THE KAFAFIAN GROUP INC.

...helping banks perform better™

First Quarter 2011 Volume 3 Issue 1

TKG Perspective

Watch for Us

Teaching/Speaking Engagements

Financial Managers Society
Philadelphia Chapter
Philadelphia, PA **February 9**
CEO Roundtable

Financial Managers Society
New York / New Jersey Chapter
Stony Hill Inn
Hackensack, NJ **February 16**
How Will Dodd-Frank Affect M&A Activity

American Bankers Association
School of Bank Marketing and Management
Southern Methodist University
Dallas, TX **May 17-24**
Product and Customer Profitability
Profitability and Strategic Issues

Pennsylvania Bankers Association
PBA School of Banking
Penn State University
State College, PA **June 5-10**
Strategic Decision Making & Organizational Structure

Financial Managers Society
2011 Finance & Accounting Forum for Financial Institutions
Boca Raton Resort
Boca Raton, FL **June 20-21**
A Practical Approach to Reducing Non Interest Expense

Pennsylvania Bankers Association
PBA Advance School of Banking
Penn State University
State College, PA **July 24-29**
How Do Banks Make Money?

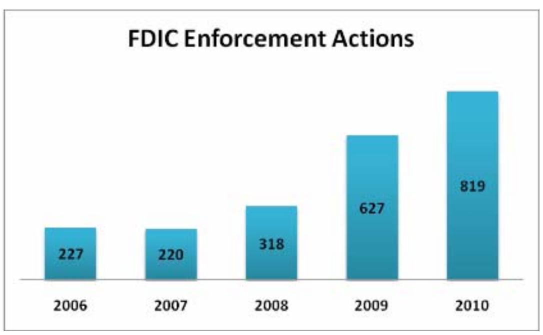
Maryland Bankers Association
The Maryland Bankers School
University of Maryland
College Park, MD **July 24-29**
Bank Financial Principles

Are the Regulators Getting You Down?

By Jeffrey P. Marsico, Executive Vice President

I've often found these past two years extremely difficult. As consultants, we should try not to personalize engagements. But I can't change the internal wiring. Last year, a client failed, and many more received regulatory orders.

Memorandums of Understanding ("MOU"), Formal Agreements ("FA"), and Cease and Desist Orders ("C&D") have been on top of our reading list for the past two years. The stark increase in such orders has been alarming. The FDIC has nearly quadrupled its enforcement actions ("EA") over the past three years.



Many of these EAs have very similar, if not identical, provisions. Take for example the language from an FA Article relating to a strategic plan issued by the OCC to The Suffolk County National Bank of Riverhead ("SCNB") in New York on October 25, 2010:

> *"The Board shall adopt, implement, and thereafter ensure Bank adherence to a written strategic plan for the Bank covering at least a three-year period. The strategic plan shall establish objectives for the Bank's overall risk profile, earnings performance, growth, balance sheet mix, loan mix, off-balance sheet activities, liability structure, capital adequacy, reduction in the volume of nonperforming assets, product line development and market segments that the Bank intends to promote or develop, together with strategies to achieve those objectives…"*

Get in your time machine and go back to February 6, 2009 when the OCC issued a Consent Order to Bay National Bank in Lutherville, Maryland. It too had an Article regarding a strategic plan that read:

> *"The Board must within sixty (60) days of the date of this Order, adopt, implement, and thereafter ensure Bank adherence to a written strategic plan for the Bank covering at least a three-year period. The strategic plan shall establish objectives for the Bank's overall risk profile, earnings performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, reduction in the volume of nonperforming assets, product line development and market segments that the Bank intends to promote or develop, together with strategies to achieve those objectives…"*

So what, right? The OCC cut and paste because they wanted a similar strategic plan from both institutions. People and organizations do this all of the time.

The difference here is that SCNB has been profitable throughout the crisis, and achieved a 1.12% ROA for the third quarter 2010. Bay National failed on July 9th. In this context, is similar treatment in an EA fair?

I would vote no. There are many Articles in EAs, and the strategic planning article in the above institutions is one of many. But life, and business, is not necessarily fair. I'm not sure the lesson we should glean from the similarity of these two orders should be about fairness.

2011 Conferences and Conventions

New Jersey Bankers Association
Annual Convention
Fairmount
Adventura, FL **May 11-15**

Pennsylvania Bankers Association
Annual Convention
Boca Raton Resort
Boca Raton, FL **May 12-15**

Maryland Bankers Association
Annual Convention
The Greenbriar
White Sulphur Spring, WV **June 5-8**

New York Bankers Association
Senior Management Conference
The Otesaga
Cooperstown, NY **June 8-10**

North Carolina Bankers Association
Annual Convention
The Homestead
Hot Springs, VA **June 11-14**

Florida Bankers Association
Annual Convention
The Ritz-Carlton Grand Lakes
Orlando, FL **June 19-22**

Pennsylvania Association of Community Bankers
Annual Convention
Hyatt Regency Lake Tahoe
Incline Village, NV **August 23-26**

New Jersey Bankers Association
Senior Management Conference
Borgota Resort
Atlantic City, NJ **September 12-14**

Maine Bankers Association
Annual Convention
Hyatt Regency
Montreal, Canada **September 15-18**

North Carolina Bankers Association
Management Team Conference
Pinehurst Resort
Pinehurst, NC **October 16-18**

American Bankers Association
Annual Convention
Grand Hyatt
San Antonio, TX **October 23-26**

New York Bankers Association
Annual Convention
Waldorf Astoria
New York, NY **November 9-11**

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The productive view about the similarity of EAs is why haven't we been doing some of the things required by regulators in the first place? Why do many, if not most of these orders contain Articles relating to strategic and capital plans?

Banking is a highly regulated industry, and has been since the Great Depression. Regulators must approve our initial business plans, capital plans, and various other operating procedures prior to granting a charter. Once granted, regulators examine us at least annually, and frequently more often, to ensure we are complying with the myriads of laws and regulations designed to promote safety and soundness. They used to approve interest rates and limit products.

Given the highly regulated environment, bankers are kept in a tight box of things they can and can't do. So why develop a strategy? Budgets have successfully served as strategy the past three generations, haven't they?

In the context of EAs, I don't believe regulators are compelling bankers to develop strategic plans to identify a competitive advantage, to differentiate from other banks, or to build a roadmap to the future. When we read between the lines of EAs, we see regulators looking to tighten the box, remove gray areas, and exert greater control by requiring banks to seek permission to deviate from the plan.

But that should not stop those operating under EAs from taking maximum advantage of the consulting and advisory dollars they are required to spend. If required to develop a strategic plan, why don't banks assess the competitive environment and build a vision and plan for their sustainable future? Similarly and almost complementary, the capital plan should be a component of bank strategy. How much capital will the bank need to execute the plan? What are the preferred and secondary sources of capital?

Imagine a bank that seeks to grow organically by positioning itself as a small business expert within its communities. This will drive products, risk appetite, credit decisions, strategic alliances, training, and capital requirements, to name a few. Perhaps the bank would like to pay higher than market dividend yields because their investor base enjoys dividends. So growth can only be partly funded by retained earnings.

Planning for this, perhaps the bank can establish dividend re-investment plans and employee stock ownership plans to enhance capital. In this context, the bank decides what it wants to be, and sets strategy to accomplish it. We don't need the OCC to tell us that!

A third Article that is oft repeated in EAs is a management study, requiring the bank to hire a consultant to evaluate the board, senior management, and/or staffing levels. Strategic plans, capital plans, and management studies are our top three regulatory-mandated engagements over the past two years. So if these appear in your EA, fear not. They are appearing in many.

Similar to strategic and capital plans, why not take advantage of the required management study expenditure to determine if you have the right team in place to execute your strategy and succeed into the future? We understand that management studies are not particularly comfortable. But, since you are required to undertake one, why not make it as beneficial to the future of your bank as it can be? You have a good idea what team members might be holding you down. Chances are the outside advisors will discover it too, and perhaps find some diamonds in the rough!

The level of regulatory activism is greater today than at any other time in the past 20 years. The political climate is exasperating the situation and creating uncertainty. Amidst our efforts to avoid or get out of enforcement actions, perhaps we should take advantage of the required introspection to determine a strategy that improves our competitive position and sustains our future.

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