

Prospects for New Jersey Based Banks

FinPro, Inc.

There has been too much bad news recently. We need to build for the future not dwell in the past . . .



So other than irreverence, nothing more on the bailout today . . .



The Banking industry will face material challenges over the next few years . . .

- Deep recession, borderline depression for next 24 months or longer



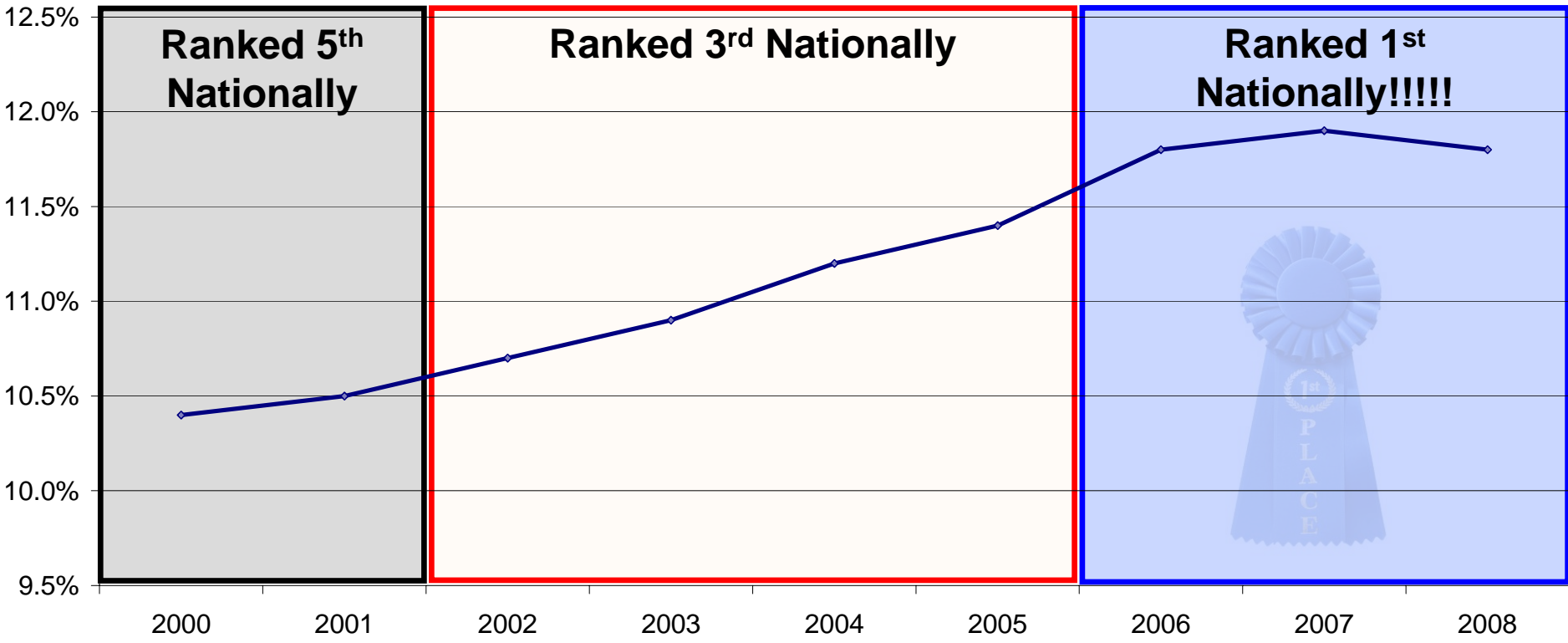
- Followed by rapid inflation and rising rates

The Federal and State Governments will impact the duration of the downturn via economic and tax policy . . .

- Tax Policy
- Business Friendliness
- Business and Consumer confidence

New Jersey has the highest tax burden and largest state deficit. **Clearly, spending is the root of the problem . . .**

State & Local Tax Burden



At least we can be excited that we're #1, right? . . .



We're
#1



So at this rate, who is going to stay in New Jersey . . .

Population almost 50% greater

A TALE OF TWO STATES

New Jersey

Pennsylvania

General Facts

8,724,560	Population	12,440,621
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Tax Facts

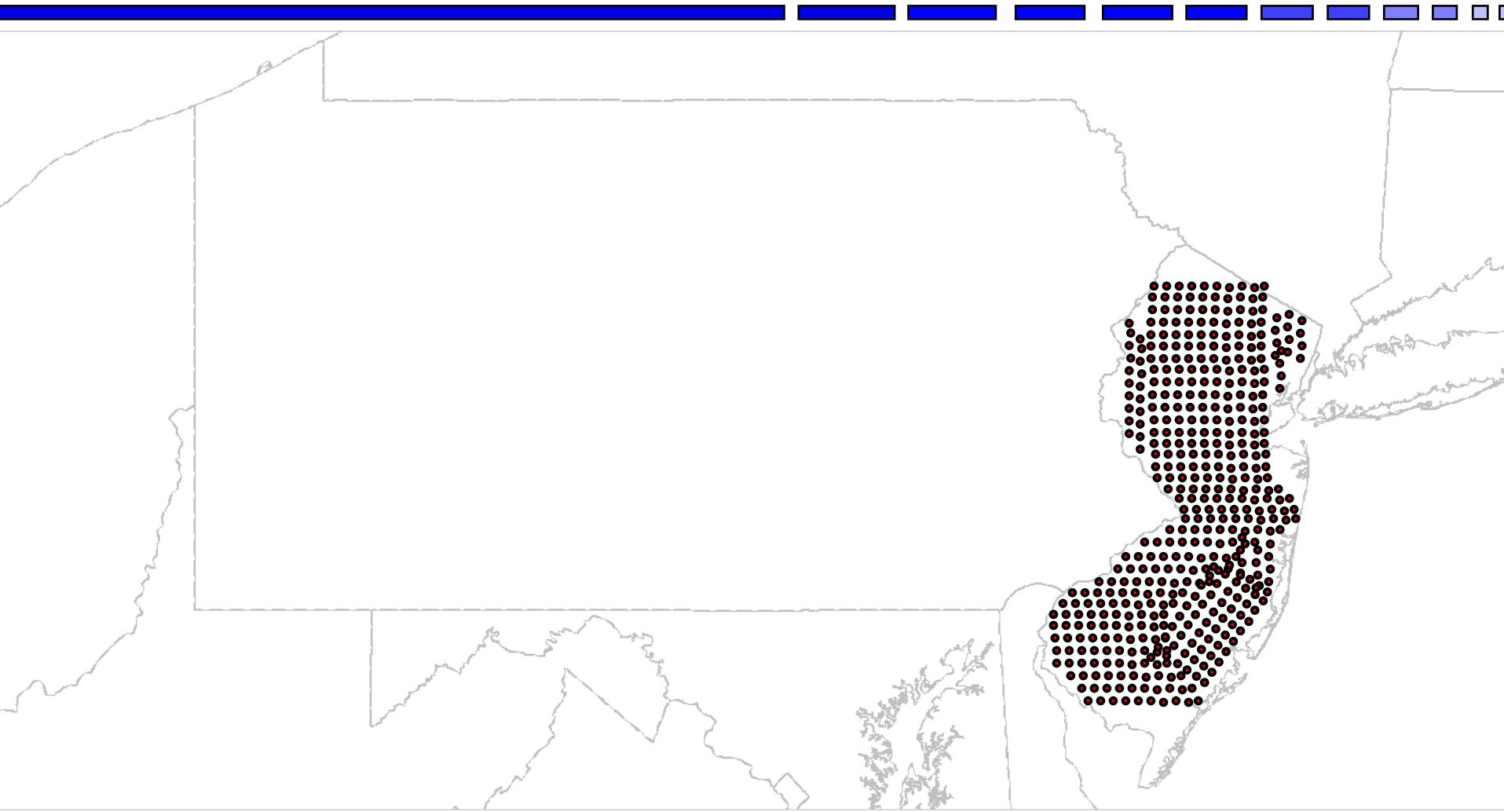
\$6,110 (1)	Average Household Property Tax Bill (National Rank)	\$2,755 (21)
3	Total State and Federal Tax Burden Rank	20
8.97%	Highest State Income Tax Bracket	3.07%
All pension income, state lottery winnings	Exempt From State Income Tax	Military pensions, state lottery winnings
7.00% (tied for 2nd)	Sales Tax (National Rank)	6.00% (tied for 5th highest)
14.5 cents per gallon (3rd lowest)	Gas Tax (Natinoal Rank)	32.3 cents per gallon (11th highest)
\$2.58 per pack (2)	Cigarette Tax (National Rank)	\$1.35 cents per pack (21)
12 cents per gallon (26)	Beer Tax (National Rank)	8 cents per gallon

Budget Facts

\$32.87 billion	General Funding Budget	\$28.26 billion
\$61.92 billion	Total Spending Including Federal and Misc. Revenues	\$48.39 billion
\$5,546	Spending Per Capita	\$4,977
\$30.21 billion (3)	Total State-Tax-Supported Debt (Rank)	\$10.82 billion (11)
\$3,478 (4)	Per Capita (Rank)	\$870 (27)
\$2,000	Maximum Property Tax Rebate Check	\$650

Smaller Budget AND Spending

Flight from New Jersey will increase until the state government breaks its fixation with taxing and spending . . .



New Jersey Banks will experience material shifts in their balance sheets and income statements over the next few years . . .

Balance Sheet Shifts

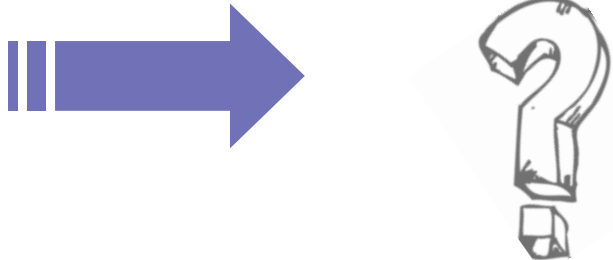
1. Investments will be hard to find, yields will be lower and more market deterioration is expected
2. Loan concentrations will shift and competition will intensify
3. Deposits will remain steady in general, but new competition will increase cost
4. Wholesale funding will be hard to obtain
5. Equity will be preserved

Income Statement Shifts

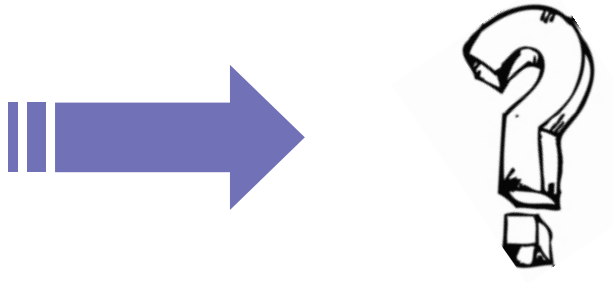
6. Net interest income will decline due to both rate and volume.
7. Provision will remain high
8. Noninterest income may diminish
9. Operating expenses will rise
10. Causing weak earnings levels

New Jersey institutions looking to survive the economic downturn should formulate strategic plans with restructuring the balance sheet as the top priority. Those that fail to plan now will fail to execute when opportunities present themselves . . .

Total Assets		(\$000s)
Cash & Cash Equivalents	50,000	
Securities & Investments	300,000	
Loans, Net	600,000	
Fixed Assets	50,000	
Total Assets	1,000,000	



Total Liabilities & Equity		(\$000s)
Deposits	700,000	
Borrowings	150,000	
Other Liabilities	50,000	
Total Liabilities	900,000	
Equity	100,000	
Total Liabilities & Equity	1,000,000	



On the asset side of the balance sheet . . .

- Recognize the current rate environment for what it is. Rates are at historic lows.
- Adjustable rate and/or short duration loans are your friend.
 - Creating a positive gap for the inevitable uptick in rates will help maximize interest income.
- Control the level of long term, fixed rate products that you keep on the balance sheet. They will be underwater eventually.

A typical New Jersey investment portfolio has the following concentration of investments . . .

Investments	(\$000s)	rate (%)
Mortgage Backed Securities	75,000	5.50%
CMOs	45,000	6.00%
Municipal Bonds	45,000	4.00%
Gov't Agency Bonds	75,000	5.50%
Corporate Bonds	60,000	6.50%
Total Investments	300,000	5.55%

Remember, “Keep it simple, Stupid.” . . .

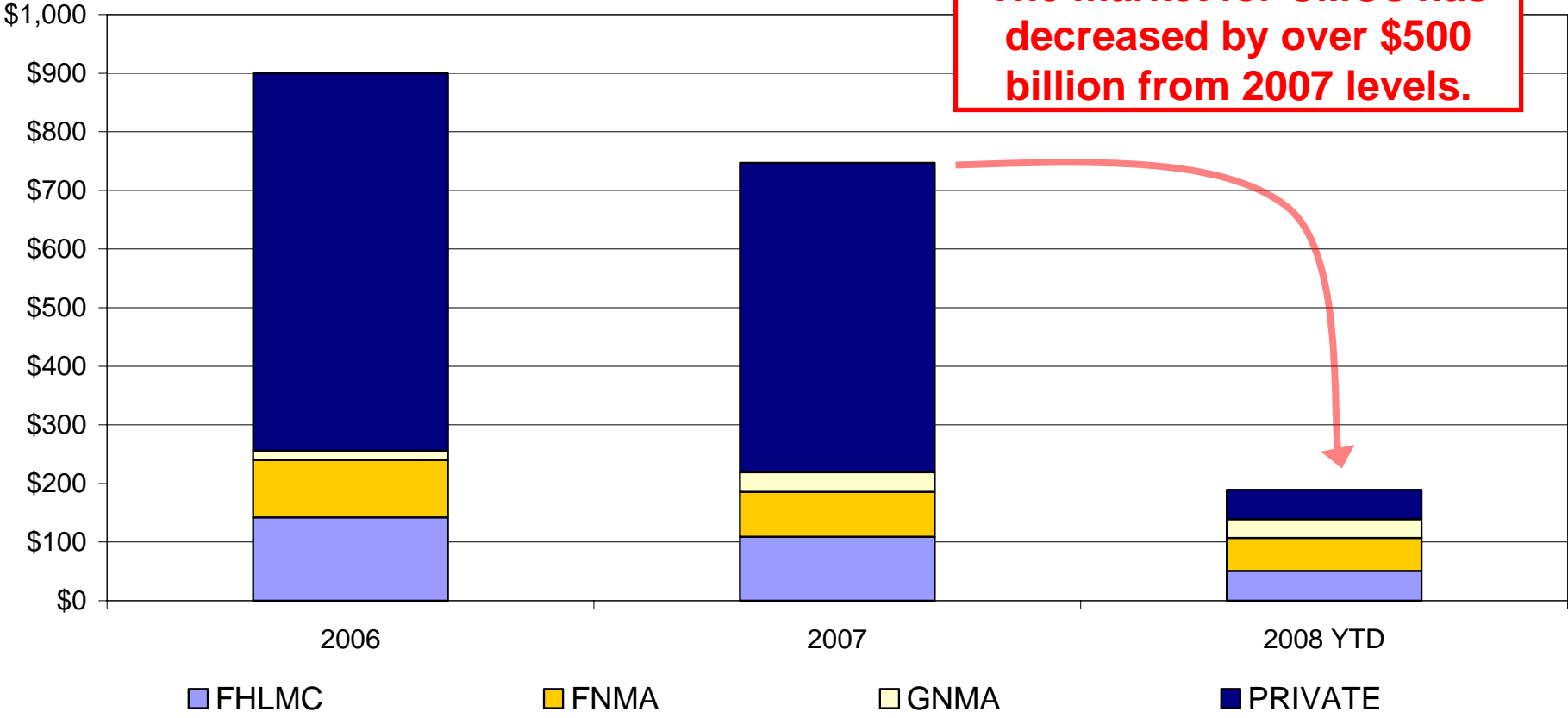
- Invest in what you know, or what is know-able.
- Every investment must be underwritten like a loan. **Improper due diligence has already cost this room millions with potential for more losses looming.**
 - Due diligence can produce some vital information on what is packaged into a mortgage backed security (investment properties, debt service coverage ratios).
 - New issues of government agency bonds still carry an implicit guarantee, but the government has shown it will step in, multiple times if needed.
- FinPro produces in depth reports for all of its partners whenever new investment opportunities come across their desk.
 - Armed with the right information, FinPro clients have avoided several investment follies that have been commonplace over the last twelve months.

Expect some changes as the quality of some investments is questioned and others may just seem unavailable . . .

1. CMO issuance has dropped dramatically as the lack of demand dried up. The private label market is all but dead.
2. Corporate debt has been downgraded across the board and yields have skyrocketed on the bonds, but investors are still doubtful about the quality after the Fannie and Freddie collapse.
 - This has been exacerbated by the lack of an auto bailout.
3. Municipal bonds seem attractive, but with states experiencing their own recessions, the market for municipal bonds is exhibiting many of the same signs as corporate debt.
 - Municipalities being downgraded and/or losing credit rating coverage due to continued economic deterioration and bond insurance agencies losing their AAA ratings.

Year to date, issuance of the collateralized mortgage obligations has seen dramatic decreases . . .

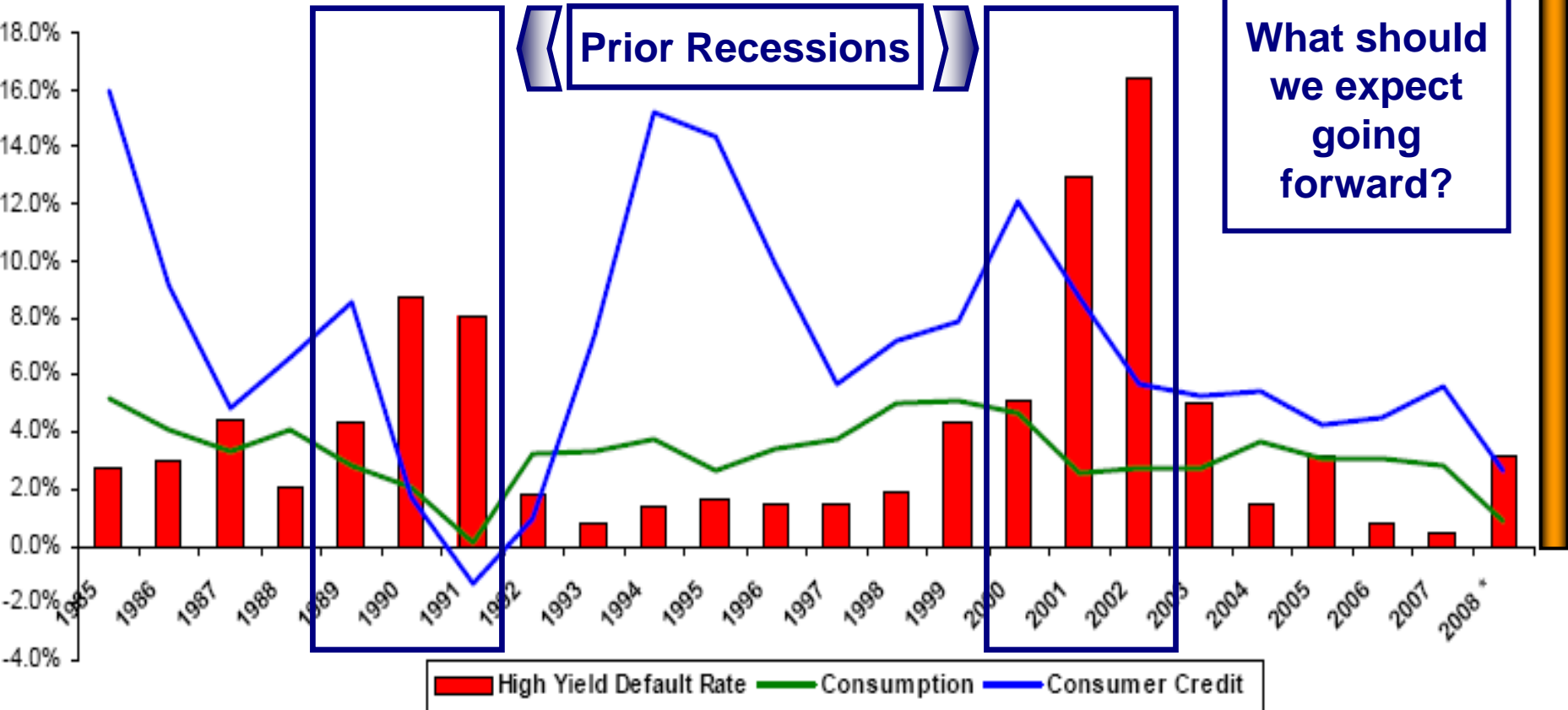
CMO Issuance by Year
(\$ in Billions)



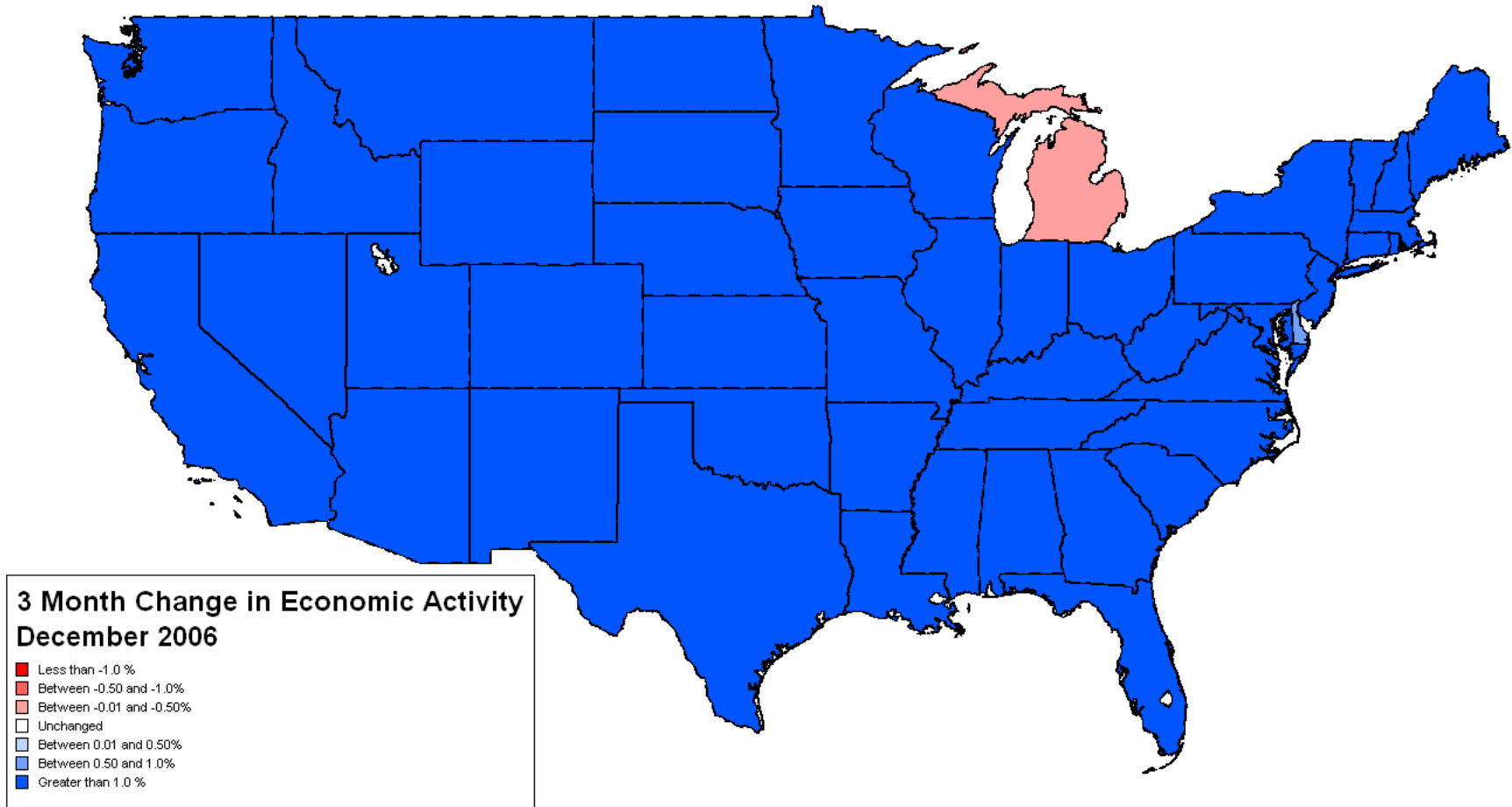
And U.S high yield default rates, despite the move up thus far in 2008, have potential to increase dramatically based on historical trends . . .



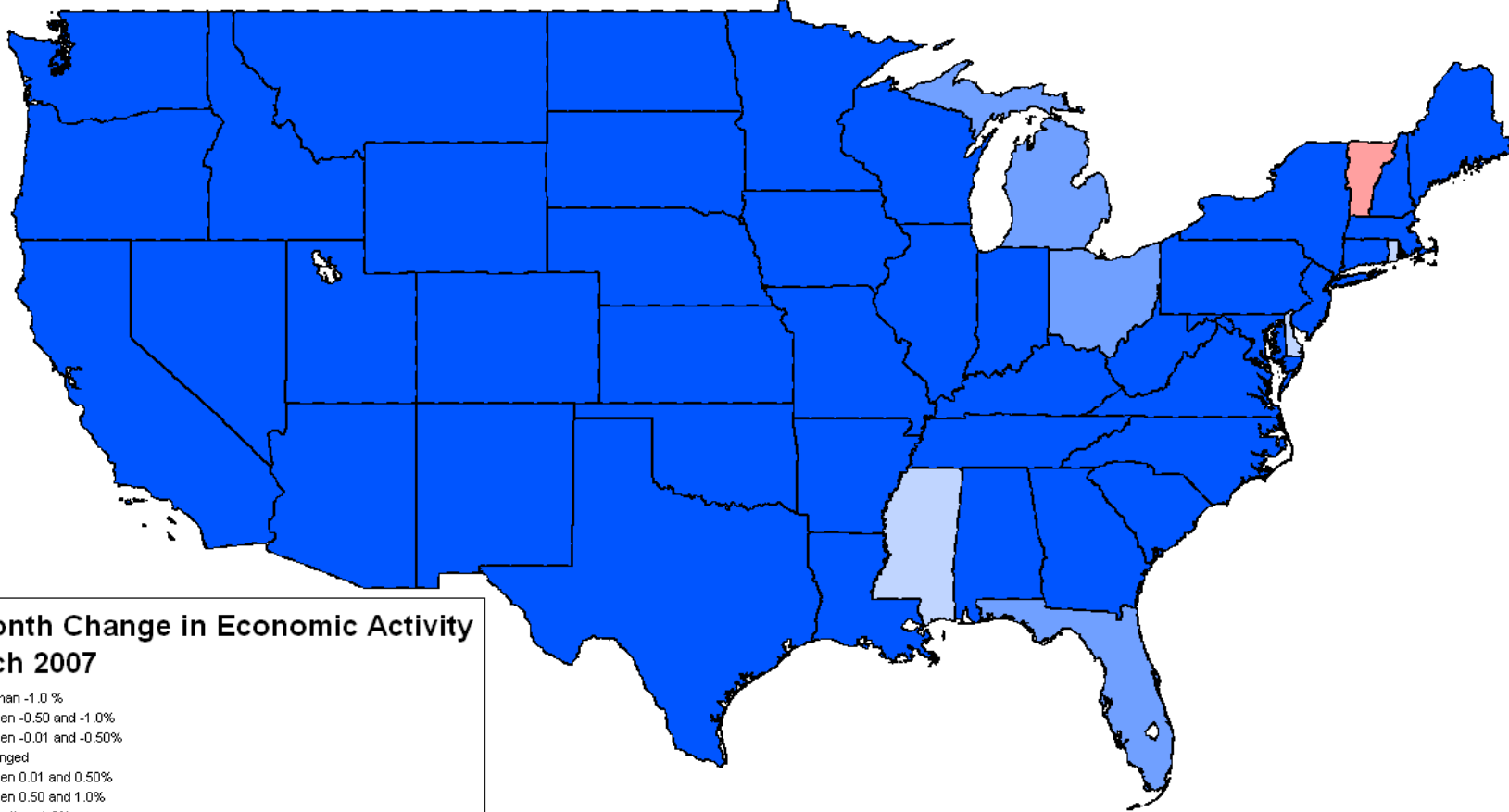
U.S. High Yield Default Rates vs Consumer Credit & Consumption



The pressing issue for the municipal bond market is whether or not the municipalities will be able to repay their bonds. Evidence of the trouble can be seen when economic activity by state is analyzed. Below is a map for December 2006 . . .



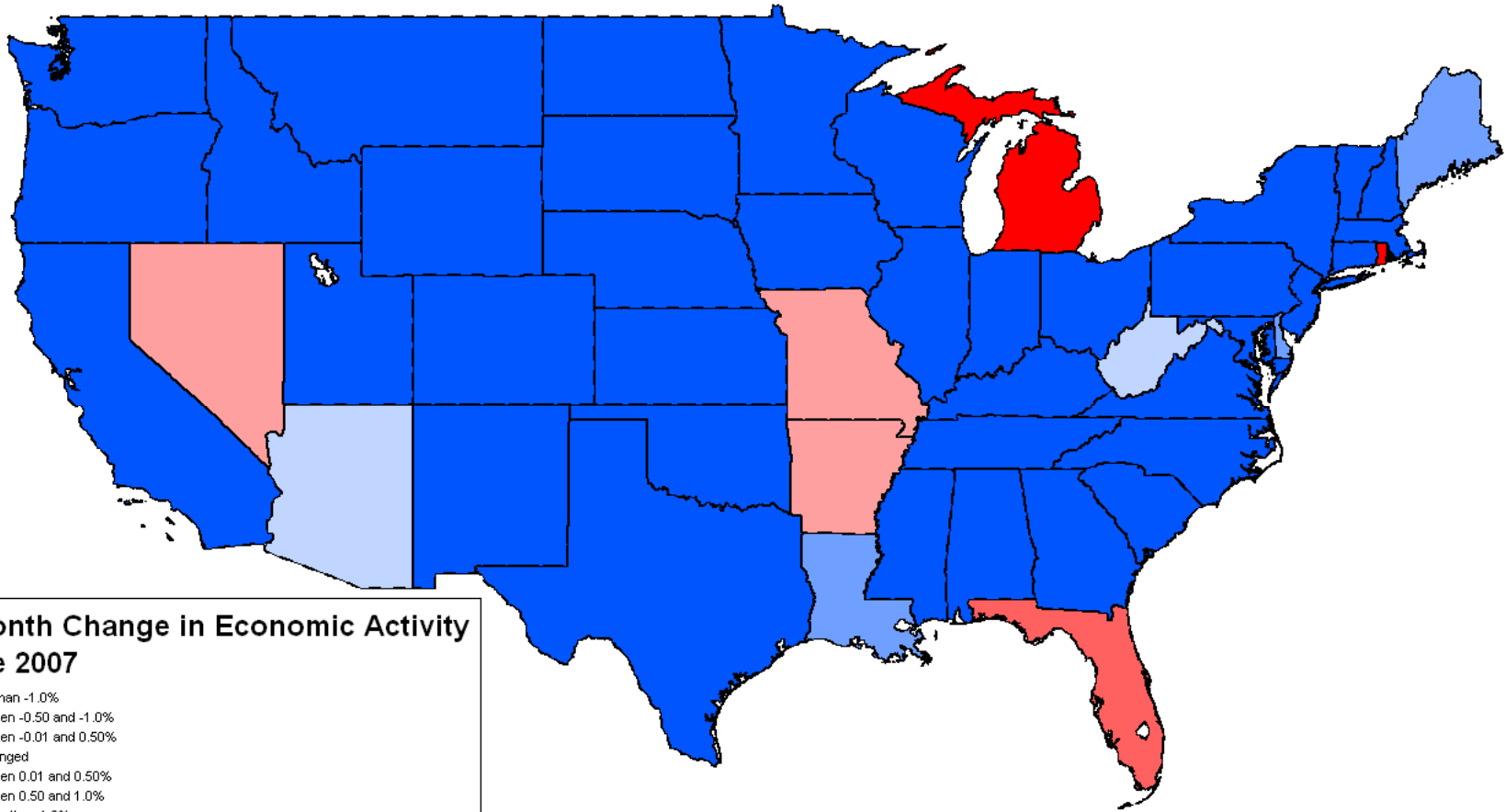
3 month change in economic activity, annualized for March 2007 . . .



**3 Month Change in Economic Activity
March 2007**

- Less than -1.0 %
- Between -0.50 and -1.0%
- Between -0.01 and -0.50%
- Unchanged
- Between 0.01 and 0.50%
- Between 0.50 and 1.0%
- Greater than 1.0%

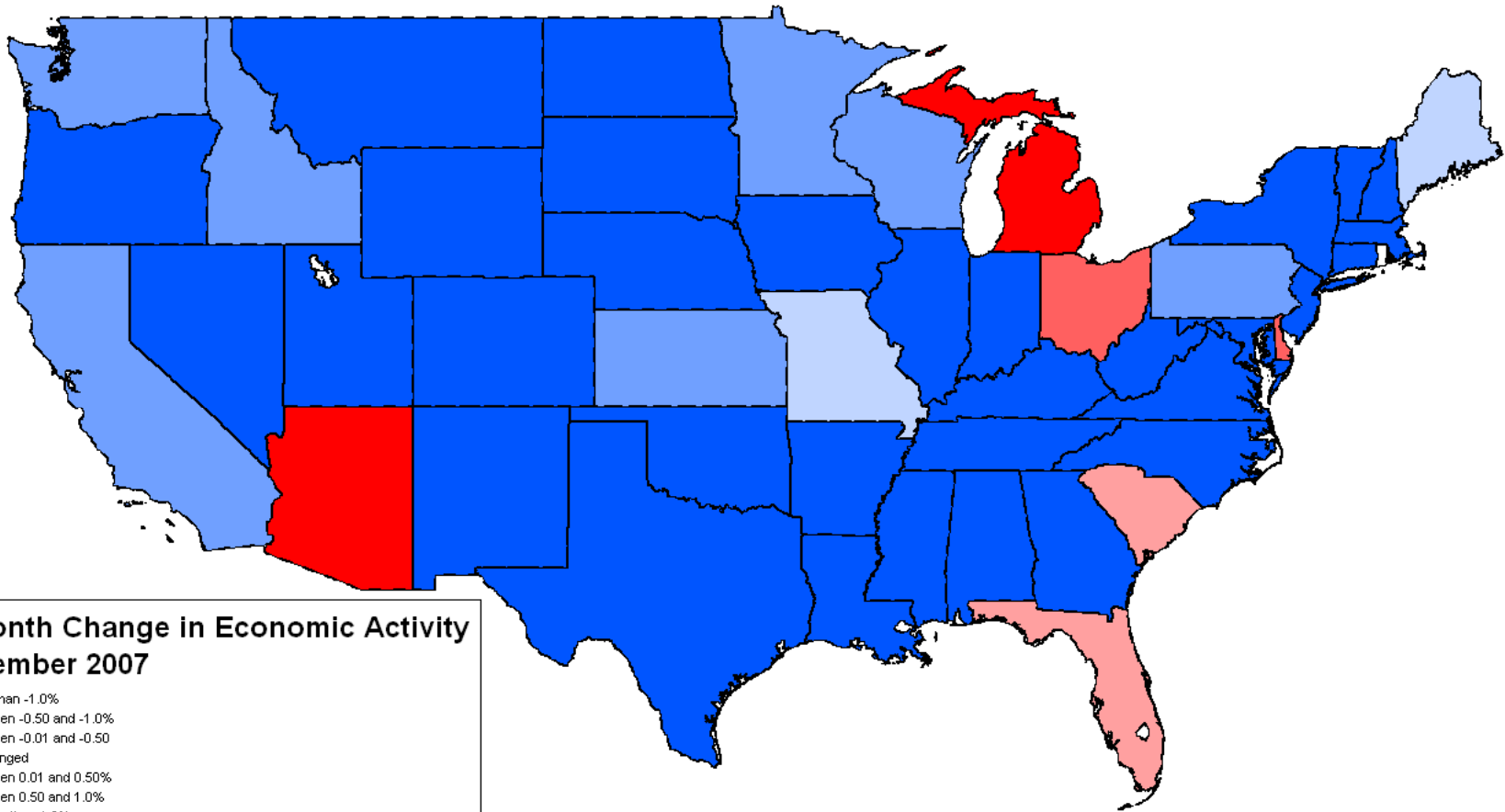
3 month change in economic activity, annualized for June 2007 . . .



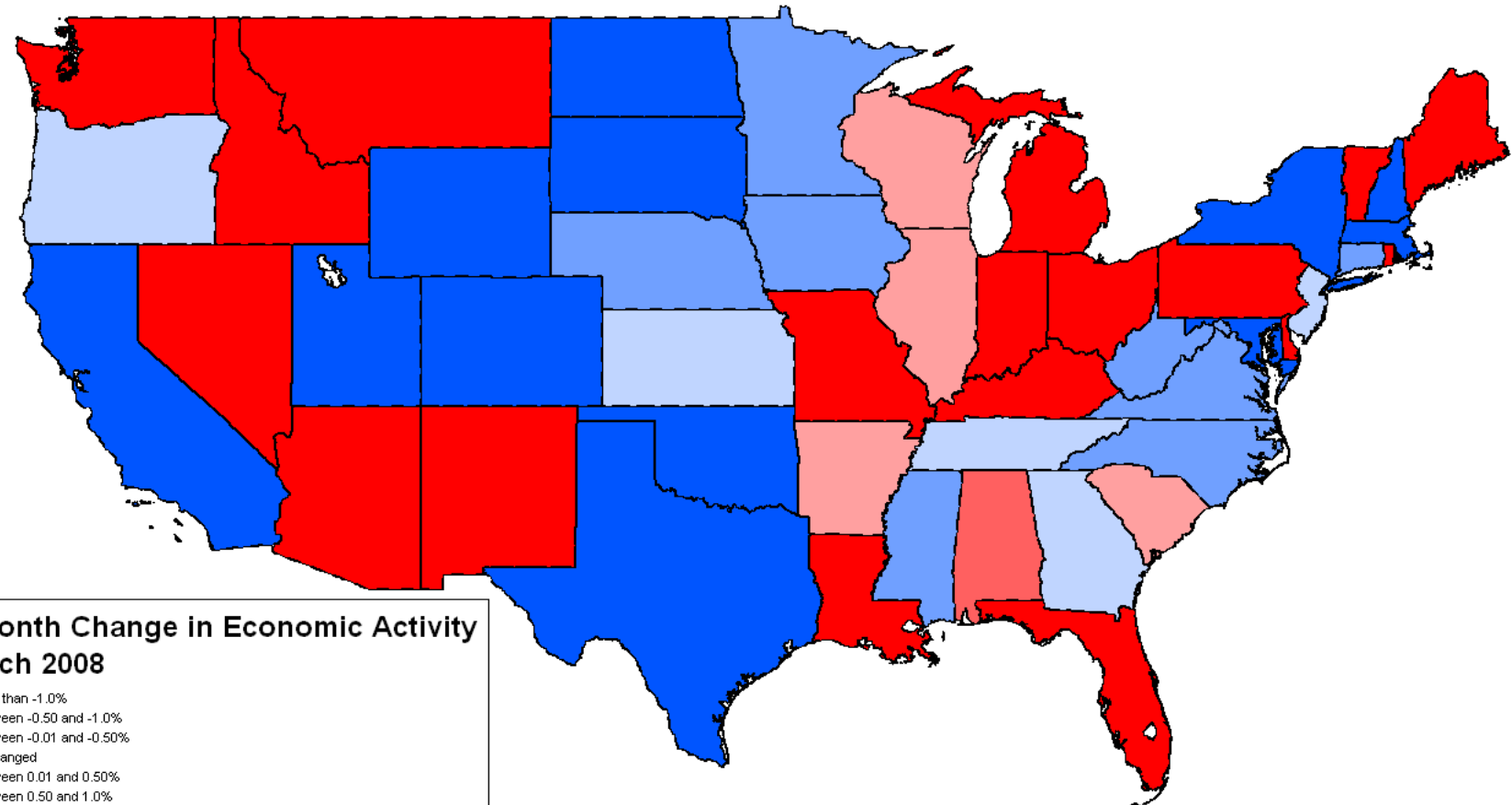
**3 Month Change in Economic Activity
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3 month change in economic activity, annualized for December 2007 . . .



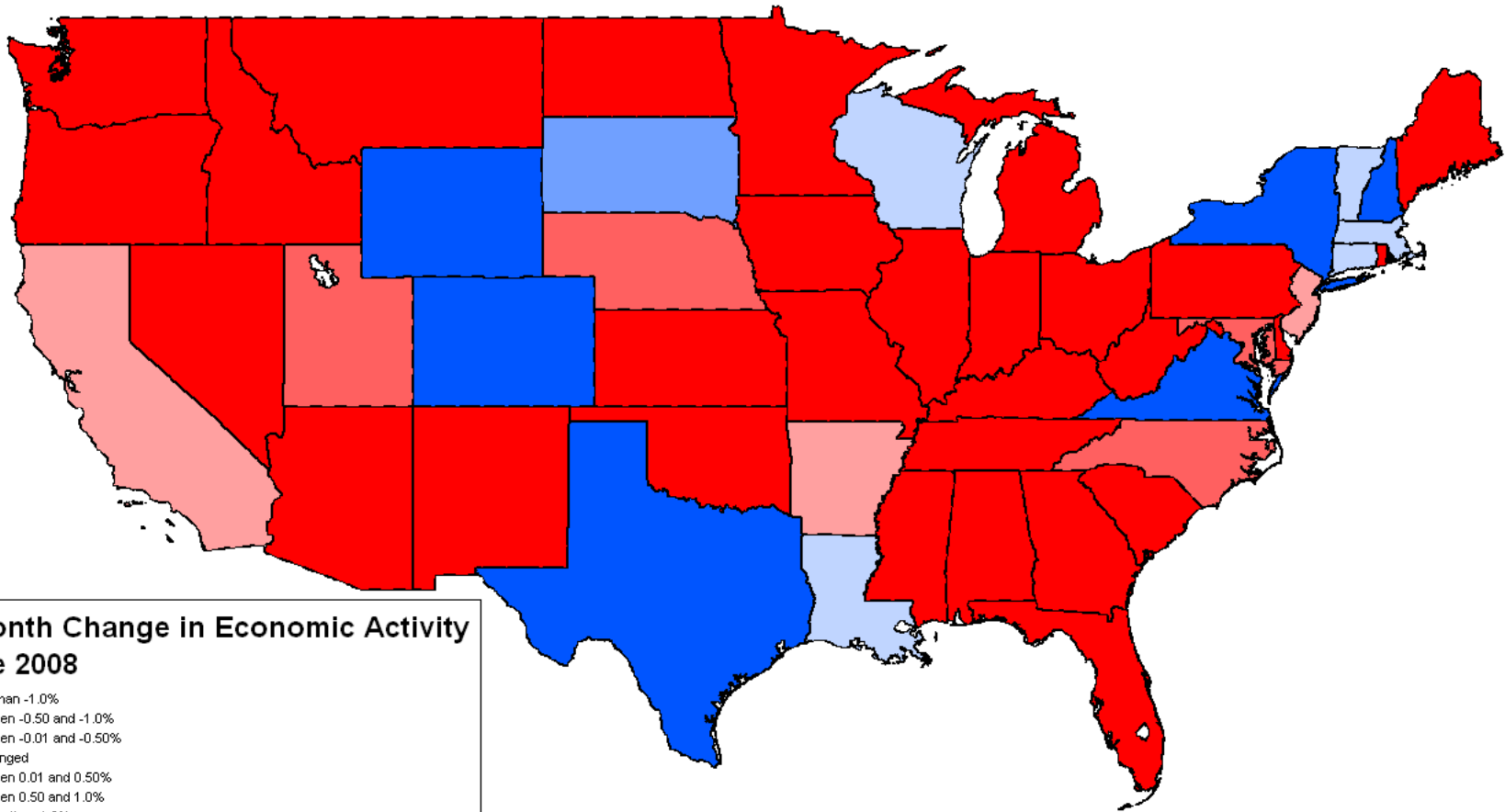
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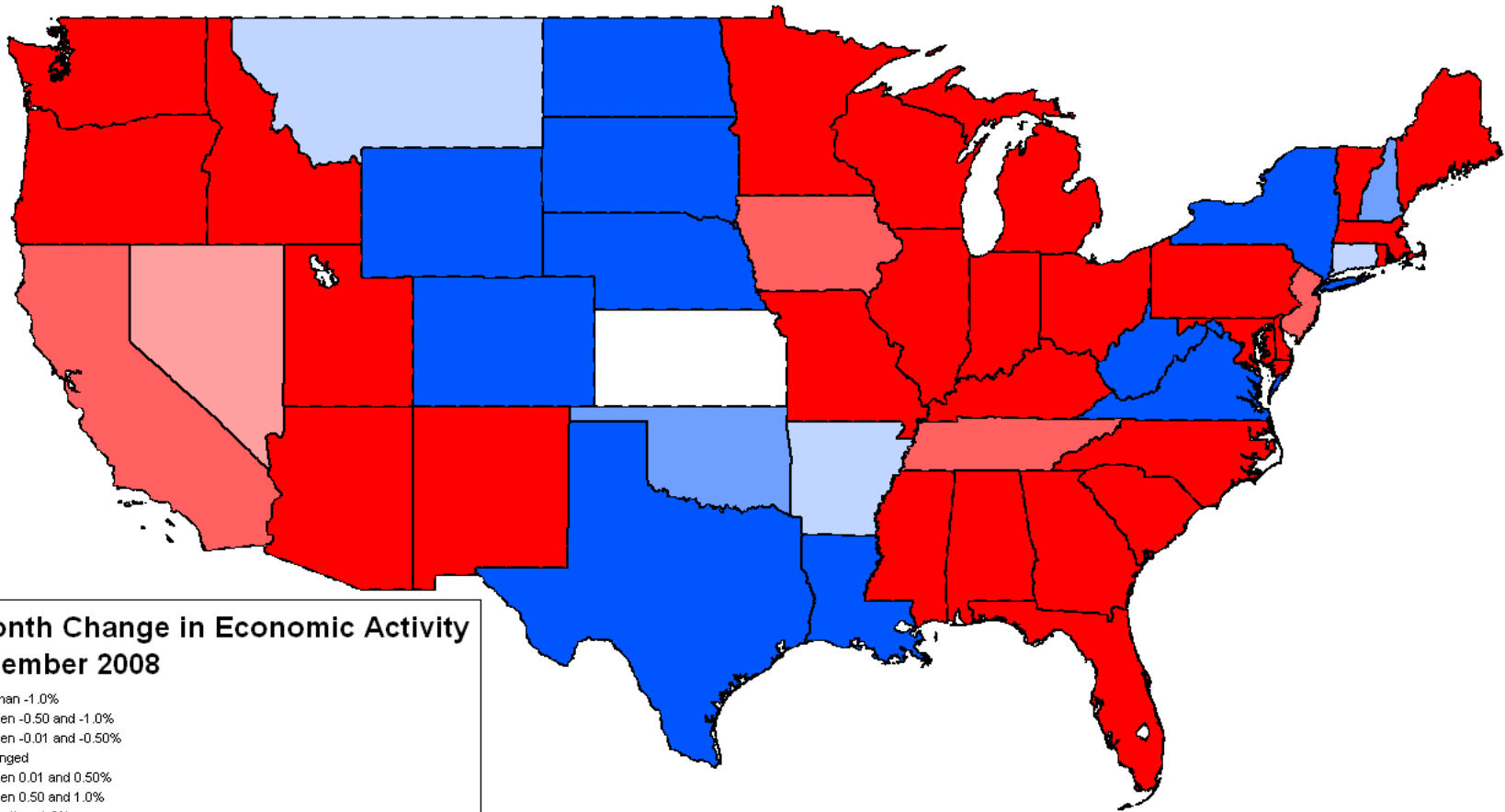
3 month change in economic activity, annualized for June 2008 . . .



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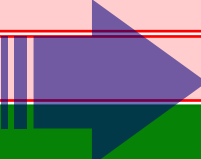
3 month change in economic activity, annualized for September 2008 . . .



**3 Month Change in Economic Activity
September 2008**

- Less than -1.0%
- Between -0.50 and -1.0%
- Between -0.01 and -0.50%
- Unchanged
- Between 0.01 and 0.50%
- Between 0.50 and 1.0%
- Greater than 1.0%

As the economic status worsens, the riskier, more convoluted securities will make their way off balance sheets and will be replaced with the “plain vanilla” mortgage backed securities and government sponsored agency bonds . . .

Investments	(\$000s)	rate (%)		(\$000s)	rate (%)
Mortgage Backed Securities	75,000	5.50%		101,250	5.50%
CMOs	45,000	6.00%		-	6.00%
Municipal Bonds	45,000	4.00%		22,500	4.00%
Gov't Agency Bonds	75,000	5.50%		78,750	5.50%
Corporate Bonds	60,000	6.50%		22,500	6.50%
Total Investments	300,000	5.55%		225,000	5.45%

- Make no doubt about it, the supply of quality investments continues to fall. Simple economics tells us price will increase and yields will decrease on what remains.

Changes to the loan portfolio should be expected over the course of the recession . . .

- As the government doles out the TARP money, institutions are encouraged, even expected to leverage it through lending.

Loans	(\$000s)	rate (%)
Residential Mortgages	30,500	5.80%
Multifamily Mortgages	91,500	6.00%
Non Owner Occupied CRE	152,500	6.13%
Owner Occupied CRE	152,500	6.25%
Construction	61,000	6.50%
Home Equity	61,000	5.00%
Consumer	30,500	6.00%
Commercial	30,500	6.25%
Loans, Gross	610,000	6.05%

The name of the game is residential mortgages.

Residential lending will make a comeback as institutions struggle to find quality loans . . .

Loans	(\$000s)	rate (%)	(\$000s)	rate (%)
Residential Mortgages	30,500	5.80%	122,000	5.80%
Multifamily Mortgages	91,500	6.00%	91,500	6.00%
Non Owner Occupied CRE	152,500	6.13%	152,500	6.13%
Owner Occupied CRE	152,500	6.25%	152,500	6.25%
Construction	61,000	6.50%	30,500	6.50%
Home Equity	61,000	5.00%	21,350	5.00%
Consumer	30,500	6.00%	12,200	6.00%
Commercial	30,500	6.25%	27,450	6.25%
Loans, Gross	610,000	6.05%	610,000	6.06%

Like investments, loans will face fierce underwriting and heavy competition as the pool of borrowers gets smaller.

This does not bode well for the economy.

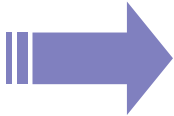
When lending it is imperative to acquire operating accounts from commercial borrowers, occasionally at the expense of yield . . .

Before Operating Accounts:	Loan	Yield	Funding	Costs	Spread
Loan for \$10 MM	10,000	6.00%			
Funded \$10 MM standard deposits			10,000	3.00%	
Net Result	10,000	6.00%	10,000	3.00%	3.00%
After Operating Accounts:	Loan	Yield	Funding	Costs	Spread
Loan for \$10 MM @ 25 bps discount	10,000	5.75%			
Funded \$8.5 MM standard deposits			8,500	3.00%	
And \$1.5 MM operating account			1,500	0.00%	
Net Result	10,000	5.75%	10,000	2.55%	3.20%

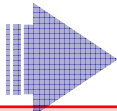
The same loan with a 25 bps discount on rate results in a higher spread if an operating account with only 10% of the loan balance is held in non interest bearing deposits.

Banks may shrink total assets due to lack of investment opportunities and a low level of demand for loans . . .

Total Assets

	(\$000s)		(\$000s)
Cash & Cash Equivalents	50,000		50,000
Securities & Investments	300,000		225,000
Loans, Net	600,000		600,000
Fixed Assets	50,000		50,000
Total Assets	1,000,000		925,000

Moving to the funding side of the equation, time deposits typically have been the largest individual source of funding for most of the institutions in this room . . .

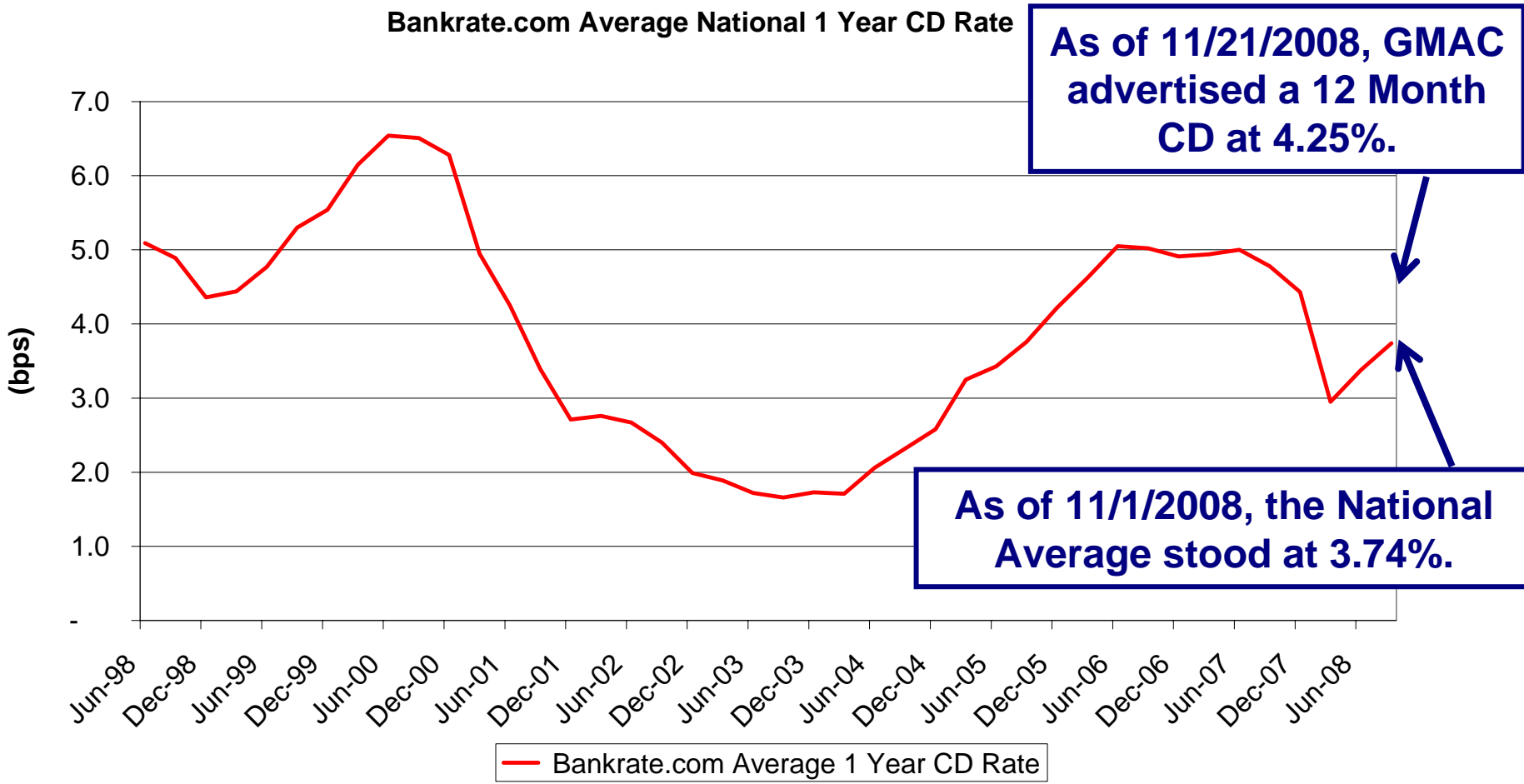
Deposits	(\$000s)	Rate (%)		(\$000s)	Rate (%)
Non Interest Bearing	35,000	0.00%		35,000	0.00%
Transaction Accounts	105,000	1.00%		105,000	1.00%
Savings	105,000	2.00%		105,000	2.00%
Money Market	105,000	2.50%		105,000	2.50%
Retail Time Deposits	315,000	4.00%		315,000	4.50%
Brokered Deposits	35,000	4.25%		35,000	4.65%
Total Deposits	700,000	2.84%		700,000	3.08%

Instinctively, playing the “pricing game” will keep time deposits from running off and deposit levels steady, but this comes with a 24 bps increase in the cost of deposits.

Maintaining deposits will not be easy over the course of this economic downturn . . .

- Expect pricing wars.
 - There is a strong demand to be a bank today because of the relatively low-cost and stable funding source that is bank deposits. Larger companies with several income streams will be pricing up deposits in every market they enter.
 - Smaller banks will be hard pressed to match prices and must compete with optimal services and relationships.
- Do your homework and pick your battles carefully when franchising.
 - If the Bank enters an overly competitive market and fails to gain deposits due to a pricing war, it will be stuck with fixed asset expenditures.
 - A detailed market analysis is more important than ever.

The presence of the “new breed” of bank holding companies is expected to cause pricing pressure for most existing banking players . . .



Banks need to focus on shifting the mix toward core deposits by introducing new and attractive core deposit accounts . . .

Deposits	(\$000s)	Rate (%)		(\$000s)	Rate (%)
Non Interest Bearing	35,000	0.00%		35,000	0.00%
Transaction Accounts	105,000	1.00%		105,000	1.00%
Savings					
<i>Personal Savings</i>	<i>105,000</i>	<i>2.00%</i>		<i>90,000</i>	<i>2.00%</i>
<i>New Signature Savings</i>	<i>-</i>	<i>0.00%</i>		<i>85,000</i>	<i>3.00%</i>
Money Market	105,000	2.50%		105,000	2.50%
Retail Time Deposits	315,000	4.00%		280,000	4.00%
Brokered Deposits	35,000	4.25%		-	4.25%
Total Deposits	700,000	2.84%		700,000	2.75%

Shifting the mix and cost by offering a new “Signature Savings” account and raising existing rates on existing accounts can maintain deposit levels and decreases the cost of deposits significantly.

And increasing transaction account rates capture new customers as rate sensitive time deposit customers run out the door . . .

Deposits	(\$000s)	Rate (%)	(\$000s)	Rate (%)	(\$000s)	Rate (%)
Non Interest Bearing	35,000	0.00%	35,000	0.00%	45,000	0.00%
Transaction Accounts	105,000	1.00%	115,000	1.25%	115,000	1.25%
Savings						
<i>Personal Savings</i>	<i>90,000</i>	<i>2.00%</i>	<i>90,000</i>	<i>2.00%</i>	<i>90,000</i>	<i>2.00%</i>
<i>New Signature Savings</i>	<i>85,000</i>	<i>3.00%</i>	<i>85,000</i>	<i>3.00%</i>	<i>85,000</i>	<i>3.00%</i>
Money Market	105,000	2.50%	105,000	2.50%	105,000	2.50%
Retail Time Deposits	280,000	4.00%	270,000	4.00%	260,000	4.00%
Brokered Deposits	-	4.25%	-	4.25%	-	4.25%
Total Deposits	700,000	2.75%	700,000	2.74%	700,000	2.69%

Obtaining operating accounts will increase noninterest bearing deposits.

It will be possible to avoid the pricing wars if you manage your core deposits effectively!

A comparison of the deposit strategies . . .

<i>Deposit Strategy</i>	<i>Original Cost of Funds</i>	<i>New Cost of Funds</i>	<i>Increase (%)</i>	<i>Increase in Interest Expense (\$000's)</i>
Price CD's Up to Hold Balances Flat:	2.84%	3.08%	0.25%	\$ 1,715.00
Shift Mix by Utilizing Core Deposit Strategies:	2.84%	2.69%	-0.15%	\$ (1,050.00)
Cost Savings Utilizing Core Deposit Strategy over increase time deposit rates:			0.40%	\$ 2,765.00

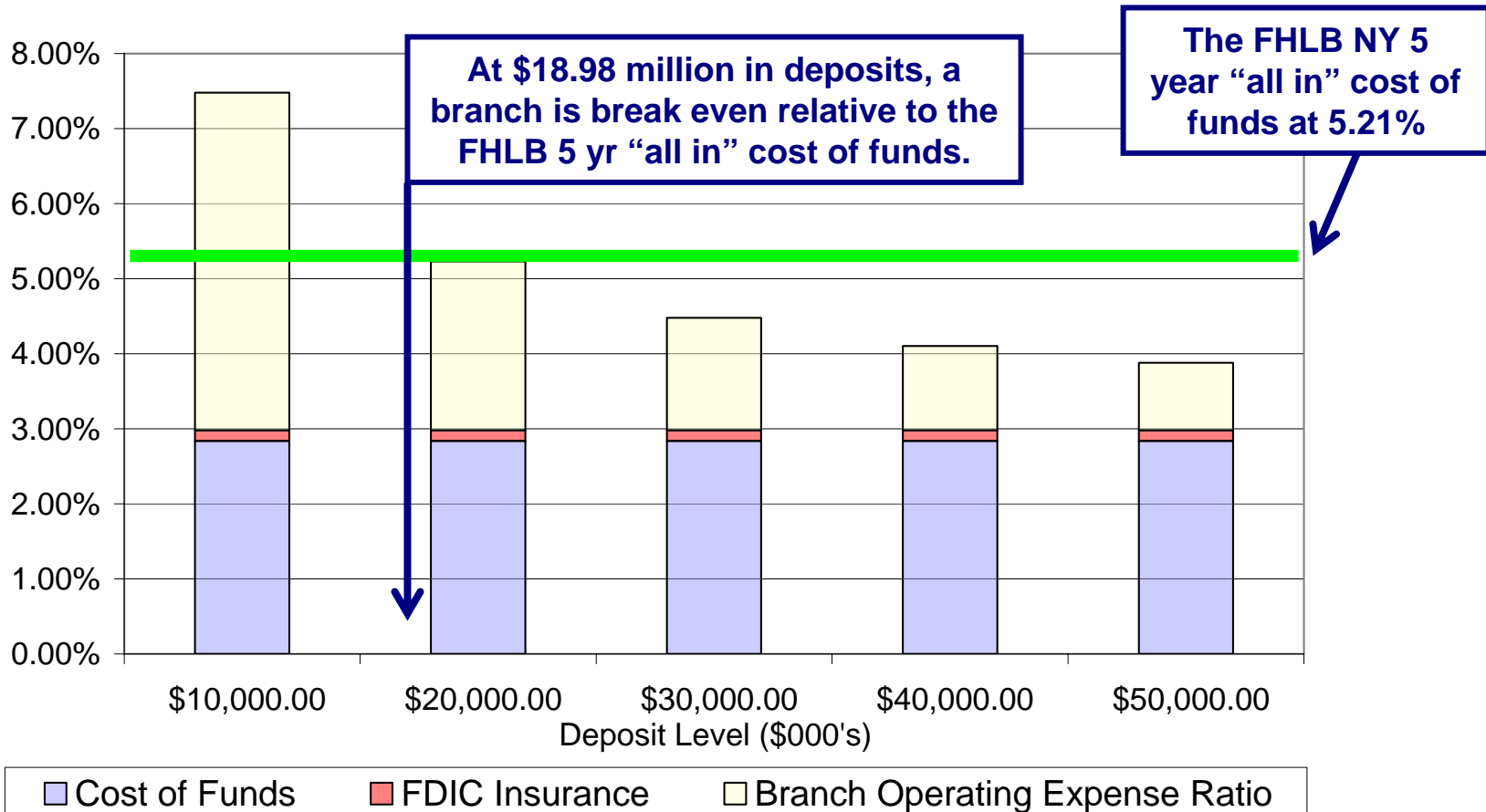
An alternative to growing deposits is utilizing alternative wholesale funding sources . . .

Borrowings	(\$000s)	Rate (%)	(\$000s)	Rate (%)
FHLB 6 Mo. Fixed Rate Advance	150,000	2.83%	75,000	2.65%
Total Borrowings	150,000		75,000	
	<u>Jun-08</u>		<u>Nov-08</u>	
Cost of Funds	2.83%		2.65%	
Interest Expense	\$ 4,245.00		\$ 1,987.50	

- Wholesale borrowings should be primarily used to fund shortfalls in deposit growth and to help mitigate interest rate risk.
 - Banks should explore utilizing the Federal Reserve Discount window as another alternative funding source.
- The overall balance of borrowings will decrease and banks must rely on deposits to fund themselves.

As a result of the changing face of funding, careful analysis should be done before executing any major objectives . . .

Borrowing vs. Branching Analysis



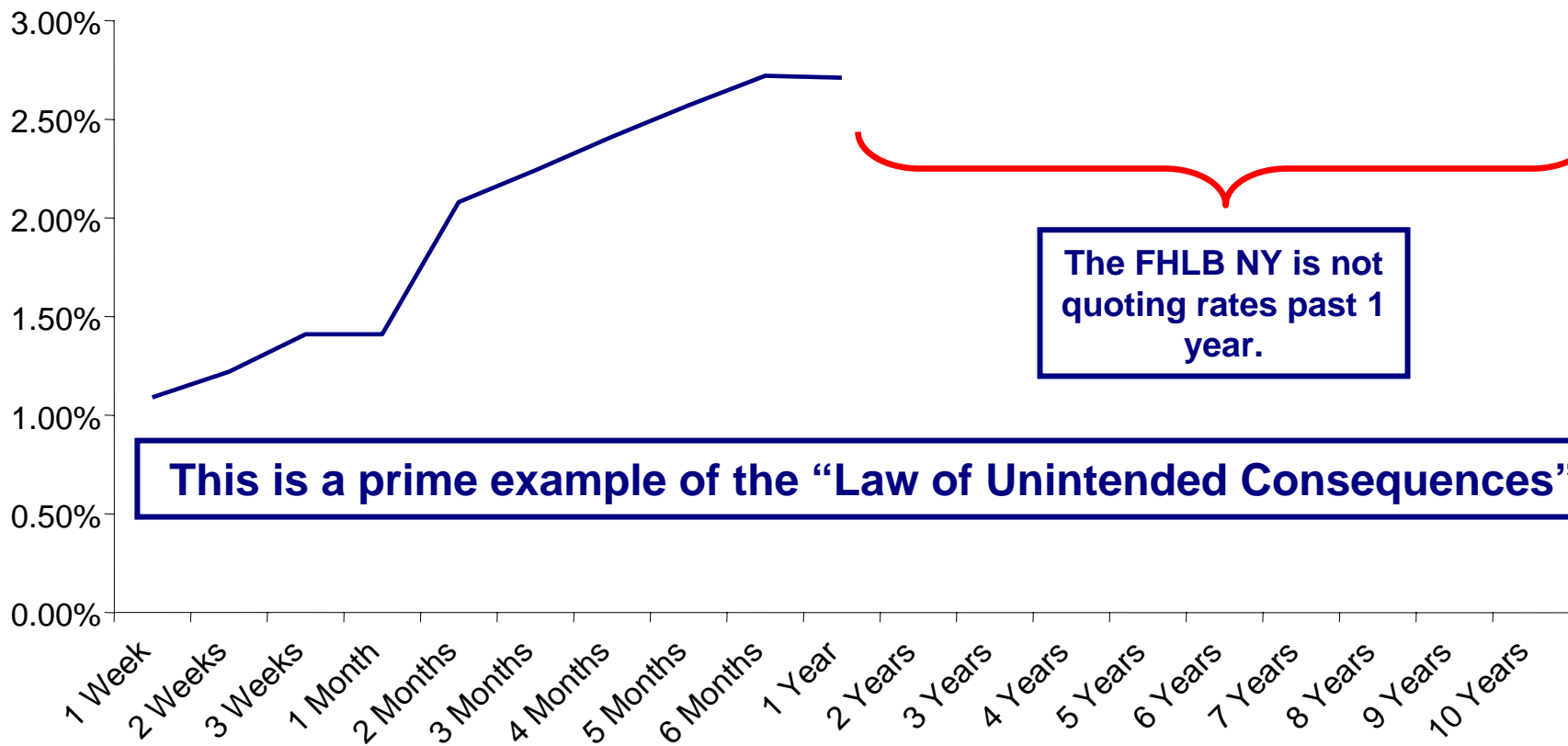
Liquidity issues . . .

- “Liquidity is an illusion. It’s always there when you don’t need it, and rarely there when you do.”
 - Michael Milken
- The time is different, but the issues remain the same . . .



Historically, the FHLB has provided a consistent long-term funding alternative. For interest rate risk purposes, how do you replace wholesale borrowings if the we cannot fund long . . .


Offering Rate on FHLB NY Fixed Rate Advances
As of 11/24/08




This is a prime example of the “Law of Unintended Consequences”

The FHLB NY is not quoting rates past 1 year.

The end result of all these changes to the financial landscape is that institutions will delever . . .

Total Assets	(\$000s)		(\$000s)
Cash & Cash Equivalents	50,000		50,000
Securities & Investments	300,000		225,000
Loans, Net	600,000		600,000
Fixed Assets	50,000		50,000
Total Assets	1,000,000		925,000

Total Liabilities & Equity	(\$000s)		(\$000s)
Deposits	700,000		700,000
Borrowings	150,000		75,000
Other Liabilities	50,000		50,000
Total Liabilities	900,000		825,000
Equity	100,000		100,000
Total Liabilities & Equity	1,000,000		925,000

As a result of the economic downturn many banks are not projected to grow substantially, however investment and loan mix are projected to shift and cost of funds is projected to increase as deposit pricing faces pressure from stiff competition . . .

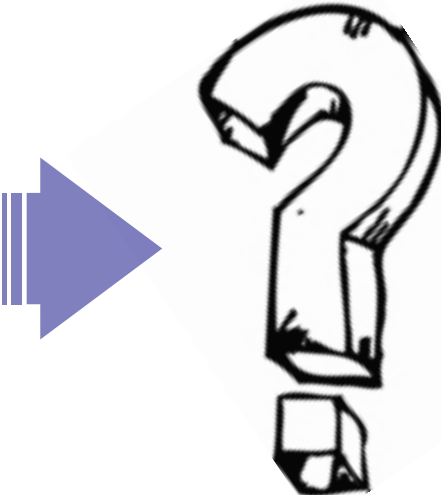
- Investments are expected to shift out of “exotic” high yielding corporate bonds, CMOs and municipal bonds and focus concentration on “plain vanilla” mortgage backed securities and government agencies.
- Loan concentrations will shift according to personnel expertise with limited growth in construction and home equity.
 - Commercial real estate has constantly been under fire, but the market has been more resilient than other areas of the loan portfolio.
 - Opportunities in the residential mortgage market will present themselves.
- The economic downturn has already created a “flight to safety”, which some banks have taken advantage of.
 - The cost of retaining and/or growing retail and commercial deposits is expected to increase as pricing wars continue as well as start on new fronts.

As a result of all the changes to the balance sheet, New Jersey Banks will experience declines in their income statements over the next few years . . .

Income Statement

(\$000s)

Interest Income	60,000
Interest Expense	25,000
<hr/>	
Net Interest Income	35,000
Provision	2,000
Non Interest Income	8,000
Non Interest Expense	26,000
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Net Income, Pre Tax	15,000
Taxes (33.0%)	4,950
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Net Income	10,050



Many of the changes will adversely affect the income statement, however a properly executed plan will mitigate losses and provide opportunity . . .

1. Lower net interest income
 - I. Lower spread:
 - As competition for deposits increases, institutions should not expect the price for customers do decrease. Larger institutions begging for funding from the government and investors have no issue with out pricing local markets all over the nation.
 - II. No growth:
 - In the past, balance sheet growth made up for lower spread. Going forward banks will have to fight hard for high quality growth.
2. Constant Provision
3. Diminishing noninterest income
4. Growing noninterest expense
5. Rising tax rates

Less traditional fee income . . .

- Customers are becoming more and more aware of fees
 - Banks have to give everything away free in order to attract new customers
 - Traditional banking fees are becoming more and more difficult
- Sheila Bair is a consumer advocate
- Once FDIC and other regulators have a chance to breath they will again hone in on assisting the consumer
 - More regulation of overdraft protection
 - More regulation of banking fees

More nontraditional fee income . . .

- Insurance Brokerage
 - Commercial and Personal Lines
 - Life Insurance
 - Employee Benefits
- Asset Management
 - Advisory
 - Securities Brokerage
 - Trust
 - Financial Planning
- Foreign remittances and wire transfers
- Prepaid cards for the unbanked or new immigrants

All of the aforementioned changes will impact the income statement . . .

Income Statement	(\$000s)	Change in Yield	Change in Cost	Fee Income Decrease	Expense Increase	Tax Expense	Result
Interest Income	60,000	(2,500)					57,500
Interest Expense	25,000		2,500				27,500
Net Interest Income	35,000						30,000
Provision	2,000						2,000
Non Interest Income	8,000			(1,000)			7,000
Non Interest Expense	26,000				2,500		28,500
Net Income, Pre Tax	15,000						6,500
Taxes (33.0%)	4,950					(2,805)	2,145
Net Income	10,050						4,355

Institutions that employ the “Ostrich Syndrome” may easily see a 25 basis point decrease in yield and corresponding increase in costs.

All of the aforementioned changes will impact the income statement . . .

Income Statement	(\$000s)	Change in Yield	Change in Cost	Fee Income Decrease	Expense Increase	Tax Expense	Result
Interest Income	60,000	200					60,200
Interest Expense	25,000		(1,500)				23,500
Net Interest Income	35,000						36,700
Provision	2,000						2,000
Non Interest Income	8,000			(1,000)			7,000
Non Interest Expense	26,000				2,500		28,500
Net Income, Pre Tax	15,000						13,200
Taxes (33.0%)	4,950					(594)	4,356
Net Income	10,050						8,844

However, managing the loan and deposit portfolio strategically, a bank may be able to hold interest income and interest expense levels flat, minimizing the impact on the bottom line.

Based on these projected balance sheet and income statement changes, we need to focus strategically on the following . . .

- 1. Expense reduction
- 2. Fee maintenance
- 3. Spread support
- 4. Hold volume

This must be done in light of the upcoming two economic phases.

Conclusion: To survive, and even thrive, in this economic downturn, its time to get creative but also return to traditional banking . . .

- It's a return to old banking:
 - Protect your capital, stay with plain vanilla investments, transfer securities into and/or hold more HTM going forward
 - More lending, particularly residential, fewer investment securities
 - Grab market share of core deposits flowing in to the banking industry
- But be creative and prepared to seize opportunity:
 - Smarter branching decisions, leverage technology
 - Better skilled staff focused on advisory and service.
 - Utilize employees as relationship managers.
 - Explore servicing options at a subsidiary level to increase fee income.
 - Unconventional but properly underwritten loans can provide yield opportunities, only if the proper expertise is there.

Just try not to get caught looking like this . . .



As a New Jersey Resident and Business Owner, I have a few recommendations for the Governor and Senator . . .

1. Start by Benchmarking to other States like PA
2. Create Expert Panel to solve Budget Problem
 - No legislators allowed, Put business folks on this committee
 - Broad Representation but Qualified, Minimize Special Interests
3. Dramatically limit borrowing – Pay as you Go
4. Cut Spending
 - Hire low cost providers, no union mandates
 - Cut NJEA in half, Spend \$10,000 per student – No more, no less
 - Eliminate NJ Family Leave Act on small business
5. Eliminate County Governments or dramatically Consolidate local governments
 - Consolidate townships and Schools
6. Freeze all Pensions NOW. Use 401k's like rest of world incl. Federal Gov't
7. Feeing NJ to death is not the answer, ***Death by a Thousand Cuts***
 - Kill the COAH fees
8. Make New Jersey Affordable
 - Business Friendly
 - Lower Real Estate Taxes – Requires REAL work on Education Costs
 - Lower income taxes – Evidence is clear that this increases revenues!

If you seriously want to fix New Jersey . . .

Start running the State more like a business.

You can find details on FinPro's most current presentations at www.finpronj.com . . .

- *Turbulent Times.*
 - Donald Musso 9/17/07
- *The Evolution of Banking and How to Position for it!*
 - Donald Musso 9/08/08
- *Solutions to Fix the Economic Doldrums*
 - Donald Musso 10/1/08
- *Tough Choices*
 - Donald Musso 10/08/08
- *Is it a New World or a return to the Old World?*
 - Donald Musso 11/6/08
- *Turmoil Breeds Opportunity*
 - Scott Martorana 11/6/08