THE KAFAFIAN GROUP INC.
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Performance Measurement

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Board & Management Advisory Services

Financial Advisory

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TKG Perspective

Special Recognition

TKG is pleased to announce that Bob Kafafian was recently honored at the AMI*fs* Annual Conference in Las Vegas by being awarded the Lifetime Member Award for his achievement in the field of Bank Management Accounting.

Teaching & Speaking Engagements

FMS NY/NJ Chapter
Spring Half-Day Seminar
The Stony Hill Inn
Hackensack, NJ **April 18**
Capital is King: Balancing Regulatory Capital Requirements and Sustainable Growth

BDO USA, LLP
New Jersey Banking Seminar
Forsgate Country Club
Monroe Twp., NJ **May 22**
Financial Industry Overview

Pennsylvania Bankers Association School of Banking
The Penn Stater Conference Center
State College, PA **June 1**
Decision Making and Organizational Structure

SNL Financial
University Center Conference Chicago
Chicago, IL **June 5-6**
Advanced Bank Valuation

Conferences, Conventions & Other Events

New Jersey Bankers Association Annual Convention
Marco Island Marriott
Marco Island, FL **April 30–May 4**

Massachusetts Bankers Association Annual Convention
Eau Palm Beach Resort & Spa
Manalapan, FL **May 1-4**

Pennsylvania Bankers Association Annual Convention
The Ritz Carlton
Naples, FL **May 14-17**

North Carolina Bankers Association Annual Convention
The Breakers
Palm Beach, FL **May 31 – June 4**

The Next Three Significant Risk Factors

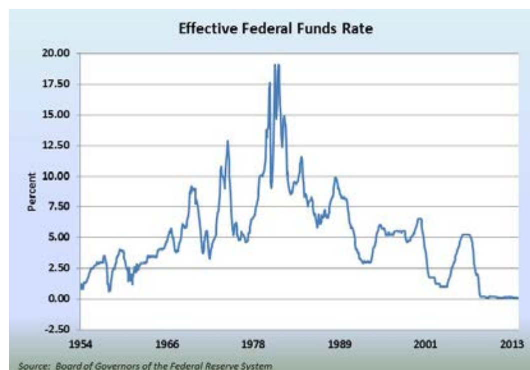
By: Robert E. Kafafian, President & CEO

The past five years have been filled with significant risk factors that have affected virtually every financial institution of all types, size, structure, and geography. We are well aware of the eight OCC risk categories: credit, interest rate, liquidity, price, strategic, reputation, IT/operational, and compliance. They have all been drilled into our heads by regulators. In addition, many banks have now appointed a senior risk management officer, or established risk committees at both the management and board levels to measure and manage risk. All of this is important and necessary to successfully operate in the current and future banking environment.

Of the eight risk factors, there are three categories, interest rate, liquidity, and IT/operational, that are of most concern at this point in time. How banks deal with these risk factors in the yet to be determined economic cycle may impact their future fate, success and viability.

Interest Rate Risk

Interest rates have remained at historical lows since the beginning of the economic crisis in 2008. The last time rates were this low was in the mid-1950's as highlighted in the accompanying chart. Rates generally increased between 1955 and 1981 when they topped out in the 20 percent range. We all remember the negative impact on net interest margins when



rates hit this level, and the resulting failure of many thrifts due to high concentrations of fixed rate mortgages.

There were some banks that thought the high interest rates in 1981 were a permanent fixture. One in central Pennsylvania developed an IRA CD product that offered a floor rate of 10%. In addition, you could continue to add your annual contributions to your account. Who wouldn't sign up for this product today? As rates dropped well below 10% and balances grew, the combined impact became one of the deciding factors in the sale of this bank.

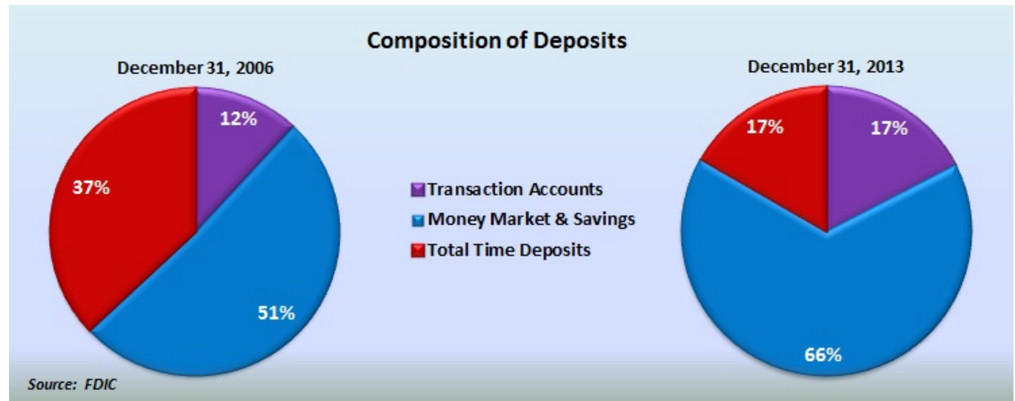
The lessons learned…don't assume anything is permanent, and don't try to predict the business and interest rate cycle with any certainty.

I'm afraid that too many banks have not heeded these lessons. As rates have hit historical lows, and remained low for an extended period of time, many banks have reached for yield by extending terms and booking 30-year fixed rate mortgages, or buying similar type securities in investment portfolios. To some extent, the length of this low rate environment has given some a false sense of security, as loans are paying as agreed, and balances are slowly amortizing down. Unfortunately, history tells us this won't last forever.

In the long run, concentrations are never good, and lack of product and maturity diversity puts everyone at risk. For some, it may be too late. For others, a focused effort on diversifying loan portfolios and funding sources, as well as deploying appropriate hedging strategies may fend off bad outcomes. While many banks claim to be asset sensitive, the real impact of a rising rate environment may prove some ALCO models wrong. Don't let assumed sensitivity, improving credit quality, and better levels of capital fool us into not addressing this serious issue.

Liquidity Risk

The liquidity issue is two-fold, and to some extent an outgrowth of the interest rate risk problem. After the stock market crash in 2008-2009, consumers fled to quality and bank funding sources grew nicely. In addition, as highlighted in the graph below, many customers transferred their funds from CD's into either low interest rate money market and savings accounts or interest bearing checking accounts. The impact of credit issues, along with the decline in loan-to-deposit ratios, meant banks needed fewer funds and as a result, deposit costs have fallen to unimaginable levels. Who remembers fretting over dropping the regular savings rate below 5.00%?



As the economy slowly recovers and loan volume begins to grow, this will likely coincide with the Federal Reserve tightening its policy and raising the Federal Funds rate. The rise is inevitable. The pace and next peak will determine the resulting impact on many banks.

Do banks have the access to funding sources to meet the demands of future loan volume? Do banks have the ability to hold onto their customers in a rising and increasingly competitive interest rate environment, especially when money market funds begin moving back to CD's? Do banks have the ability to attract, or take customers from the marketplace or competitors? Do banks have alternative funding sources available to bridge gaps and make sure they are liquid and stable? I anticipate we are about to find out the answers to all these questions.

IT/Operational Risk

Perhaps the biggest and broadest risk of all is IT/Operational risk. We need only to look at the recent Target, Neiman Marcus, and Michaels incidents. ***Technology is taking over.*** In fact, we at TKG have often stated that banks who can adapt to technology will be the winners and those that can't will be the losers. We have been stating this above all other factors. Let's also recognize that we live in a global economy which has been taken over by social media. We've witnessed how technology and related social media can take down governments. Is it any surprise that many of the despots of the world are trying to corral its impact? In fact, the Basel accord has often mentioned this category of risk as the most significant risk when developing world-wide capital standards.

I remember back to 2009, listening to Jamie Dimon, CEO of JP Morgan Chase, speaking at a New York Bankers Association event. The timing of the event was in the heart of the financial crisis, and Mr. Dimon spoke of his college age daughter asking him how concerned he was about the current economic crisis. Amazingly, his response was that he was "already worrying about the next crisis."

He reflected back upon his lifetime and career, and spoke of the oil embargo of the early mid-70's, the high interest rate environment in the early 80's, the savings and loan crisis of the late 80's, the commercial real estate crisis in the mid-90's, the dot-com crash right after the millennium, and finally the current real estate crisis. He opined how it seemed that every five to seven years there was another major event and rhetorically asked the audience, "Do you really think there won't be any more to come?"

The logical question posed to him was, "Well then, what do you think the next crisis will be?" He stated that he wasn't completely sure, but said that if he were to guess, he thought it would have something to do with data security and technology. His response was prophetic, but obvious in many ways.

Let's remember, there's no turning back as it relates to the world that we live in now and the technology that permeates it. Identity theft, fraud and the need for data security are pervasive. I believe, similar to the Tylenol scare that Johnson & Johnson faced and successfully navigated, the banking industry will have to do the same. After all, it really wasn't just Johnson & Johnson's problem, but everyone's problem, and collectively the pharmaceutical industry had to secure its product and image. Just like in our industry, it's not just the problem of retail stores, but everyone's problem. MasterCard, Visa, banks, and retailers as well as consumers must face the facts and collectively take responsibility and secure the risk.

Stay tuned because I believe there is more to come!

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, regulatory assistance, profit/process improvement or financial advisory services, please call us at (973) 299-0300 or visit us at www.kafafiangroup.com.

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