


THE KAFAFIAN GROUP INC.

...helping banks perform better™


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TKG Perspective

Watch for Us

Speaking Engagements

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

American Bankers Association
2009 De Novo Banking Forum
Washington, DC **July 12-14**
http://www.aba.com/Events/denovo.htm

Computer Services, Inc.
Users Conference
Indianapolis, IN **August 19-20**
"How to Survive in Today's Financial Climate"
http://www.csiweb.com/news_events/news.cfm

Educational/Teaching

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

Pennsylvania Bankers Association
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

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

2009 Conferences/Conventions and Events

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

North Carolina Bankers Association
Annual Convention
Chapel Hill, NC **June 14-15**

M&T Bank/Rowles & Company
62nd Annual Financial Institutions Crab Feast
Conrad's Ruth Villa
Middle River, MD **July 9**

New Jersey Bankers Association
Annual Golf Outing
Raritan Valley Country Club
Bridgewater, NJ **August 10**

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

NY/NJ FMS Chapter
Golf Outing
North Jersey Country Club
Wayne, NJ **August 24**

How did we get into this mess and what can community banks do to get through it?

By Robert E. Kafafian

Much has been written about the current economic crisis, the worst since the Great Depression. Unfortunately, many successful, safe, and sound community banks have been whitewashed by the bad deeds of a few and the misconceptions of many, including the media.

Using the word "bank" generically to include large banks, small banks, mortgage brokers, insurance companies, and investment banking and brokerage firms has confused the general public. Recently, a TV commentator mistakenly stated, with no correction, that a community bank in North Carolina was one of the few banks in the country to **NOT** make sub-prime mortgages. A writer from a noted financial publication was unaware that the TARP/CPP program required financial institutions to pay interest on the government investment, was structured for the eventual return of the capital, plus required warrants. In fact, it is estimated that the government may make as much as $45 billion from the TARP/CPP program. Apparently, the word bailout has led people to believe the money is actually free.

Additionally, ***Government Mandates*** like CRA and the pressuring of Fannie Mae and Freddie Mac to lower mortgage standards are contributing factors. The seeds of the so-called "mortgage bubble" were planted long ago.

Other contributing factors include:

- Often unscrupulous ***Third-Party Mortgage Brokers*** who were largely unregulated, paid for production, and shared none of the credit risk.
- ***Rating Agencies*** whose emphasis increasingly shifted to revenue generation rather than the attendant responsibility to be accurate. The analysts who assigned an initial triple A rating to a security that was subsequently downgraded to junk status were probably paid much more than the analysts who challenged those ratings.
- The ***Inverted Yield Curve and Prolonged Period of Low Interest Rates*** caused some to believe the Federal Reserve Bank had contributed significantly to the crisis. Low interest rates for such a long period of time effectively lowered mortgage payments while simultaneously promoting a rise in home prices. Housing, in a normal rate environment became essentially unaffordable and the inevitable drop in prices destroyed $2 trillion in home values.
- The development of proactive ***Asset/Liability Management and Securitization*** were originally a positive outgrowth of the savings and loan crisis of the 1980's because they helped banks to mitigate interest rate risk and assisted in quantifying and spreading risk among many participants. Unfortunately, the need to securitize became the desire to securitize and Wall Street greed created exotic securities and products while making gross and excessive profits. Many are unaware that most toxic assets lie outside the banking system, which makes trying to stabilize the market much more difficult.
- The ***SEC, FASB, the Federal Government, and Bank Regulators*** have confronted bankers with conflicting points of view. The SEC, in what they described as an effort to protect shareholders and restrict financial institutions from managing earnings, began restricting banks' ability to reserve for loan losses in good times to cover losses in bad times. This is fundamental to banking and left many banks exposed to unexpected losses. FASB in their effort to create transparency established mark-to-market and fair value accounting, the impact of which is destroying the capitalization of the industry. Unfortunately, FASB never anticipated the impact of their decrees in catastrophic markets. And while the President and Congress are encouraging banks to lend, Bank Regulators are frequently saying "don't make that loan."

- The ***Investment Banking, Brokerage, and Insurance*** worlds and their collective greed exacerbated the problem. Their relentless pursuit of transactions and fees led them to create securitization products that were not backed by real underlying financial instruments. When there weren't enough prospective sub-prime home buyers to fill the desire and demand for bonds backed by those types of mortgages, synthetic products were created that accelerated and increased the size of the market and the problem. Additionally, insurers began insuring products and structures they either did not understand or could never insure if massive defaults occurred. The excessive pay structures for individuals at these companies rewarded them for taking risk in good times, but not to be culpable or accountable in bad times. What makes this worse is that many of these Wall Streeters, both Democrats and Republicans, have stepped into or been appointed to high ranking government and elected positions. Many are still in those positions.

SO HERE'S A QUICK SUMMARY OF THE PROBLEM:

- Many people bought homes they couldn't afford.
- Unscrupulous mortgage brokers ran rampant and unregulated.
- Some banks made loans they shouldn't have made.
- Wall Street packaged these loans and created securities that no one understood, including themselves, and insurance companies backed them.
- Wall Street accelerated the problem with exotic securities, synthetic product and greed.
- The Government stood by and watched or in some cases encouraged the bad behavior and continues to encourage bad behavior.

WHAT ARE COMMUNITY BANKS TO DO?

First, they need to remain relevant to their employees, customers, communities, and shareholders. This means being relationship-driven, not transaction-driven and providing real customer service, not just lip service.

Second, they need to clearly define strategy and overall strategic direction. This means having a clear sense of vision and mission, and communicating the plan throughout the organization. The plan should include a situational assessment, or SWOT analysis, defined strategic objectives and critical issues for success, tactical goals and initiatives that are proactively measured and tracked, and rolling three year financial projections. Additionally, the plan should be updated on an annual basis. It is time to start planning for how to take advantage of the economic recovery.

Third, they need to maintain credit quality and credit standards. This means for both the loan and investment portfolios. Additionally, community banks need to focus on lending within their market area, lend to businesses they know, tie compensation to production and credit quality, and better understand some of the instruments brokers are selling them for the investment portfolio.

Fourth, they need to provide customer service and sales. In community banking, service and relationship drive sales. Too often banks have gotten this backwards and overly aggressive sales tactics have backfired. Service also doesn't mean giving away everything from waiving fees to modifying rates. If we are providing value, we should be paid for that value, which helps mitigate pricing pressure. Remember to market hard, sell soft…make a friend, make a customer.

Fifth, they need to manage cost and efficiency. This doesn't necessarily mean cutting costs, but does imply the ongoing nature of cost management. Periodic and systematic reviews of operating processes, procedures, and expenses are a critical component of performance and success.

Sixth, they need to understand where they do and don't make money. Banks need to have the management accounting systems to emphasize high performers, improve mediocre performers, and sometimes jettison losers. This is necessary for organizational units, lines-of-business, branches, products, customers/relationships, market segments, officers, etc. If you can't measure it, you can't manage it!

Seventh, 2009 is the year to focus on safety and soundness and preserving capital. Earnings are always important, but the banks that survive the current economic crisis will be in a strong competitive position to take advantage of future opportunities and the market's eventual recovery…which ties into number eight.

Eighth, they need to start to plan for the opportunities that will appear and be available as the crisis ends. This is why all of the above are so important. It's time to start planning for the future and stop looking back. The competitive opportunities for the survivors and those that succeed will be vast in the new financial industry landscape. It is important to be prepared to take advantage of opportunities such as improving credit quality, flights to safety, the weeding out of mortgage brokers, perhaps fewer competitors, and the renewed focus for community banking as some of the larger banks are broken up into smaller pieces.

Ninth, and finally, they need to go to work every day. This isn't rocket science, but it does require diligent work and renewed effort. Unfortunately, too many bankers have been coasting until they retire or until their bank is sold, and then they and their employees wonder "What happened to our bank?" The days of bankers' hours and easy business are over. However, a renewed vigor and determination can go a long way.

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