


THE KAFAFIAN GROUP INC.
...helping banks perform better™

Fourth Quarter 2009 Volume 1 Issue 4

TKG Perspective


Watch for Us

Speaking Engagements

Financial Managers Society
Philadelphia Chapter
Philadelphia, PA **January 13**
Roundtable Discussion

New Jersey Bankers Association
Jamesburg, NJ **February 17**
Cost Savings and Increasing Revenue

American Bankers Association
ABA School of Bank Marketing and Management
Dallas, TX **May 21-22**
Profitability and Strategic Issues
Product and Customer Profitability

Pennsylvania Bankers Association
PBA School of Banking
State College, PA **June 6-10**
Strategic Decision Making and Organizational Structure

Pennsylvania Bankers Association
PBA Advanced School of Banking
State College, PA **July 11-16**
How do Banks Make Money?

AMIfs
AMIfs Institute
St. Louis, MO **July 19-23**
Organizational, Branch, Product and Customer Profitability

Maryland Bankers Association
The Maryland Banking School
College Park, MD **August 1-6**
Bank Financial Principles

2010 Conferences and Conventions

Pennsylvania Bankers Association
Annual Convention
Baltimore, MD **May 12-15**

Maryland Bankers Association
Annual Convention
Hot Springs, VA **May 15-19**

New Jersey Bankers Association
Annual Convention
Naples, FL **May 19-23**

Florida Bankers Association
Annual Convention
Naples, FL **June 6-9**

North Carolina Bankers Association
Annual Convention
Charlotte, NC **June 20-21**

Pennsylvania Association of Community Bankers
Annual Convention
Palm Beach, FL **August 27-31**

What's Happened to Bank Profitability?

Robert E. Kafafian

The economic crisis has certainly taken its toll on the financial industries' profitability and overall performance at many levels. Without a doubt, deteriorating credit quality in investment and loan portfolios and fair value accounting have had a significant impact. Staying safe and sound and preserving capital have become watch words for the immediate future.

However, the reasons of poor performance lie deeper. For an industry that often measures success by achieving a return on assets ("ROA") greater than 1.00% and a return on equity ("ROE") greater than 15.00%, today's trailing twelve month national averages are a paltry 0.20% and 2.50%, respectively.

In addition, the bottom line performance of community bank spread and fee-based product lines has shifted materially since 2002. Even with the current credit quality woes, the asset side of the balance sheet is carrying the limited levels of profitability of most financial institutions. Let's explore why this is occurring.

Bank Profit Contribution

	2002	2009
Fund Using Products	67%	119%
Fund Providing Products	40%	-11%
Fee-Based Products	-7%	-8%
	100%	100%

First, let's review fee-based products and lines of business. The numbers in the above table exclude service charges on spread-based products and include areas like trust, wealth management, insurance, etc. The performance of these areas have not materially changed and on average have been slightly but consistently unprofitable. This is the result of community banks' lack of expertise in these lines along with their inability to achieve the critical mass necessary to be profitable. For this reason, many banks have chosen to use third-party providers to offer these types of products and services. While this limits the upside profitability benefit, it significantly limits the downside exposure and still allows community banks to fill out product lines and meet customer needs. To the extent that an individual bank achieves critical mass, consideration can then be given to bringing these product lines in-house.

Second, let's review the liability side of the balance sheet. Interest rates remain at historical lows and at certain maturity terms close to zero percent. This is the opposite end of the spectrum from 1981 when interest rates exceeded twenty percent. The currently low interest rates affect the funds transfer credits given to all products based upon risk and maturity characteristic and materially affect the credits given to liability products in particular.

As a result, the market value of this money is so low there is an inability to give enough credit to liability products to cover operating expenses. Consequently, many of these products are now unprofitable. This is especially egregious with certificates of deposits ("CDs"), which are currently operating at negative spreads (see table, top of next page). This is due to the artificial pricing floors which competitive markets often create and cause financial institutions to price CD's at higher rates than the resulting credit. Effectively, CD's have little to no chance of being profitable in this current environment, and even in the best of environments have significantly less spread than all other liability products.

Third Quarter 2009 Net Interest Spread	
Liability-Spread Products	**Average**
Non-interest Bearing Demand Product	2.98 %
Interest-Bearing Demand Product	2.62 %
Money Market Product	1.69 %
Savings Product	3.05 %
Time Product	(0.33)%

An additional way of measuring the performance of liability spread-based products is through the branch network. On average, branches historically have broken even on a direct cost basis at about $10 million in deposits, on a fully absorbed basis at $15 million in deposits, and hit "critical mass" (defined as the ability to achieve a return on liability of greater than one percent) at $25 million in deposits. This also assumes a mix of deposits of one-third checking product (both non-interest bearing and interest bearing), one-third savings and money market, and one-third CD's. Today these break points are approximately $15-20 million higher for each level. As a result, many branch networks are breakeven at best in this environment.

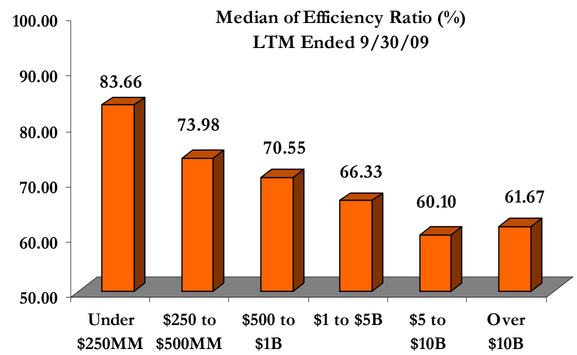
Please don't conclude that this means banks shouldn't be interested in growing and maintaining core deposits and resulting relationships, especially core checking, savings, and money market accounts. Economic cycles prove that interest rates will again rise and the value and profitability of these deposits will return and rival the asset side of the balance sheet. Core funding sources and branch footprint are still at the top of the list of what drives franchise value.

Third, let's review asset-spread products which include investments and loans. The industry has been severely affected by losses in the investment and loan portfolios. This has been especially painful in bank investment portfolios, which normally have more narrow spreads than loan products due to their primary purpose of funding loans and providing liquidity (see table below). Unfortunately, a variety of instruments and funds have led to defaults and write downs previously not experienced by many banks.

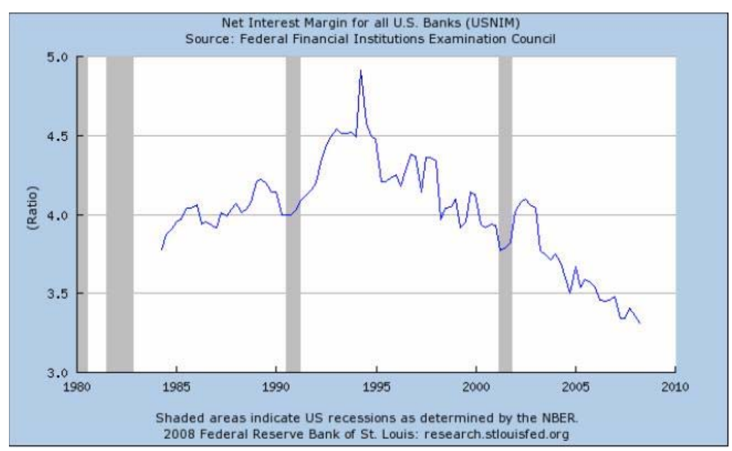
From a lending perspective, credit quality continues to deteriorate. However, in spite of credit issues, most loan categories, and in particular commercial loans (both Commercial/Industrial and Commercial Real Estate), are outperforming most other products and services. This is due to the lack of commoditization and relational pricing in commercial products. This, along with the overall poor performance of profitability in general, explains why fund-using product profitability (specifically lending) now exceeds 100% of community banks bottom-lines.

Third Quarter 2009 Net Interest Spread	
Asset-Spread Products	**Average**
C&I Loans	3.42%
Commercial Mortgage Loans	3.25%
Consumer Loans	2.74%
Residential Mortgage Loans	1.48%
Investment Products	0.76%

Fourth, let's explore operating expenses. In general, operating expenses have historically averaged less than 3.00% of average total assets for all banks in the United States. This is counter to the fact that community bank efficiency ratios have risen over the past few years from the low 60% range to over 70% (see chart below). This increase is largely the result of declines in revenue sources and not necessarily increases in actual proportionate expense. While expenses in some categories such as loan workouts, FDIC assessments, regulatory compliance, etc., have increased, generally speaking the industry has managed expenses at a steady level. This does not mean, however, that there is not room for improvement. Continued and ongoing management of operating efficiency is a must in today's and all future economic environments.



Final points. Net interest margins continue to decline, which further argues the importance of operating efficiency and critical mass (see chart below). The biggest single factor affecting profitability is average balance per account, not necessarily numbers of accounts per customer. Numbers of accounts creates stickiness, average balances create profitability. The combination of both can have a significantly positive effect on relationship building and becoming a high performing bank.



Remember, if you can't measure it, you can't manage it!

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.