


THE KAFAFIAN GROUP INC.
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TKG Perspective

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Client Conference
Philadelphia Technology Park
Philadelphia, PA **December 5**
Reducing Bank and Information Technology Non-Interest Expense

Northern NJ Community Bankers
Annual Financial Industry Update
The Stony Hill Inn
Hackensack, NJ **January 31**

Financial Managers Society – Philadelphia Chapter
Annual Financial Industry Update
Radnor Hotel
St. Davids, PA **February 13**

Washington/Oregon Bankers Associations
Executive Development Program
Washington Bankers Association
Seattle, WA **March 13**
Bank Profitability

Utah Bankers Association
Executive Development Program
Wasatch Retreat & Conference Center
Salt Lake City, UT **March 15**
Bank Profitability

2012 Conferences & Conventions

Financial Managers Society – Philadelphia Chapter
Annual Holiday Meeting
Four Seasons Hotel
Philadelphia, PA **December 11**

Northern NJ Community Bankers
Holiday Dinner
The Stony Hill Inn
Hackensack, NJ **December 14**

American Bankers Association
ABA National Conference for Community Bankers
JW Marriott Orlando
Orlando, FL **February 17-20**

The Current State of Banking, Relevance and Technology

By Robert E. Kafafian, President & CEO

The past five years have been the most trying times in most current bankers' careers.

The economy continues to struggle through a long downturn. Interest rates remain at historical lows, depressing margins and crushing the profitability of the liability side of the balance sheet, as well as branch networks. Credit quality remains a concern, and competition for good loans is driving yields down further. Finding and sustaining profitable fee income is a challenge. Managing costs is at best difficult given the constant bombardment of regulation, particularly for community banks. The availability of capital is virtually non-existent for banks under $2.5 billion in assets, and Basel III is lurking around the corner.

Banks continue to suffer reputational risk given the disdain that the public has been instructed to feel by the media and federal government. Add to all of this the increased scrutiny by regulators, which is the result of the composite of regulatory bodies missing key indicators of the pending economic predicament.

It's ironic that the GM bailout is lauded as a great accomplishment, while the TARP program, which was forced on many banks, is seen as the poster child of the crisis, even though the majority of TARP was paid back with interest providing billions of dollars of profit to the federal government.

The unfortunate part of all of this is that community banks did not create this collection of problems but now may be paying the biggest price. Since 2008, 457 banks have failed and through September, 694 banks remain on the FDIC watch list. "Too big to fail" still appears to be the model of the day, even though large banks are required to create living wills to provide for a systematic break-up of a troubled bank. We'll see if one of the larger banks is truly allowed to fail when one is in serious trouble.

Add to all of this the fiscal cliff, larger federal deficits, more taxes, the prospects for an extended economic malaise, and the federal government's propensity to put community banks out of business. Are we now significantly depressed?

Strategic Issues

Through the year TKG has been espousing the following key issues for community bank survival and success:

1. Community Bank Relevance
2. Capital
3. Regulatory Compliance
4. Credit Quality and ERM
5. Interest Rate Environment
6. Operating Efficiency
7. Emerging Trends and Technology
8. M&A and Industry Consolidation

While each of these categories is important for survival, we believe items one and seven are keys to future success. Let me first touch on the other six items.

Capital is a must given the regulatory need for increased capital and the potential impact of Basel III. This is significantly challenging for community banks for many reasons, but improved and sustainable performance will assist in raising capital.

Regulatory Compliance is the category most bankers would put on the top of the list. However, compliance by itself does not attract customers and drive performance. We need to assume compliance is a given and move on in order to be successful.

Credit Quality & ERM. Credit quality can bring a bank down the fastest, but most banks have learned their lessons, improved underwriting and credit management processes and, hopefully, will continue to stay focused on this area. It is critical that community banks focus beyond just credit quality and better understand and manage interest rate, liquidity, price, reputation, strategic, IT/operational/transactional, and compliance risks.

The ***Interest Rate Environment*** is out of our control, so we must be prepared to manage within the confines of whatever the level and slope of the curve may be, as well as related balance sheet exposures.

Operating Efficiency can help support performance in the short run and periodic improvements in cost management and processes and procedures should be the norm. However, this category by itself does not lead to a sustainable high performing bank.

Significant ***M&A and Industry Consolidation*** has been predicted by investment bankers for the past three years without meaningful volume. However, industry consolidation will occur and community banks that survive will benefit from the decreased level of competition. There is and will be a place for community banks. The question is will your bank survive, succeed and participate as a consolidator?

Community Bank Relevance

Money center and regional banks have the ability to compete on transaction and volume. Their sheer size and capacity can out price and out product community banks. It is a rare community bank that can compete at this level. As such, it is imperative that smaller banks compete on relationship, local knowledge, and service. This can't just be lip service. It must be accomplished by attracting, developing and retaining the right employees who can build and sustain relationships with the right attitude to truly serve customers and the market place. More and more business must be performed outside of the bank than within the bank. In other words, the days of waiting for customers to come to us and being an order taker is over.

Additionally, customer service is not just about people and face-to-face relationships; it includes every single touch point we have with a customer (i.e., delivery channels) and includes providing self-service opportunities. Community banks must do all of these things well in order to remain relevant and viable to the communities and customers being served, otherwise they will end up being part of the industry's consolidation.

Emerging Trends and Technology

Finally, we arrive at technology. The rapid pace of technological change can be the most significant factor in a community bank's future success and survival. Those banks that embrace technology in a strategic fashion, understanding the limitations of cost, change, and obsolescence, will be in a position to provide customers a reason to stay rather than leave for a larger bank. Technology is the way for community banks to bridge the gap between large and small banks, and assists in overcoming limited branch networks.

Data shows that branch transactions have declined over 40% in the past ten plus years. Branches are becoming more consultative centers, requiring less physical space, but often higher quality personnel who are willing to leave the branch frequently to meet with customers on their "turf." This trend will continue. The total number of branches in the U.S. has declined for the past four years. Experts are predicting as many as 15,000 branches will be closed or consolidated from the system within five to ten years. The only category of bank transactions that has grown in the past five years is electronic channels. All others, such as branches, call centers, ATMs, etc., have declined over this same period.

Having said this, older customers still desire a branch close to where they work or live, but more and more infrequently visit, or if they do it is often through a drive-up window. For those below the age of thirty-five, all bets are off. These individuals will be the leaders in their community, business owners, and corporate executives within the next fifteen years. The industry must adapt to this generation and future generations' desire of how they would like to bank. It should also be noted that surveys have shown that the majority of those all the way up to seventy-five years of age are comfortable using some form of electronic banking.

Concluding Thoughts

So in conclusion, I believe that the greatest risk to community bankers is becoming irrelevant to your customers and not adapting to technology. As it relates to technology, it is therefore important that community banks address the following technological issues in the strategic planning process:

Core Systems remain the backbone of a bank's data, tracking, balancing, and audit operation. The core provider industry has essentially consolidated to four major vendors. Whichever vendor a bank uses, significant care must be given to negotiating the best contract and utilizing the system's features, many of which banks are unaware of and subsequently do not take advantage of.

We've learned that ***Delivery Channels*** are not profit centers but necessities. Customers assume the plethora of branches, drive-ups, ATMs, on-line and mobile banking, remote capture, merchant services, etc. are the norm and failure to deliver these channels successfully can have negative impacts.

Social Media propelled by the youth of the world is driving how people communicate and market. Banks must be prepared to participate in this channel in a deliberate fashion.

Management Information plays an increasingly important role daily. Those that have timely information to make informed decisions will leave others in the dust. This is both internal and external information.

Data Security may be the biggest challenge of all given a world-wide economy and multiple delivery channels. This is a never ending battle that must be dealt with deliberately, often expeditiously and continuously. There is no turning back.

And finally, ***Business Continuity***, the importance of which we continue to learn from terrorist attacks, major weather issues, power outages, etc. Are we prepared for the future disasters that may occur and how long does it take us to get back in business?