


THE KAFAFIAN GROUP INC.

...helping banks perform better™


First Quarter 2009 **Volume 1 Issue 1**

TKG Perspective

Watch for Us

Speaking Engagements

New York Bankers Association
"Earn It, Save It, Bank It" Seminars
New York, NY, **April 22**
Poughkeepsie, NY **April 23**
Syracuse, NY, **April 24**
"How did we get into this mess, and what can community banks do to get through it"
http://www.nyba.com

Pennsylvania Bankers Association Annual Convention
"How Did We Get Into This Mess"
Aventura, FL **May 15**
http://www.pabanker.com/eventsInfo/convention.htm

Maryland Bankers Association
Annual Convention
Cambridge, MD, **May 17-19**
"Key Strategies and Drivers of Performance, Profitability, and Success"
http://www.mdbankers.com

FMS Forum
Keytstone, CO, **June 22**
"Mergers & Acquisitions: Critical Mass or Critical Mistake"
http://www.fmsinc.org/events

PNC Bank
Client Conference
Northeast, PA, **June 24-26**
"Profitability & Performance Measurement"

Educational/Teaching

ABA School of Bank Marketing & Management
Dallas, TX**,** **May 18-20**
"Profitability & Strategic Issues"
"Product & Customer Profitability"
http://www.aba.com/Events

Pennsylvania Bankers Association
PBA School of Banking
State College, PA, **June 1-4**
"Organizational Planning at Community Banks" and "Strategic Thinking & Bank Decision Making Process"
PBA Advanced School of Banking
State College, PA, **July 26-31**
"How Do Banks Generate Money?"
"Management Information Systems"
http://www.pabanker.com/eduTrain/schools.htm

AMIfs Institute
St. Louis, MS, **July 19-24**
"Profitability & Performance Measurement"
http://www.amifs.org/calendar.asp

Maryland Bankers Association
Advanced School of Banking
College Park, MD, **August 3-4**
"Bank Financial Principals"
http://www.mdbankers.com

Does congress know how to run your bank?

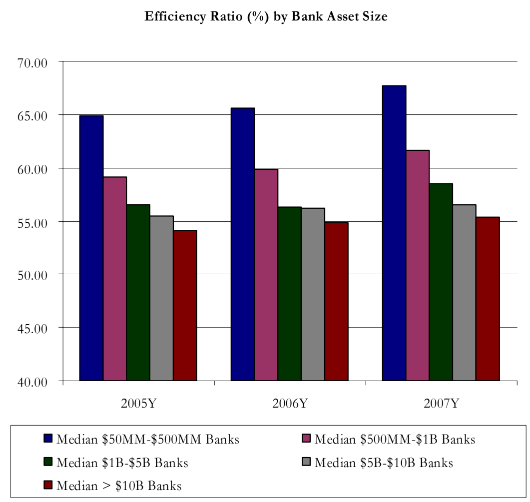
By Jeff Marsico

"Bank Bailout Plan Revamped" read an early February Wall Street Journal headline. The sub-text was equally alarming. Throughout the article, there was no distinction between the select few financial institutions that were at the heart of our current morass and the rest of us. Will Ken Lewis, seated behind a wall of microphones in front of a Senate subcommittee, have an impact on your bank?

Although the answer is somewhere between yes and maybe, we should not sit idly by waiting for events to happen to us. In light of overwhelming uncertainty there is certainly opportunity.

We have recently completed a strategic planning season at The Kafafian Group ("TKG"). What has struck our staff the most is the continued focus on long-term strategy in light of today's events, although current events is certainly impacting many strategic discussions. Focusing on strategic opportunity is a very positive development. What was clear is the desire to grow by most, if not all, of our clients. Growth, so the conventional wisdom goes, drives down costs and enables community banks to compete with their larger brethren.

This philosophy has merit, as far as it goes. The following chart demonstrates a declining efficiency ratio as financial institutions become larger. But clearly the law of diminishing returns applies once a financial institution reaches a certain size. In a recent presentation I made to community bankers, I pointed out that the annual expense of originating and maintaining a business checking account was actually *greater* for our larger profitability outsourcing clients than our smaller ones. Larger financial institutions were more profitable in this product group



only because the average balances per account were larger. In other words, larger banks were able to generate more revenue per account, not have less expense per account.

To be fair, over the past three years, our profitability outsourcing clients as a whole have driven down the median annual cost of a business checking account from $827 at the end of 2006 to approximately $689 today. This is a positive trend that should continue as community banks strive to be relationship driven versus transaction driven, and therefore must dedicate more resources to front-line versus support functions.

Let's dig deeper into the observation that community banks desire to be relationship versus transaction driven. It has long been a resounding theme in strategy sessions we have moderated over the years. Being relationship driven implies that banks focus resources on those activities that create and solidify relationships. The table on the following page highlights the total resources, in the form of operating expenses, in the median branch network of our profitability outsourcing clients.

2009 Conferences and Conventions

North Carolina Bankers Association
Bank Directors Assembly
Greensboro, NC, **March 9-10**

New Jersey Bankers Associations
Directors and Managing Officers Conference
Forsgate, NJ **March 27**

New Jersey Bankers Association
Annual Convention
Palm Beach, FL **May 13-17**

Pennsylvania Bankers Association
Annual Convention
Aventura, FL **May 13-16**

Maryland Bankers Association
Annual Convention
Cambridge, MD **May 17-20**

Florida Bankers Association
Annual Convention
Orlando, FL **June 10-13**

North Carolina Bankers Association
Annual Convention
Chapel Hill, NC **June 13-15**

Pennsylvania Association of Community Bankers
Annual Convention
Quebec, Canada **August 10-13**

New York Bankers Association
Annual Convention
New York, NY **October 7-9**

Does congress know how to run your bank?

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Banks invest relatively the same amount in direct and indirect expenses into their branch network. In other words, we are placing equal value on the transaction processing and the relationship building functions. One may argue that some of the indirect expenditures are for relationship building, and I will accept that argument. However, one must concede that some of the direct expenditures within branches revolve around transaction processing as well.

	2006	2007	2008*
Branch Direct Expense	1.18%	1.17%	1.30%
Branch Indirect Expense	1.20%	1.26%	1.19%
Total Non-interest Expense	2.38%	2.43%	2.49%
(dollars in thousands)			
Average Branch Deposit Size	38,126	37,892	36,051
Branch Direct Expense	450	443	469
Branch Indirect Expense	458	477	429
Total Non-interst Expense	907	921	898

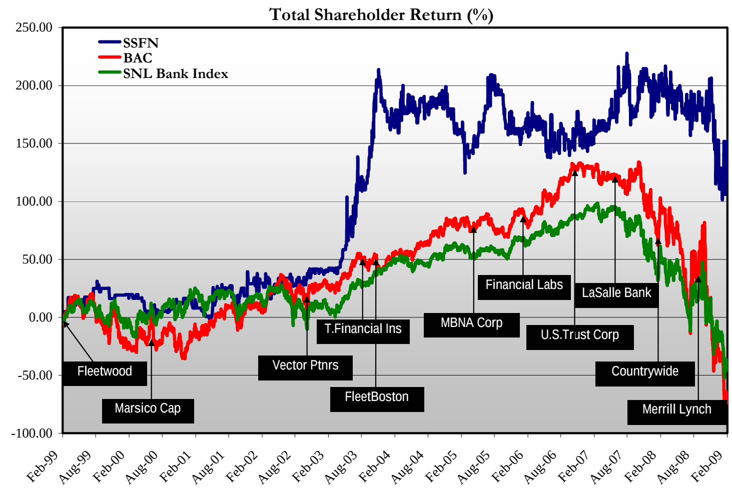
*Data from 3Q08. Source: TKG profitability peer database.

What is the point of all of this? Banks must look within their organization to identify if their operating cost structure is aligned with their strategy. The objective for support functions is plain and simple, drive down the cost to maintain each account. Relationship builders, the cornerstone of your strategy and your future success, should be allocated the resources to properly motivate them to gain a larger share of business from current customers, and to increase customers.

The fallback position to driving down costs per account has typically been to get bigger. As previously mentioned, this has some merit. But I encourage you to focus equally if not more on being relevant to your customers.

To further my point, look at the chart comparing the total return of the SNL Bank Index, Bank of America, and Stewardship Financial, a community bank based in Bergen County, New Jersey.

Over the past ten years, Stewardship Financial has delivered greater shareholder returns than the SNL Bank Index and Bank of America. During that time, BofA made several acquisitions. At this writing, BofA had $1.8 trillion in assets. Stewardship Financial had $612 million. So much for critical mass.



Critical to Stewardship's success is its singular uniqueness. The company gives ten percent of its pretax income to charity. All things being equal, this clearly distinguishes them from competitors.

In a recent article in an industry publication, a CEO of a consulting firm indicated they performed a mystery shop on several financial institutions, asking representatives why the mystery shopper should bank with them. Most had either no answer or fumbled through a from-the-hip response. Do your relationship management personnel have a response?

The future of banking is changing at breakneck pace. What hasn't changed is the level of complexity for a business or a household to manage finances. Are we helping them manage their balance sheets, or are we singularly focused on ours? For community banks to succeed, we must elevate our game beyond that of transaction junkies and product pushers. Our largest competitors already own that market. I think we should cede it to them.

TKG, as part of our strategic planning engagements, periodically evaluates our industry, its trends, successes, and challenges. We are pleased to share our thoughts with you, our valued clients, in the form of this periodic newsletter. If you would like to discuss strategy further, or learn more about our performance measurement, strategic planning, profit/process improvement, or financial advisory services, please call us at (973) 299-0300 or visit us at www.kafafiangroup.com.