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

Performance Measurement | Strategic Management | Profit & Process Improvement | Board & Management Advisory Services | Financial Advisory

Fourth Quarter 2014 Volume 6 Issue 4

TKG Perspective

Teaching & Speaking Engagements

Financial Managers Society
Radnor Hotel
St. Davids, PA **March 11**
Financial Industry Update

PA Bankers Association
School of Banking
The Penn Stater Conference Center
State College, PA **June 7-12**

PA Bankers Association
Advanced School of Banking
The Penn Stater Conference Center
State College, PA **June 12-17**

Conferences, Conventions & Other Events

Southeastern Conference for Community Bankers
The Hyatt Key West
Key West, FL **January 28**

Pennsylvania Bankers Association
Annual Convention
Baltimore Marriott Waterfront
Baltimore, MD **May 17-20**

New Jersey Bankers Association
111th Annual Conference
Omni Nashville Hotel
Nashville, TN **May 27-31**

Maryland Bankers Association
Annual Convention
The Greenbrier
White Sulpher, WV **May 31-June 3**

North Carolina Bankers Association
119th Annual Convention
The Westin Resort and Spa
Hilton Head, SC **May 31-June 3**

Maine Bankers Association
Annual Convention
Quebec City
Canada **September 17-20**

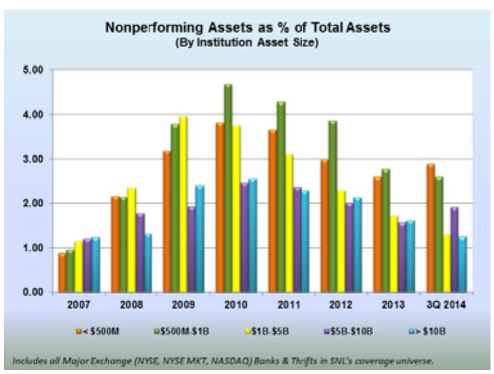
New York Bankers Association
Financial Services Forum
The Breakers
Palm Beach, FL **November 2-4**

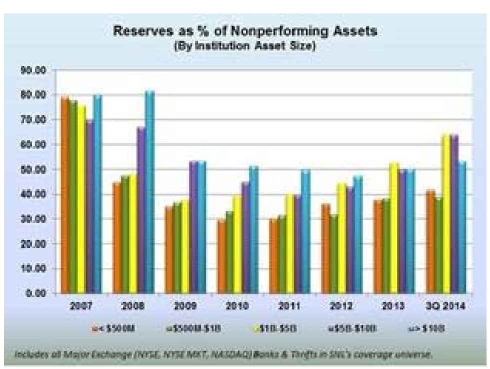
Things to Think About in 2015

By: Robert E. Kafafian, President & CEO

The Kafafian Group would like to wish all of our clients, business associates, and friends a Happy Holiday season and much future success in the coming New Year. We are grateful for your business and the relationships we have mutually developed over so many years.

It's hard to believe that the beginning of the financial crisis is over six years old (September 2008) and the financial industry, the country and the entire world, while doing better, have still not fully recovered. We need only look at the key credit quality metrics shown in the graphs below to understand that the banking industry is still challenged.





Prior to 2008, if a bank had non-performing loans to total assets of greater than one percent (1.00%), and reserves to non-performing loans of less than one-hundred percent (100%), it would have been considered a troubled bank. We have obviously not yet returned to these norms.

In addition, interest rates remain at historical lows and while the Federal Reserve continues to hint that rates may begin to rise by mid-2015, I'll believe it when I see it. After all, they have been predicting rate increases for most of the past six years, and each year they have continued to push potential increases off until the following year.

Interestingly, I was recently debating this exact subject with an economist friend of mine who guaranteed that the Fed would raise rates by next June. When I said that I'd bet him a beer that they wouldn't, he said you're on until I said, "the reason the Fed can't raise interest rates is due to the cost of the national debt and the impact rising rates would have on this cost." In fact, I continued, "until there is meaningful economic growth with tax revenues to offset this cost, it would be difficult to justify a rate increase."

He paused for a moment and stated, "Well, you're probably right, but for all the wrong reasons." Leave it to an economist!

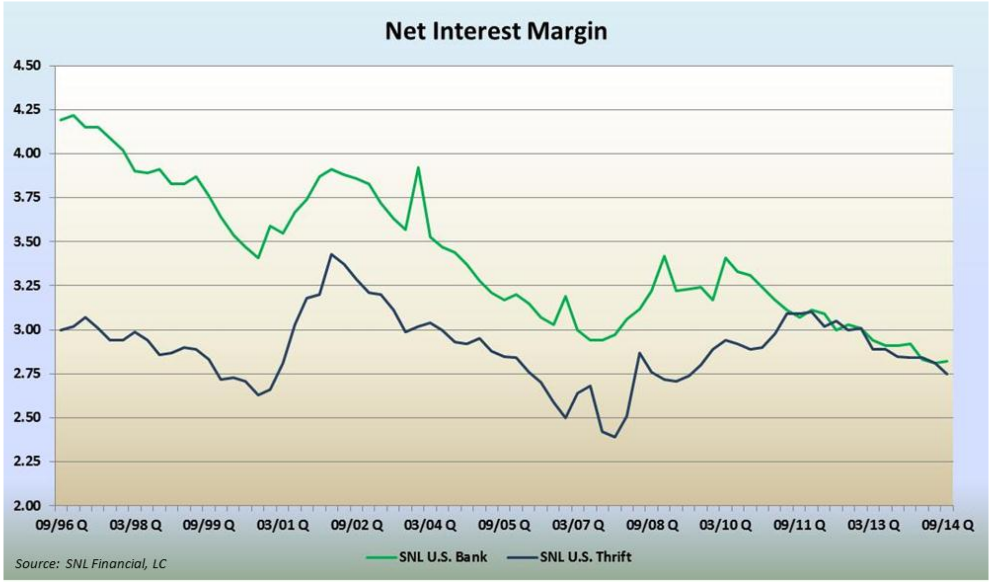
So listed below are some things to think about in 2015.

<u>Enforcement Actions</u>, whether formal or informal, are still at historical highs and regulators are still finding new ways to make life difficult for community banks, in particular. The dirty little secret is that while the larger banks and many non-bank participants created the majority of the financial crisis, the pain is greater for smaller banks, and it is still unclear whether "too big to fail" has really been done away with.

This rears its ugly head with the burden of **<u>Regulatory Compliance</u>** which is significantly greater for community banks, costing time and money. In order to successfully navigate this challenge, many will have to rely on specialty third party firms and vendors to stay current with the constantly changing regulatory environment, due to the difficulty in finding and retaining capable in-house staff. In addition, many of the non-bank competitors mentioned below do not face the same regulatory scrutiny as banks.

The industry has largely **Re-capitalized** itself, and **Capital** has proven to be available to the financial sector, especially for larger banks. In addition, there are a now a number of alternatives available for community banks to access capital. Patriot Financial Partners and FIG Partners are two examples of funds and capital sources that are looking to invest in community banks, as well as the traditional broker/dealer sources. A byproduct of this capital, however, is that the banking industry is now over two-thirds owned by institutional investors, and these investors have specific expectations within given time horizons to achieve desired results.

Net Interest Margins (see graph below) nation-wide have settled around 3.00%, clearly over 100 bps below historical performance for commercial banks. Interestingly enough, commercial banks and thrifts have merged with regard to margin. Certainly, these numbers vary by region, but the days of 4.00% margins for most banks, might be a thing of the past. Even rising rates may not return these numbers to historical norms, given the commoditization of products, access to technology, and the broad competitive nature of the market.



The **Mortgage Business** is challenged by increased regulation and the end of the "refi" market and transition to a purchase market. Many community banks are struggling to find their place in the future of mortgage financing, as the government has effectively taken control of this market.

The **Consolidation of the Industry** is accelerating on both the bank and branch levels. Nation-wide we are now below 6,600 banks, and improved performance and M&A pricing appears to be attracting and connecting more sellers and buyers. In addition, more and more **Mergers of Equals** ("MOEs") are being considered. On the branch level, the number of branches continues to drop from a high of 99,540 in 2009, to 94,715 as of this past June. Some predictions for further declines in branches lower this number to 65,000 within ten to twelve years. The size, look and staffing of branches are also going through significant change and overhaul, as transaction volumes continue to decline.

Given the difficulty in maintaining margins, along with the challenges of profitably operating fee-based lines of businesses, many banks are doing everything they can to **Operate More Efficiently,** and **Manage Costs.** However, this is only a short term solution, and future success will ultimately need to come from meaningful and profitable revenue growth at the margin along with balance sheet growth, in addition to being supplemented by fees from transaction products (i.e., spread based products) and true fee-based lines-of-businesses like, for example, trust, wealth management, insurance, cash management and other merchant services.

Competition is everywhere from traditional providers such as banks, thrifts, and credit unions. But the new world of competitors includes Bitcoin, Lending Club, Bluebird, Walmart, Amazon, Google, and Apple, to name just a few. Keeping control of the payment system will be key to future banking success. This may include the need to partner with many of these non-traditional competitors. Remember, the youth of today, who have grown up having access to technology and many of these non-traditional competitors, will someday soon be starting families, buying homes, building businesses, and becoming CEOs of companies. The way they have learned to bank is materially different than most of us that have participated in this business for the past 30-40 years and they do not fear these non-bank competitors.

Finally, much of future banking success will be built around **Technology** and the ability of community banks in particular to adapt to this technology and customer expectations. This train has already left the station and there is no turning back. Unfortunately, however, there are mine fields as we go. The easier part is the cost and willingness to adapt. The more difficult part is the challenges related to cyber security and the need for the entire industry to come to terms with this collective challenge, much like the pharmaceutical industry came to terms with the Tylenol scare.

Community banks definitely have a place in the future of the financial services industry. But it will require the adaption of technology, along with an attention to the details of managing revenues, expense, and operating processes and procedures, as well as finding the niche products, services and customers within each market area.

Wishing you all the best in 2015.