporation Monthly Market Activity Report for September 2007

E*Trade Captured Similar Success in Checking Accounts

E*Trade Total Checking Account Balance, Q3 06 – Q3 07
Millions of Dollars



Source: E*Trade Financial 10-Qs

The Three “Most Dangerous” Threats

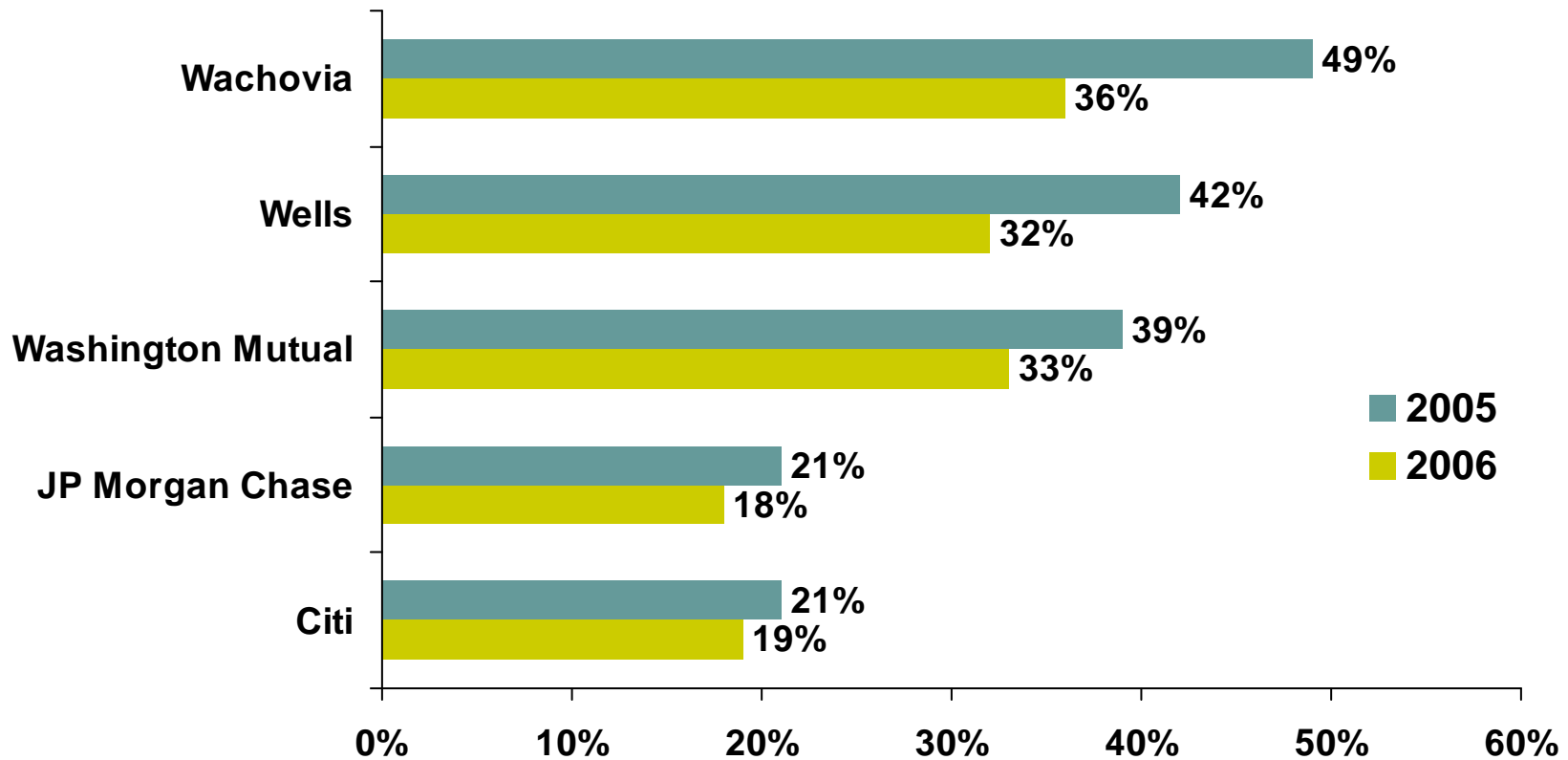
- **Threat #1: Competitive Irrelevance**
- **Threat #2: Erosion of Consumer Trust**

Banks Are Also Threatened By Waning Consumer Trust in Banks' Core Value Proposition

Threat #2:
Erosion of
Consumer
Trust

Customers of each firm who agree with the statement:

*“My financial provider does what’s best for me,
not just for its own bottom line.”*

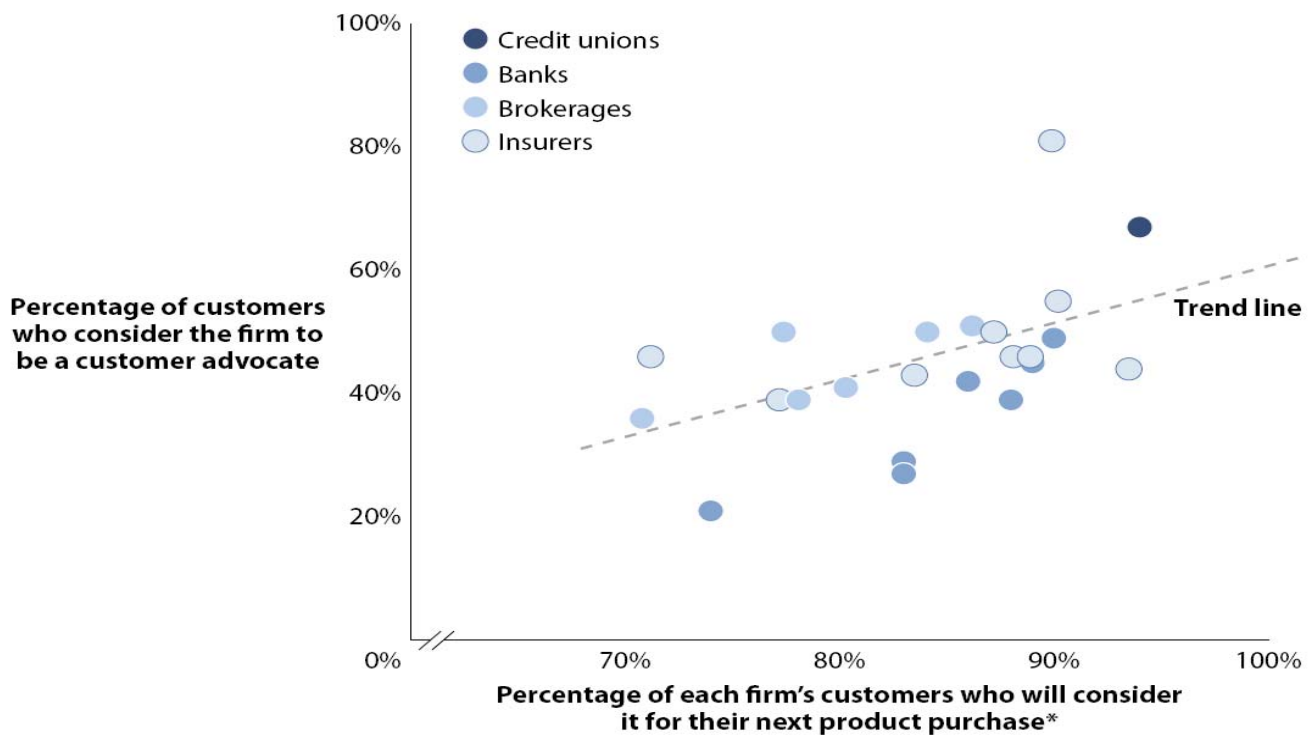


Source: Forrester Research, 2005, 2006.

As a Group, Banks are Not Perceived as Customer Advocates

- Making customer advocacy gains is critical

Consumer Advocacy Drives Future Purchase Intent

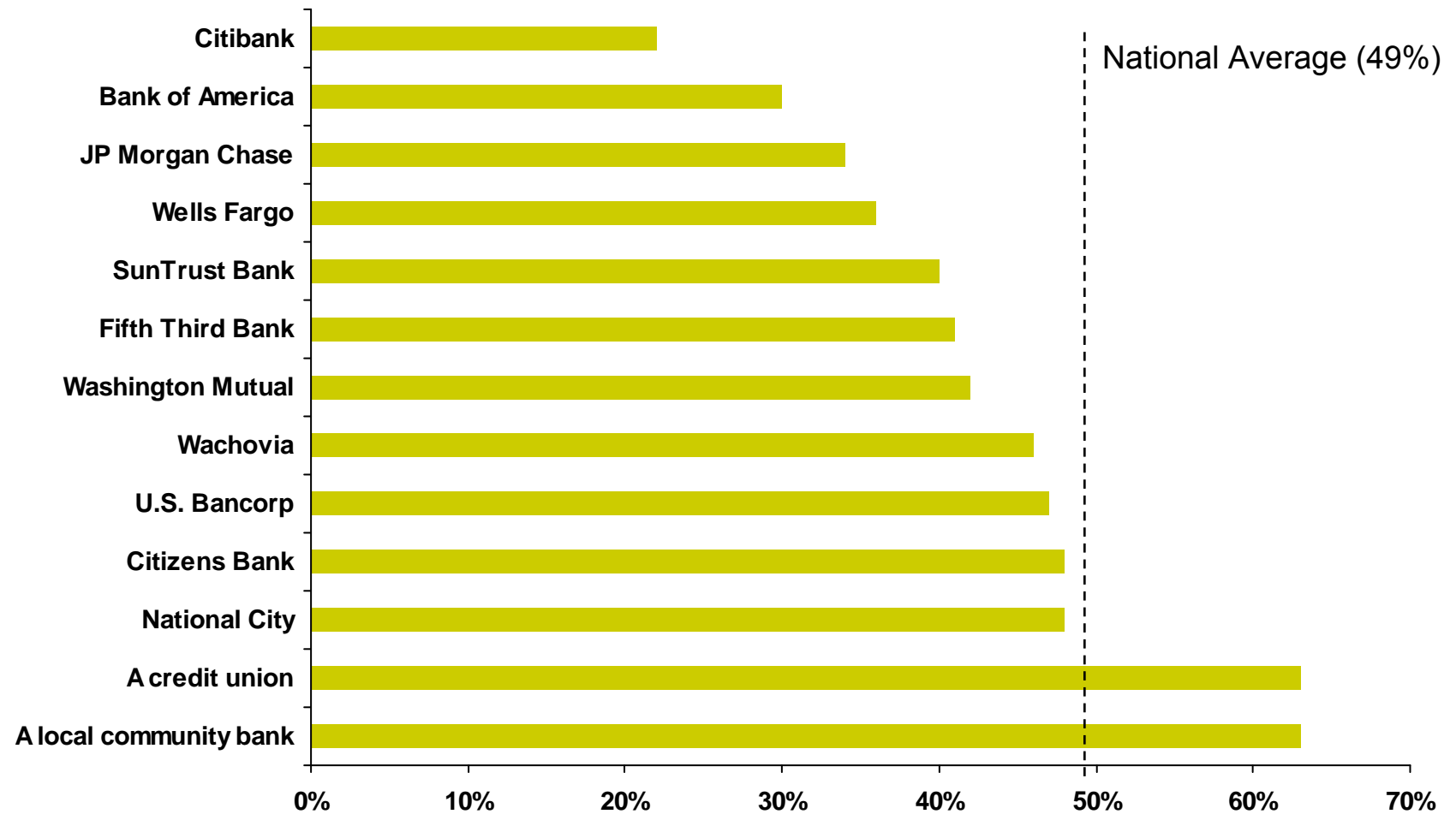


Base: US households

Source: "Customer Advocacy: The Secret to Loyal Financial Services Customers," Forrester: August 1, 2005.

For Banks, Addressing Fundamental “Honesty” Issues Is a Prerequisite to Healthy Growth

Percent of Respondents Who View Their bank as “Honest”

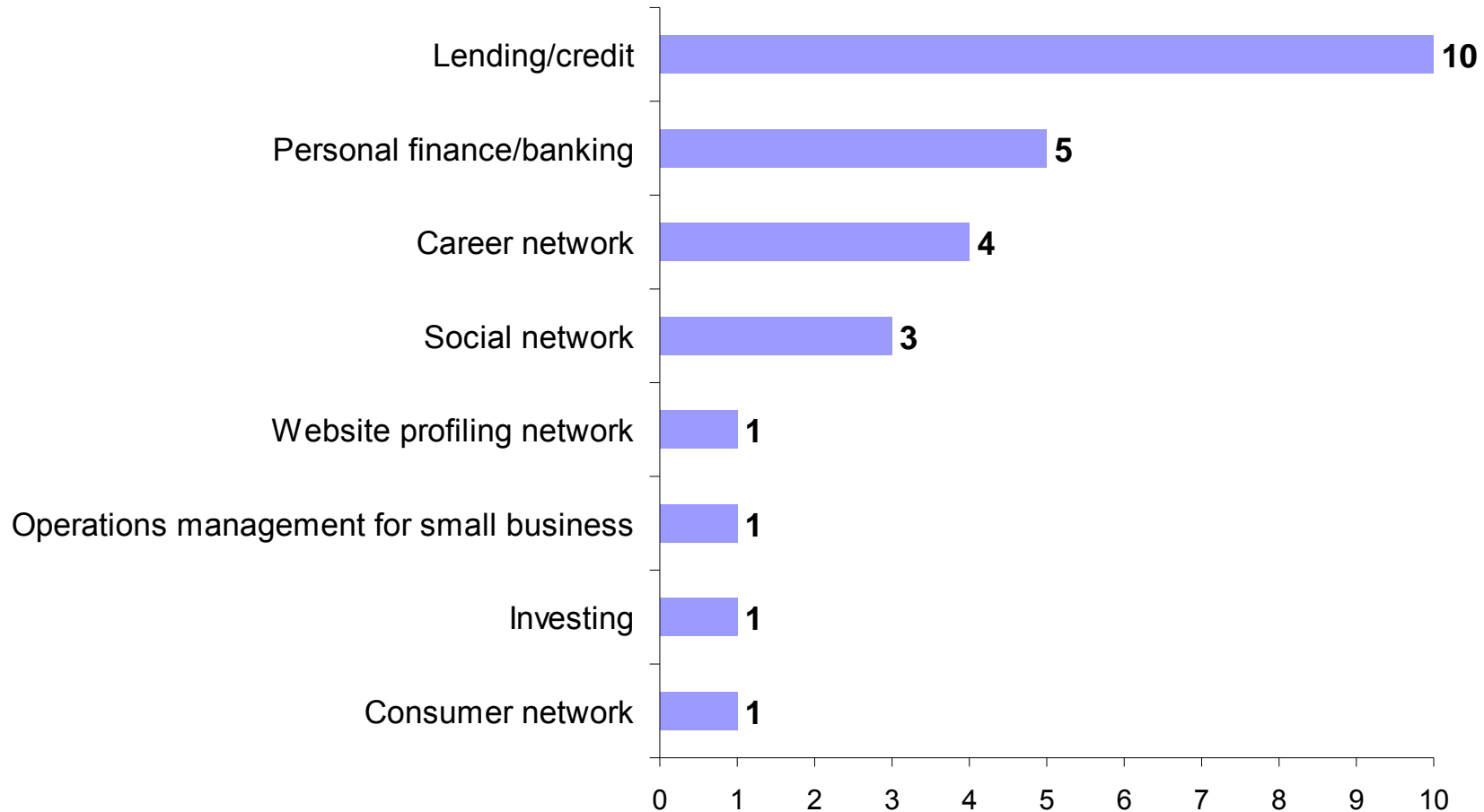


Source: Forrester Research NACTAS Q4 2006 Finance Online Survey

A Whole New Set of Competitors are Emerging to Compete on the Basis of Trust and Advocacy

Threat #2:
Erosion of
Consumer
Trust

Number of Social Financial Management Companies by Category



Source: Mercatus analysis (January 2008)

The Three “Most Dangerous” Threats

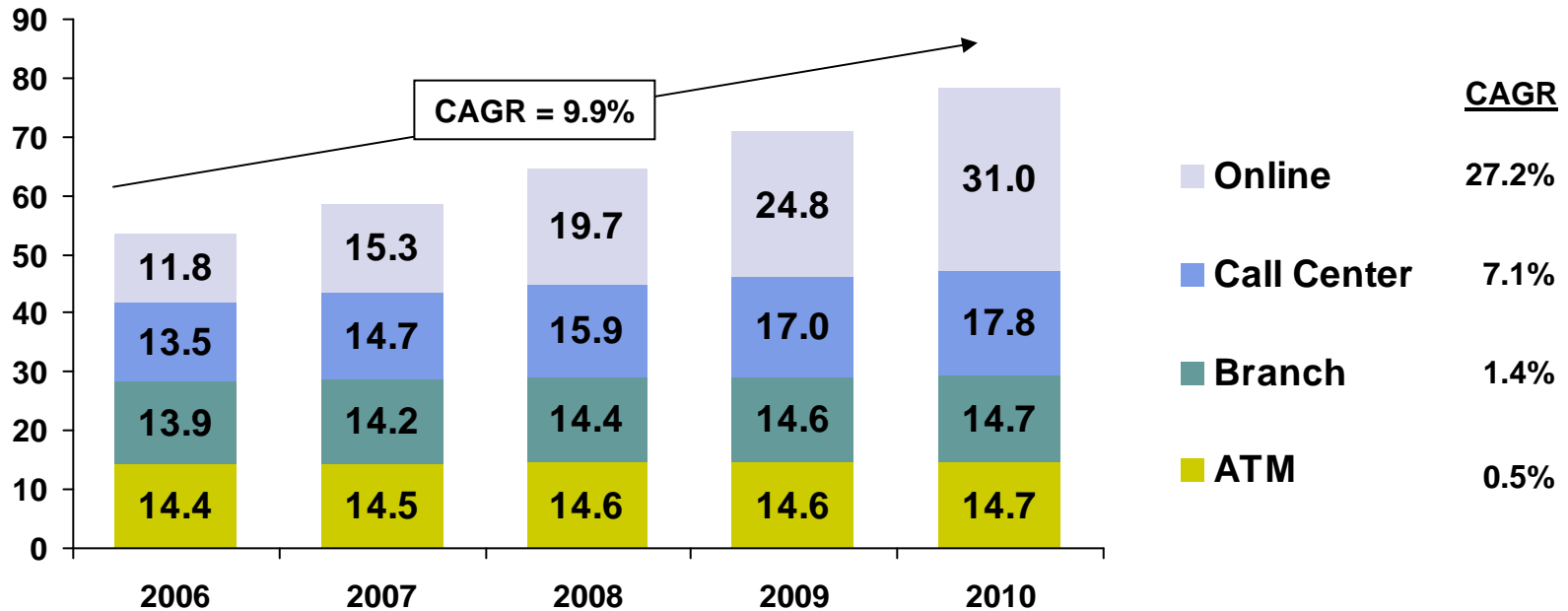
- **Threat #1: Competitive Irrelevance**
- **Threat #2: Erosion of Consumer Trust**
- **Threat #3: The World is Flat**

Reflecting Increasing Consumer Acceptance, Online Will Grow to be the Dominant Channel

Threat #3:
The World
is Flat

US Banking Delivery Transactions by Channel, 2006-2010

Thousands of Transactions

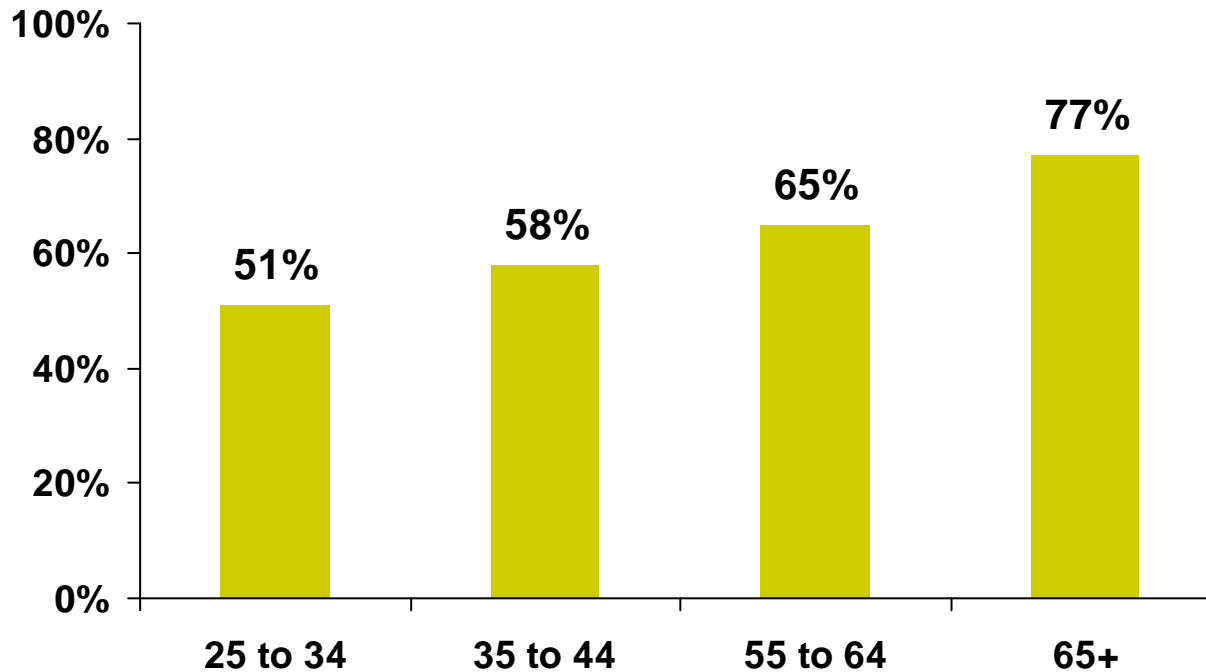


Channel Usage Patterns and Preferences Are Heavily Age Cohort-Driven

Threat #3:
The World
is Flat

Percent of customers, by age, that “agree” or “strongly agree”
with the following statement:

“I prefer to use by bank’s branch for most banking activities.”

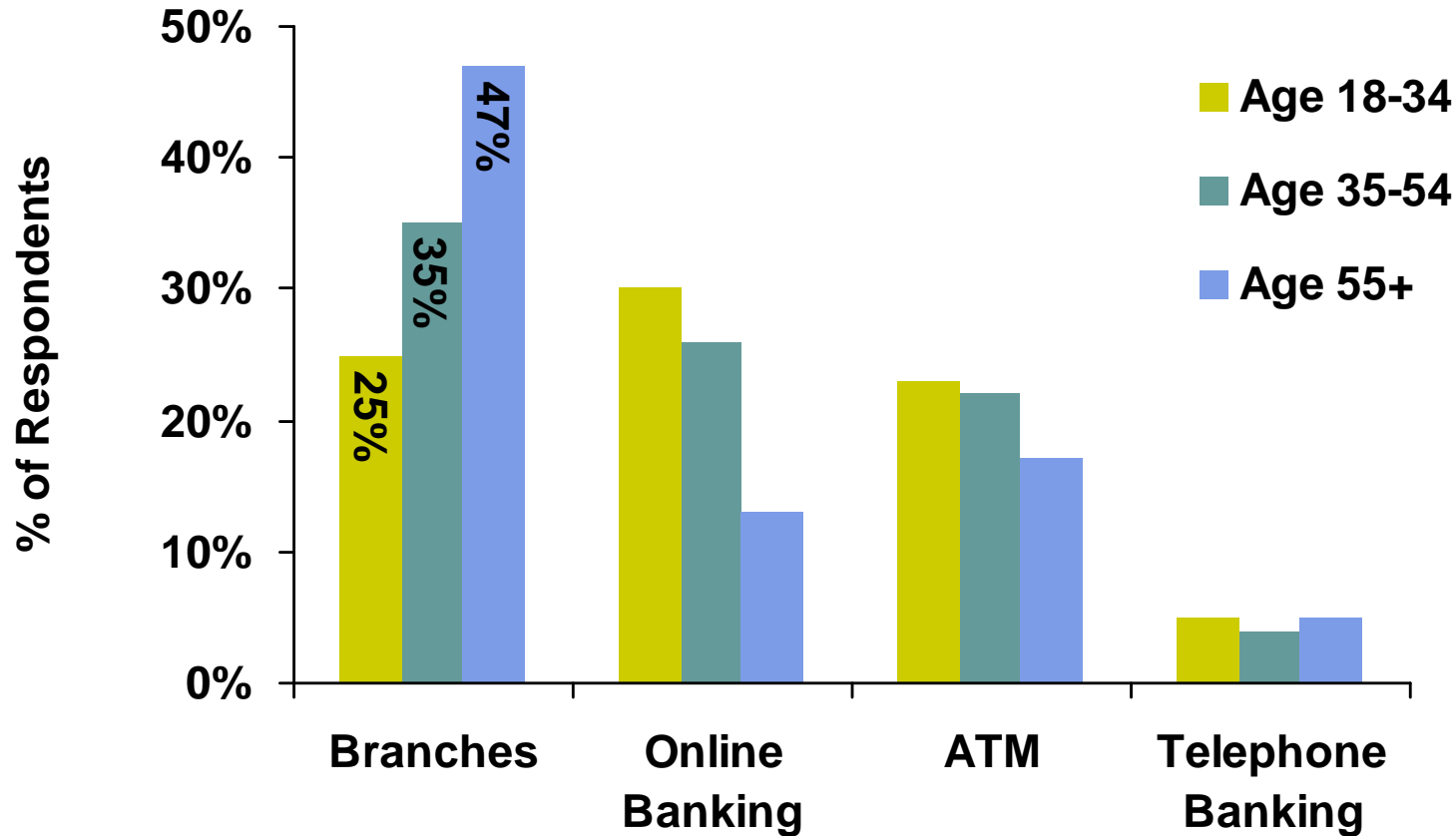


Source: Forrester Research Consumer Technographics Q4 2005 North American Survey

Demographic Shift Will Continue to Drive Changes in Channel Behavior

Threat #3:
The World
is Flat

Which Banking Channel Do You Use Most Often?

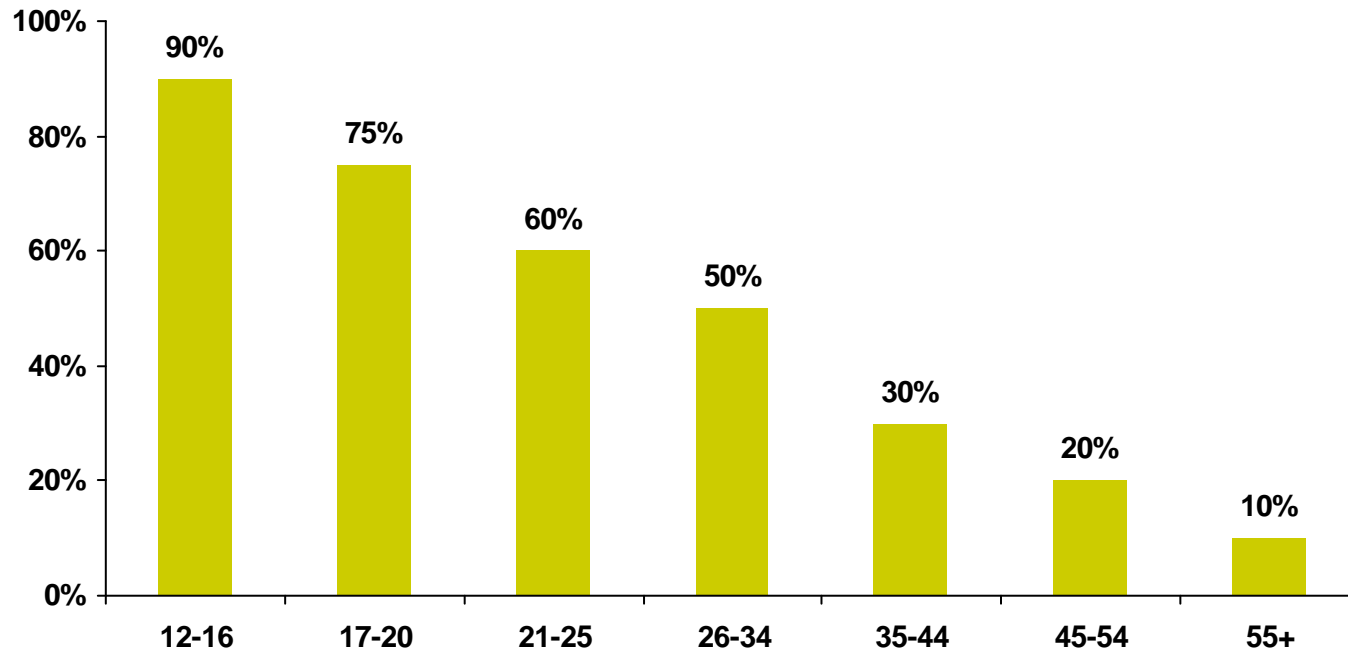


Source: "Branch, ATM, or Online? Generations Clash," ABA Survey: August 2007. n=1013

New Channels, Reflecting Different Behavior Patterns of Different Demographics, Will Emerge

Threat #3:
The World
is Flat

Percent of Consumers By Age Who are Active Users of SMS



Source: Mercatus Analysis, 2007

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About Mercatus LLC



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Mercatus LLC is a boutique private equity and consulting firm focused on the retail financial services space with strong expertise in the retirement services industry. We work with private equity investors and industry executives to make investment and business growth decisions. Mercatus is dedicated to delivering the insights, innovative thinking, and information required by our clients. We place a premium on analytical rigor and intensity, innovation and discipline, and customer focus and passion.

OUR SERVICES

INVESTING: We employ a fact-based, quantitative approach to help assess and value market opportunities, and assess what will be required to succeed. We look for opportunities for market share and earnings growth by applying a disciplined customer perspective.

STRATEGIC CONSULTING: We work with senior executives to pursue dramatic and sustainable improvements in performance. Our focus is on delivering profitable and sustainable market share gains. We understand both the market dynamics to be addressed, as well as the internal dynamics around resources and priorities that need to be managed.