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TKG Perspective

Teaching & Speaking Engagements

American Bankers Association
National Conference for Community Bankers
Hilton Hawaiian Village Waikiki Beach Resort
Honolulu, HI **February 25-28**
Merging Mutuals

Pennsylvania Bankers Association
School of Banking
The Penn Stater Conference Center
State College, PA **June 3-7**
Strategic Decision-Making and Organizational Structure

American Bankers Association
Stonier Graduate School of Banking
University of Pennsylvania
Philadelphia, PA **June 10**
Stress Testing for Community Banks

Conferences, Conventions & Other Events

New Jersey Bankers Association
Economic Leadership Forum
The Palace at Somerset Park
Somerset, NJ **January 19**

Bank Director
Acquire or Be Acquired Conference
Arizona Biltmore Resort
Phoenix, AZ **January 28-30**

Pennsylvania Bankers Association
2018 Economic Forecast Summit
Sheraton Harrisburg-Hershey
Harrisburg, PA **February 15**

Pennsylvania Bankers Association
Women in Banking Conference
Hershey Lodge and Convention Center
Hershey, PA **March 4-5**

New Jersey Bankers Association
Board and Management Summit
Renaissance Woodbridge Hotel
Iselin, NJ **March 9**

AMIfs
Annual Conference
Tempe Mission Palms Hotel
Tempe, AZ **April 18-20**

Will Your Bank Be Independent and Relevant in Fifteen Years?

By: Robert E. Kafafian, President & CEO

As 2017 enters the history books, it's hard to believe that Y2K was eighteen years ago. We all remember the furor over how the world might come to an end. We feared that power would be cut off, appliances wouldn't work, trains would stop, planes wouldn't be able to land, and computers would freeze-up.

It's also hard to believe that eighteen years ago we were still getting adjusted to using email addresses and surfing the web. The iPhone, Facebook, Twitter, Uber, and Snapchat, to name a few, had not even been contemplated or invented yet. We didn't have to worry about texting and driving because very few cell phones had the ability to text.

In the early part of my career it seemed that technology was invented and adapted over long periods of time, perhaps as long as twenty-five years. Take the ATM, for example. It took years of adoption and utilization before becoming part of mainstream banking. I'd bet there are many who are still afraid to make a deposit into an ATM. And, as of this writing, the ATM is becoming obsolete due to digital banking, iPhones, Venmo, laptops, and tablets. Their only real use that is left is as a cash dispenser, and this need is slowly dissipating as digital banking and online payments are fast becoming the norm.

For the past few years TKG has been espousing that banking as we know it will be flipped on its head within the next fifteen years. Recently, I read that the CEO of Barclays, Anthony Jenkins, stated that banks may face Kodak-style obsolescence in as soon as five-to-fifteen years.

There are a multitude of reasons for this obsolescence.

First, millennials are quickly moving into mainstream society. Within fifteen years, they will be advancing in their careers, starting families, buying houses, accumulating wealth, becoming CEO's, and starting businesses. They will become the dominant part of our society, and the way that they've learned how to bank is materially different than any generation that has come before them.

Second, the pace of change and speed of innovation is days and months, not years and decades. We've all heard the comparisons of the changes in the Fortune 500, and how very few of the companies from 50 to 100 years ago still exist or are dominant today. In addition, were Blockbuster Video and the taxi cab industry prepared for how quickly they would be challenged and/or become obsolete?

Third, we now in live in a global society and global economy. It is nearly impossible to remain or become an isolationist. Goods and services are made and sold throughout the world, and consumers demand these products and services, as well as having unmitigated and unlimited access to acquiring them. And while we in the United States live in a free society, it is becoming increasingly difficult for dictators, and/or communist countries to control their citizens and the mass of their population. The technology and its capabilities are beyond their control.

Fourth, the traditional payment system is being challenged. For the mere 250 years that our country has been in existence, our government and banking system have successfully controlled the payment system. With advances in digital technologies, the explosion of non-regulated Fintech and BigTech companies, the development of blockchain technology and related record keeping, and the availability of numerous crypto currencies, banking as we know it will likely never be the same. In fact, it soon may not even exist as we know it.

Additional Challenges

The commercial banking industry has lost approximately 100 basis points of net interest margin since 1996. This is not only due to the extended low interest rate environment, but also the result of the commoditization of products, and advancements in technology. Additionally, it is difficult for community banks to make significant net income from fee-based lines-of-business due to the scale that is required to be successful. This is all occurring as operating expenses continue to rise.

Furthermore, community banks must recognize that larger regional, money center, and multinational banks have the financial wherewithal to make significant investments in new and advancing technologies. These large financial institutions also have the financial strength to try new ventures, and potentially fail, without significantly impacting capital and financial performance. This doesn't, however, guarantee that these larger banks will be successful, and they in fact, might also risk becoming obsolete.

So, what are Community Banks to do?

Continuing with business as usual is a recipe for failure, unless you have a short-term time horizon and plan on selling your bank within the next five years. Even if selling is imminent, not implementing "fast follower" changes to attract and retain customers will likely deteriorate franchise value. In addition, banks whose facilities look tired, whose employees look tired, and whose technology is antiquated need to look seriously in the mirror. This means, you should probably *sell sooner, rather than later, if selling is your strategy*.

Does your board and management team have the desire and willingness to think long-term? This requires thinking broadly and developing strategies to be successful, operating and executing on those strategies, and earning the right to remain independent.

Over the next 15 years, we will also be operating in a transitional period. A period defined by rapid change in technology, aging millennials, and older generations that have one foot in traditional banking, and the other in digital banking. This requires banks to provide a multitude of delivery channels as consumers and businesses adapt to new and advancing technologies and payment systems.

The following three areas of focus will be necessary to have a chance and opportunity to remain independent and be successful:

1. **Growth** – Balance sheet growth, fee-income growth, and scale will be required to offset increasing operating expenses and build brand identity and critical mass. While there is no magic size to be successful, our industry is balance sheet driven, and increasing net interest income is necessary to offset declining margins. A caveat to this is the location of your bank, i.e., the more metro your bank, the more net interest margin and market share are challenged; the more rural your bank, the better the opportunity to have greater net interest margins and market share. This is due to larger banks increasingly migrating towards metro markets, ceding rural markets to community banks. Balance sheet growth will be the key to determining which community banks successfully emerge from the pack.

2. **Human Capital** – Do you have the right employees to execute your strategy? If so, great. If not, can you begin to attract, retain, develop, and reward the people necessary to create and drive strategy, serve customers, and operate your bank? Even with the advancements and utilization of technology, banking is still a people and relationship business. Your employees must have the interpersonal skills to develop and maintain relationships. Look in the mirror and ask who around the board table and management team will still be part of the bank in ten or fifteen years. This will highlight the importance of succession planning to achieve and sustain success.

3. **Adapting to Technology and Change –** Do you have the desire and willingness to adapt to advances and changes in technology, and will you be prepared for what may happen to our current payment system? This may be the most important component of future success. Without this, your bank risks rendering itself obsolete and irrelevant. While not all technologies and currencies will succeed and become mainstream, future changes are inevitable. The question is speed and timing.

So just like Y2K, eighteen years from now will be here in the blink of an eye. Will your bank be one of the survivors and success stories, or will your bank be consolidated? ***The choice begins now.***