

**Managing the Balance Sheet and  
CAMELS Ratings in Troubled  
Times**

**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 . . .

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## And this is why I am irreverent . . .

- Obama says we must lend more to restart the economy, but
- The FDIC will not approve new charters for specialty finance companies who have over \$500 billion of loans at risk and no way to fund them in the future, and
- The FDIC says lets take \$225 billion out of circulation by assessing the one time charge for insurance.

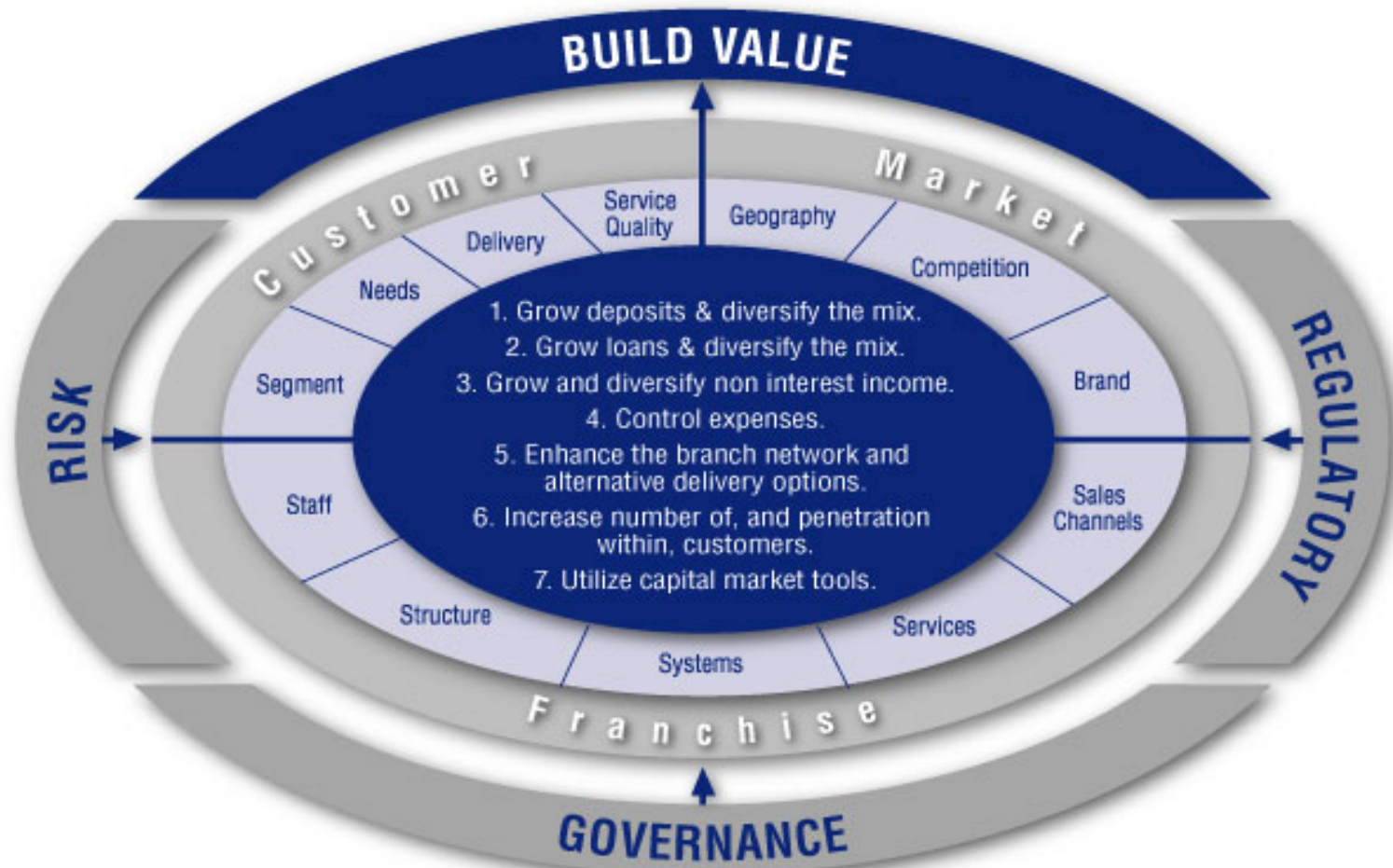
	As of 12/31/2008	
Total Banks	8,261	
Banks with ROAA less than 0.20%	2,449	29.65%
Total Deposits	9,021,791,720,000	
FDIC Insurance Cost (one time)	0.20%	
Reduction of Capital to Industry	18,043,583,440	
Leverage Ratio	8.00%	
Lost Growth	225,544,793,000	

## Some quick thoughts before we get into the balance sheet . . .

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- We must win the PR war.
- We must not let the system beat us down.
- We must be aware of hidden intentions
  - FDIC
  - Federal Reserve
  - FHLB?
- Now, more than ever, we must speak as one.
- We must avoid the “war on the classes”

Every decision a bank makes should be in consideration of FinPro's Seven Ways to Build Value . . .



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

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



In either event,  
all of us **MUST**  
**RESTRUCTURE**  
our Balance  
Sheets **NOW!**

- Followed by rapid inflation and rising rates or, worse yet
- A prolonged depression lasting as long as 7 years

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

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- Tax Policy
  - Hold taxes on the high end and lower taxes on the low end. In any event, lower business taxes and FEES
- Business Friendliness
  - The USA must become business friendly again. This economic correction should be used as the vehicle to accomplish this.
- Business and Consumer confidence
  - Will the stimulus promote consumer confidence? Typically, confidence follows jobs which follows business.
- The New “New Deal”?
  - Huge Government spending and pumping dollars into the system usually creates inflation. Can the USA withstand this one/two punch?

If there is no action, ultimately, people will vote with their feet . . .

Population almost  
50% greater

## A TALE OF TWO STATES

### New Jersey

### Pennsylvania

#### General Facts

8,724,560

Population

12,440,621

#### 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)

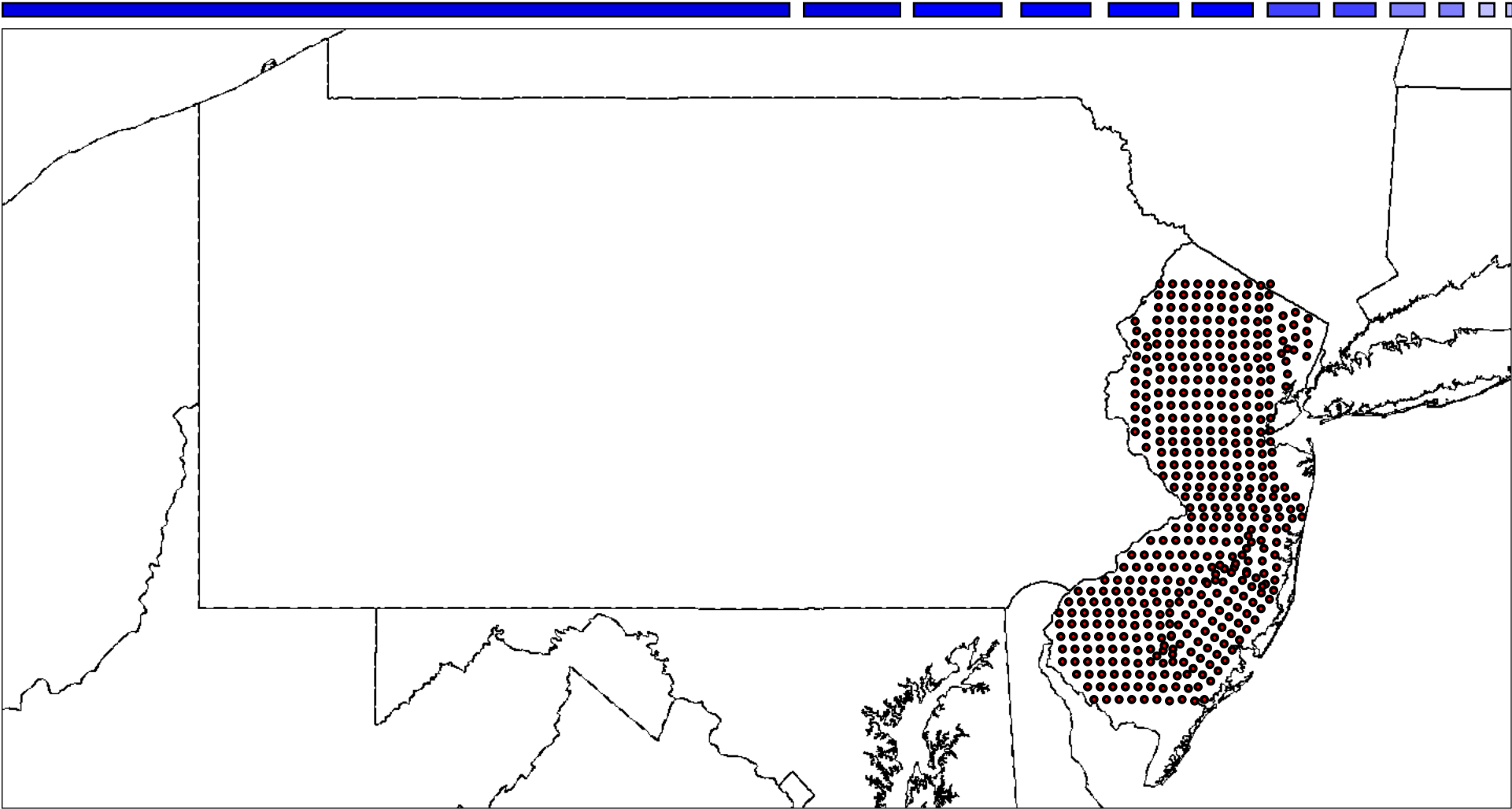
\$2,000

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 . . .



And the regulatory environment will not offer any help . . .

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1. Increasing FDIC insurance
  - Penalty for volatile funding
  - Move to “risk based” premiums
2. Dislike of Monoline businesses
  - Will they change their mind when they need capital?
3. Too big too fail policy
  - Completely unfair to community banks
4. Cramdowns?
5. Regulatory reform and restructuring
6. Push to higher capital levels at the worst time
7. Mark to market accounting

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
<b>Total Assets</b>	<b>1,000,000</b>



## Total Liabilities & Equity

(\$000s)

Deposits	700,000
Borrowings	150,000
Other Liabilities	50,000
<b>Total Liabilities</b>	<b>900,000</b>
Equity	100,000
<b>Total Liabilities &amp; Equity</b>	<b>1,000,000</b>



## On the asset side of the balance sheet . . .

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- Recognize the current rate environment for what it is. Rates are at historic lows.
  - Control the level of long term, fixed rate products that you keep on the balance sheet. They will be underwater eventually.
- 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.
- Loans should outperform investments in the near term and leverage strategies are almost nonexistent.
- Manage the cash flows closely – prepayment speeds will go haywire this year.

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



<b>Investments</b>	<b>(\$000s)</b>	<b>rate (%)</b>
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%
<b>Total Investments</b>	<b>300,000</b>	<b>5.55%</b>

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

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- 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.

Here are some recent examples . . .

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- Agency Mortgage Backed Securities:
  - Sales are down, so brokers are trying to increase their markups
  - On one series of transactions involving \$5mil we were able to improve the pricing by almost one full point, (**a savings of almost \$50,000**) with market intelligence and by expanding the bidding process.
  
- Asset Backed Floaters:
  - By doing our homework we were able to achieve a return of LIBOR + **550** basis points on a short term investment grade note purchase. On a \$500,000 purchase that resulted in **over \$25,000** more in annual income versus fed funds.

Here are some recent examples (continued) . . .

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- Portfolio Restructurings:
  - Several clients, with advice, are improving the overall quality of their investment portfolios, avoiding potential future downgrades, and booking gains.
    - Sell longer term maturities to shorten duration / fix interest rate risk
    - Avoid future mark to market losses / premium write downs
    - Utilize gains for offsets or repositioning
  
- Product Development:
  - The collapse of the securitization market for asset backed lending means that there will be unique situations for short/medium term yielding investments.

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

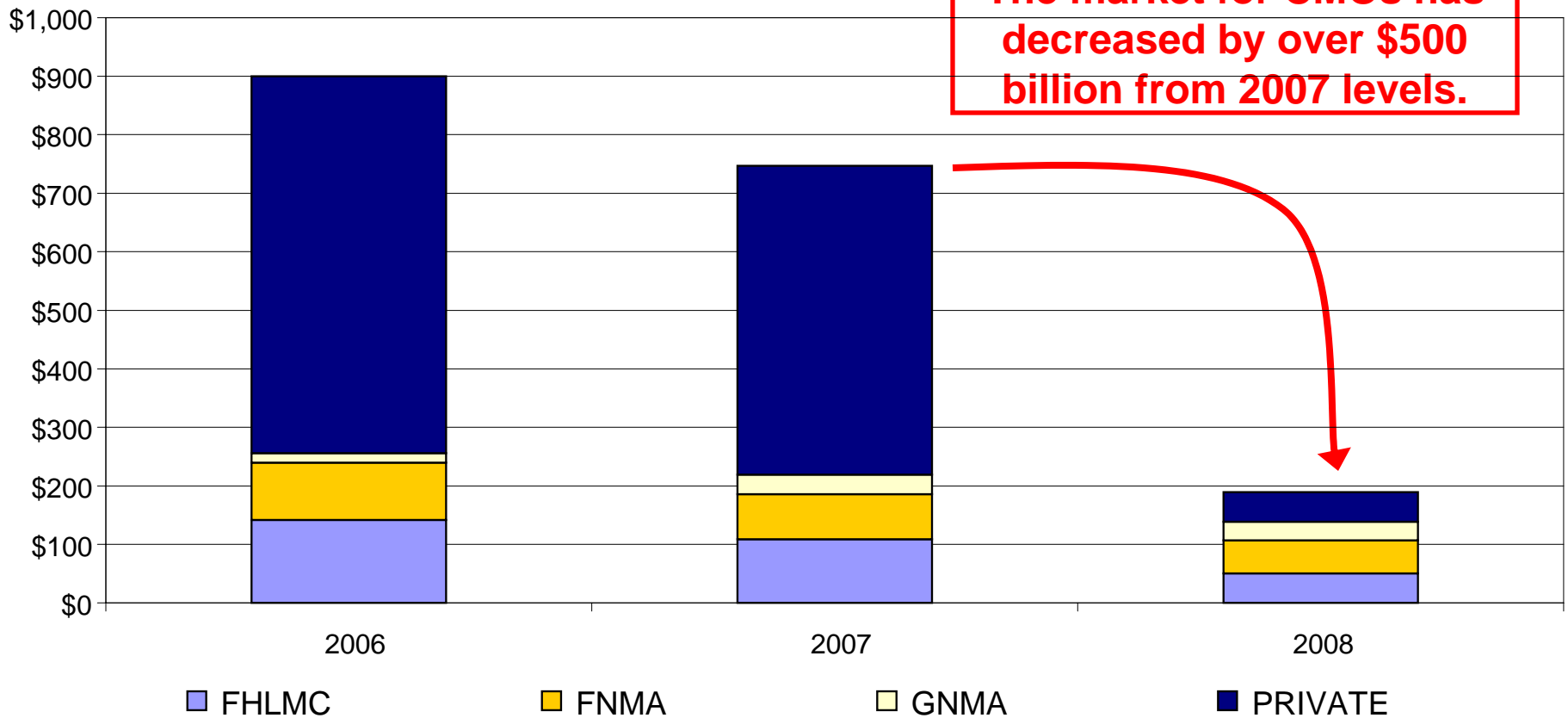
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1. CMO issuance has dropped dramatically as the lack of demand dried up. The private label market is all but dead.
2. Corporate debt has been downgraded across the board and yields have skyrocketed on the bonds, but investors are still doubtful about 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.

By the end of 2008, the issuance of collateralized mortgage obligations had seen a dramatic decreases . . .



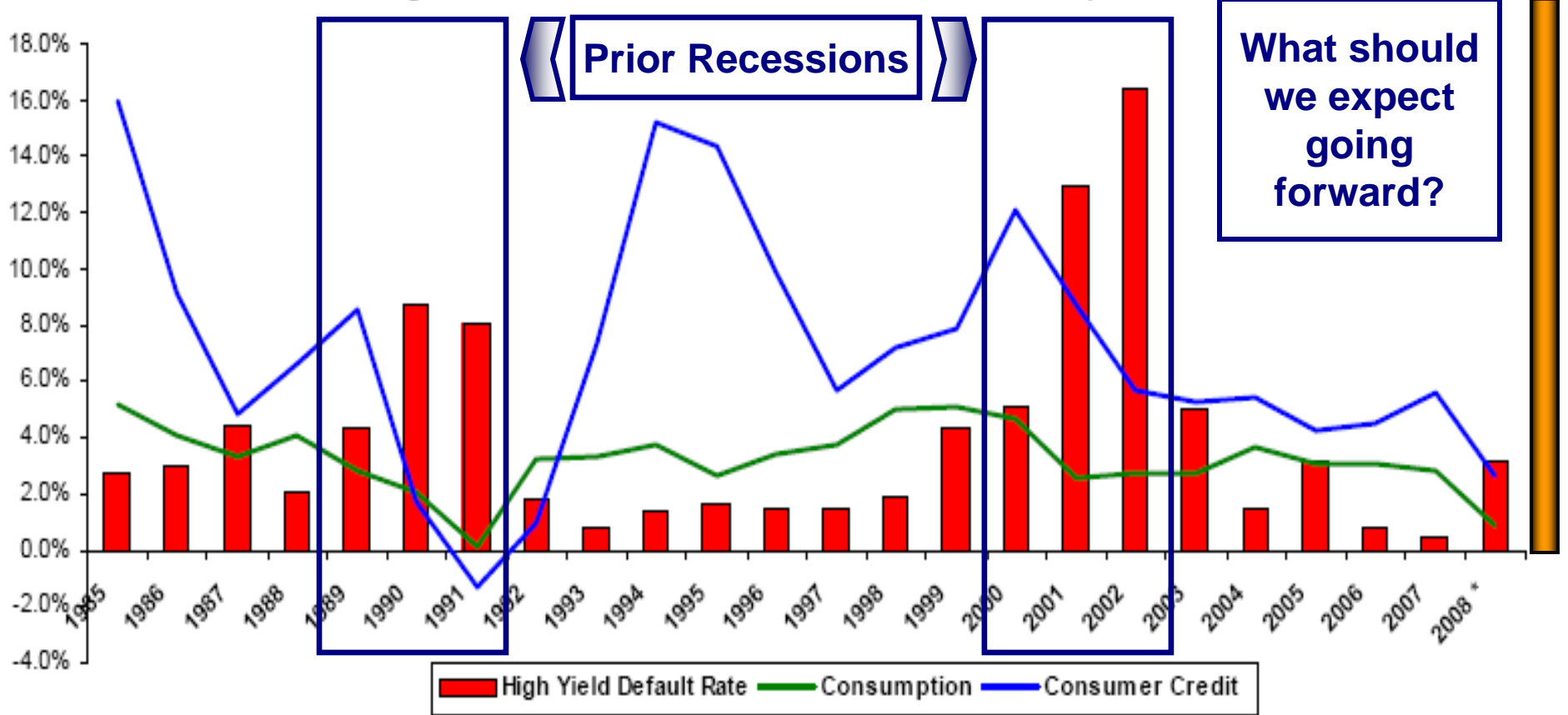
**CMO Issuance by Year**  
(\$ in Billions)



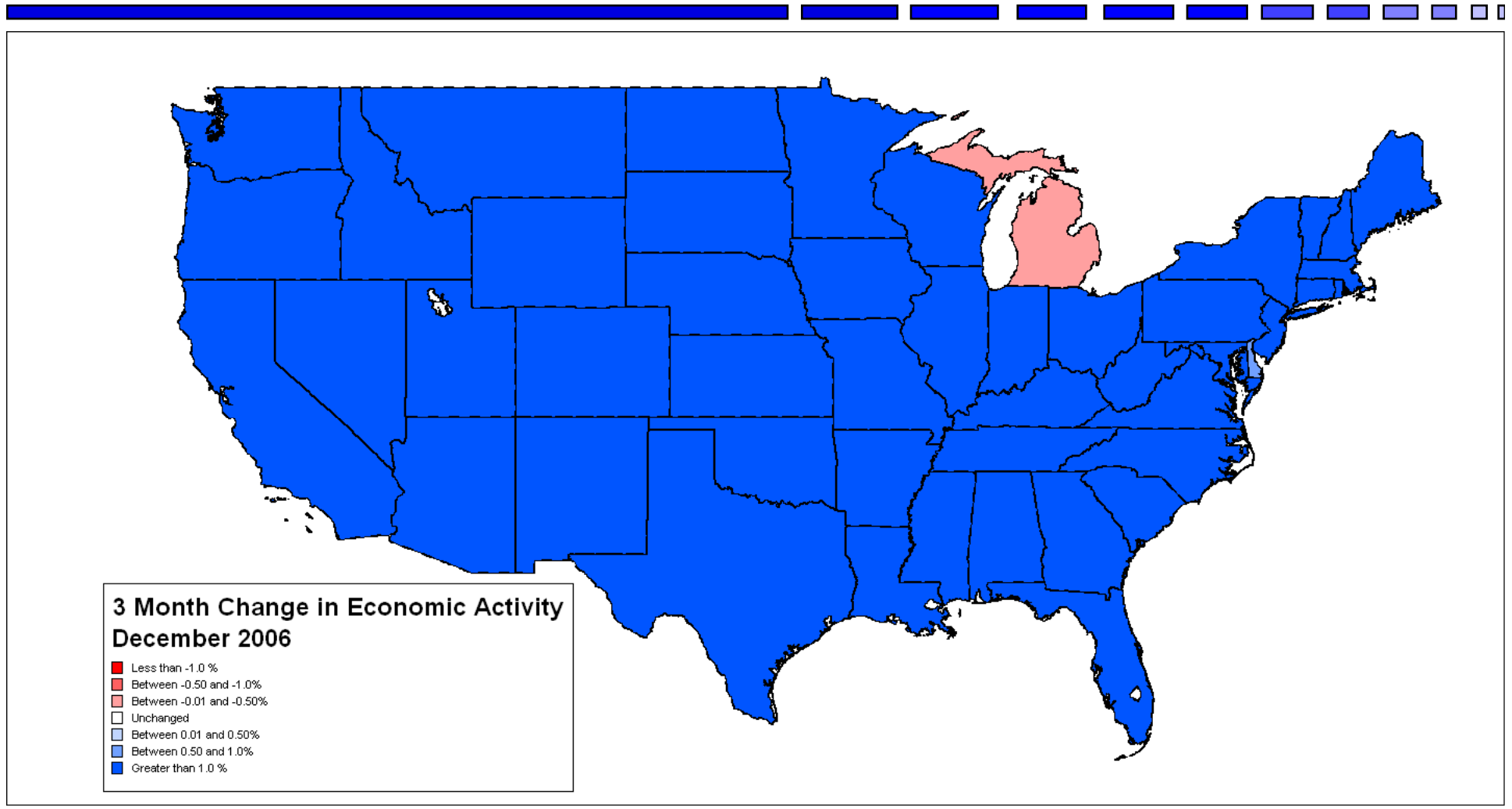
And U.S. high yield default rates, despite the move up thus far in 2008, have potential to increase dramatically based on historical trends . . .



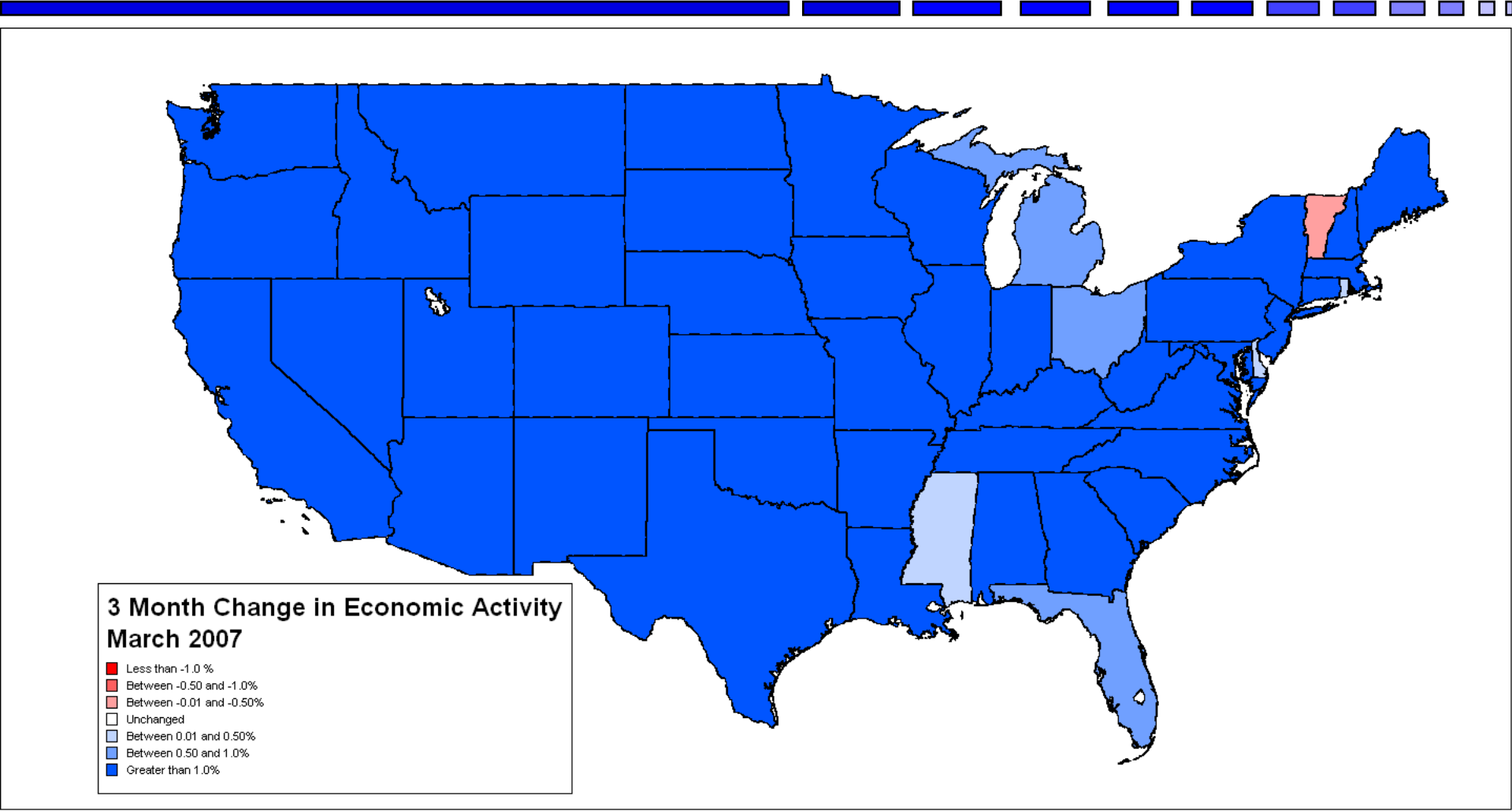
U.S. High Yield Default Rates vs Consumer Credit & Consumption



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 . . .



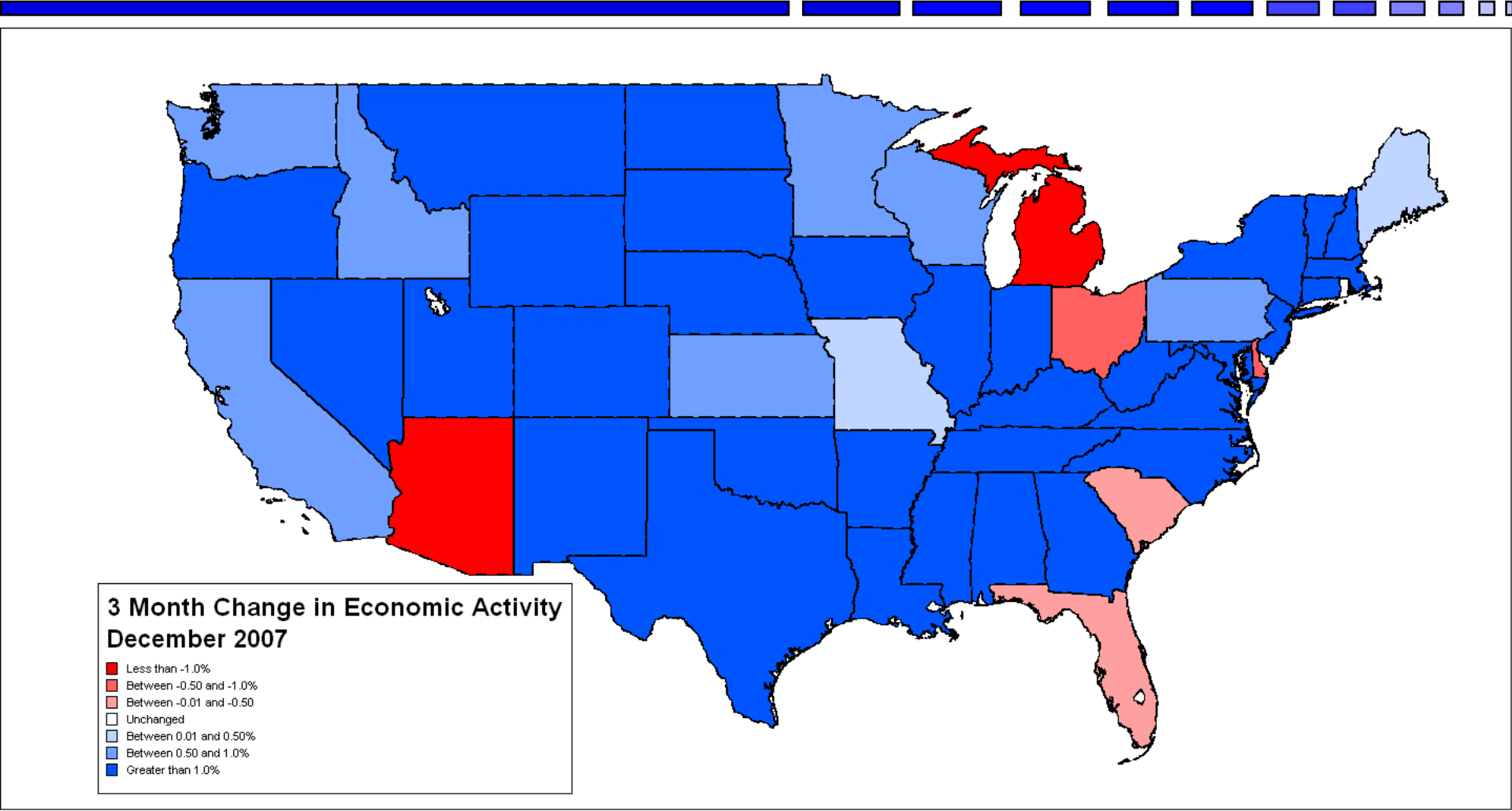
# 3 month change in economic activity, annualized for March 2007 . . .



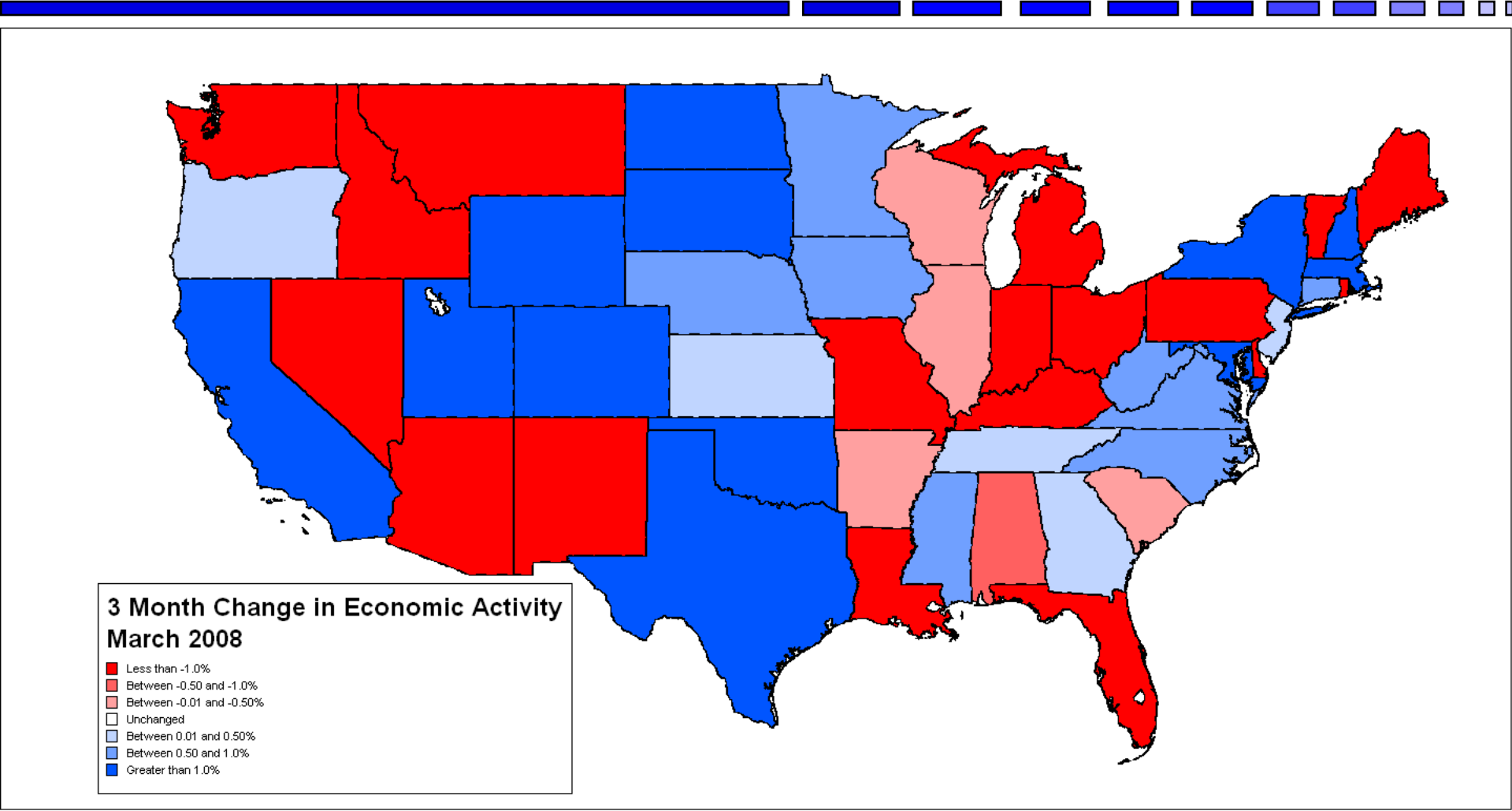




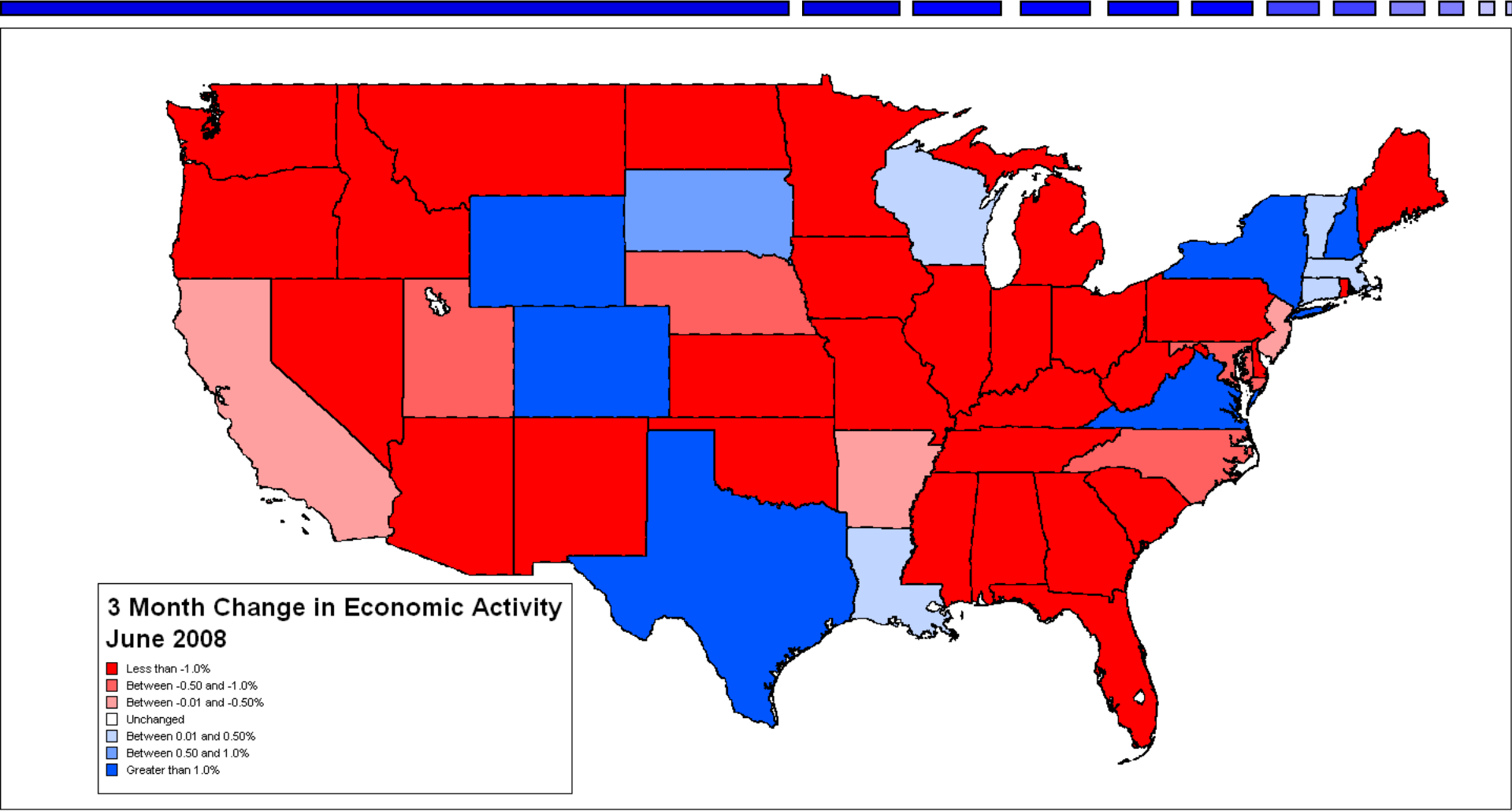
# 3 month change in economic activity, annualized for December 2007 . . .



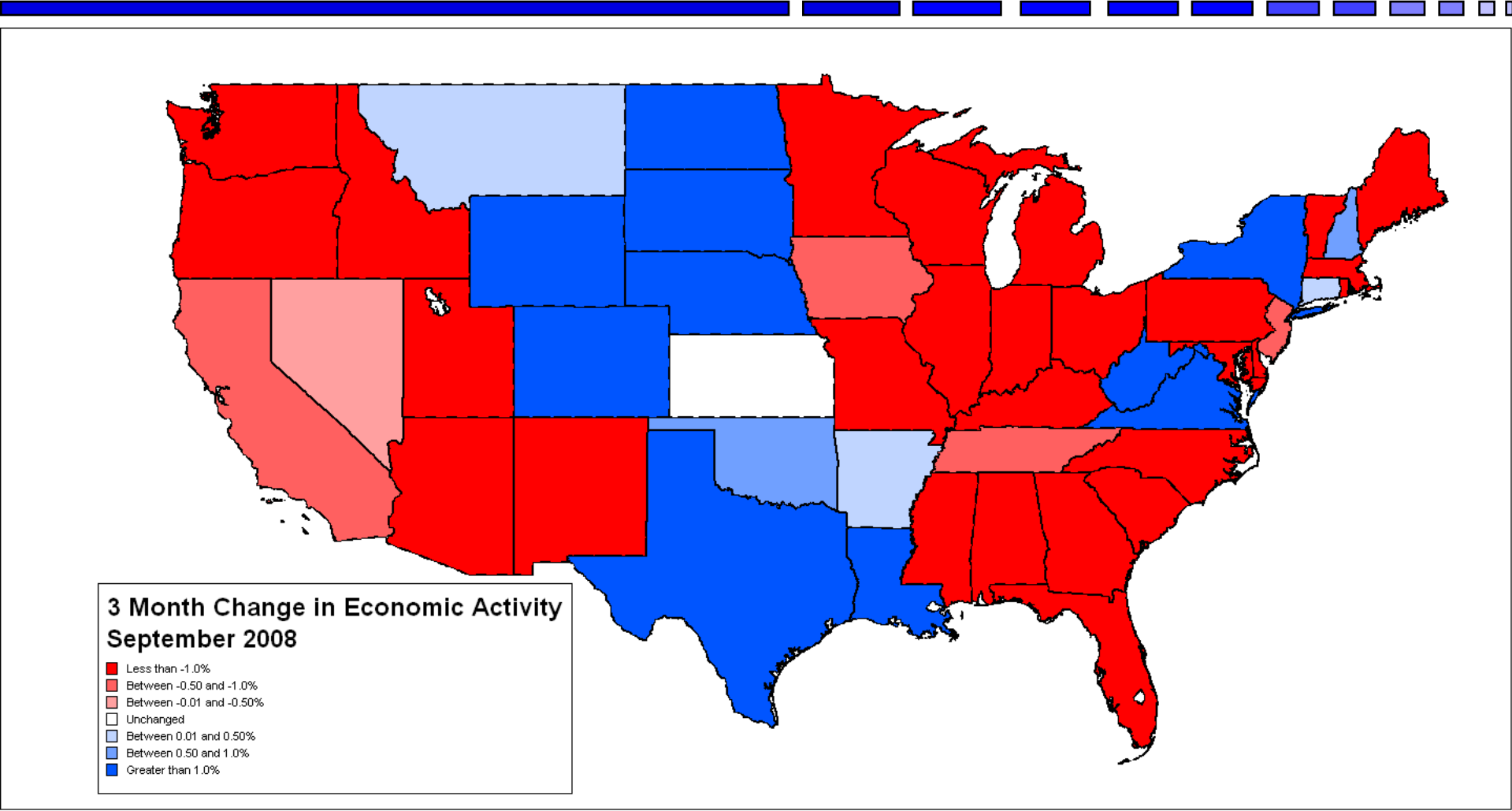
# 3 month change in economic activity, annualized for March 2008 . . .



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



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



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	2008		Unprepared 2009	
	(\$000s)	rate (%)	(\$000s)	rate (%)
Mortgage Backed Securities	75,000	5.50%	101,250	4.46%
CMOs	45,000	6.00%	-	4.00%
Municipal Bonds	45,000	4.00%	22,500	2.00%
Gov't Agency Bonds	75,000	5.50%	78,750	3.50%
Corporate Bonds	60,000	6.50%	22,500	4.50%
<b>Total Investments</b>	<b>300,000</b>	<b>5.55%</b>	<b>225,000</b>	<b>3.88%</b>

- 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.

Adding another asset class with a shorter duration and higher yield than a mortgage backed security limits the decline in the portfolio yield . . .

Investments	2008		Unprepared 2009		Prepared 2009	
	(\$000s)	rate (%)	(\$000s)	rate (%)	(\$000s)	rate (%)
Mortgage Backed Securities	75,000	5.50%	101,250	4.46%	51,250	5.50%
CMOs	45,000	6.00%	-	4.00%	-	4.00%
Municipal Bonds	45,000	4.00%	22,500	2.00%	22,500	2.00%
Gov't Agency Bonds	75,000	5.50%	78,750	3.50%	53,750	3.50%
Corporate Bonds	60,000	6.50%	22,500	4.50%	22,500	4.50%
New Asset Backed Sec.	-	0.00%	-	0.00%	75,000	4.25%
<b>Total Investments</b>	<b>300,000</b>	<b>5.55%</b>	<b>225,000</b>	<b>3.88%</b>	<b>225,000</b>	<b>4.16%</b>

Looking at the change in the investment portfolio, the “Unprepared” scenario experiences a significant hit to interest income after cutting the size of the investment portfolio and taking a significant hit on the yield. The “Prepared” scenario minimizes the lost income . . .

<b>Rate Volume</b>	<b>2008</b>		<b>Unprepared 2009</b>		<b>Prepared 2009</b>	
<b><i>Changing Investment Mix &amp; Shrinking Balance</i></b>						
Balance & Rates	<b>300,000</b>	<b>5.55%</b>	<b>225,000</b>	<b>3.88%</b>	<b>225,000</b>	<b>4.16%</b>
<b>Change in Interest Income due to:</b>						
Change in Volume from 2008		-		(4,163)		-
Change in Rate from 2008		-		(3,750)		613
<b>Investment Interest Income</b>		<b>16,650</b>		<b>8,738</b>		<b>9,350</b>
<b><i>Difference</i></b>				<b>(7,913)</b>		<b>613</b>

Making use of the “New Asset Backed Security”, the institution is able to pick up 25 bps on the investment portfolio

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	2008	
	(\$000s)	rate (%)
Residential Mortgages	30,500	5.80%
Multifamily Mortgages	81,500	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%
<b>Loans</b>	<b>600,000</b>	<b>6.05%</b>

The problem is that loans will be hard to find. Residential lending will make a comeback as institutions struggle to find quality loans . . .

Loans	2008		Unprepared 2009	
	(\$000s)	rate (%)	(\$000s)	rate (%)
Residential Mortgages	30,500	5.80%	122,000	5.52%
Multifamily Mortgages	81,500	6.00%	81,500	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	7.00%
Home Equity	61,000	5.00%	21,350	4.00%
Consumer	30,500	6.00%	12,200	6.00%
Commercial	30,500	6.25%	27,450	6.25%
<b>Loans</b>	<b>600,000</b>	<b>6.05%</b>	<b>600,000</b>	<b>5.99%</b>

**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.**

But institutions need to change their lending focus to short term and variable rate products. Employing specialty financing will help to maintain loan volume and the portfolio's yield . . .

Loans	2008		Unprepared 2009		Prepared 2009	
	(\$000s)	rate (%)	(\$000s)	rate (%)	(\$000s)	rate (%)
Residential Mortgages	30,500	5.80%	122,000	5.52%	60,000	5.62%
Multifamily Mortgages	81,500	6.00%	81,500	6.00%	81,500	6.00%
Non Owner Occupied CRE	152,500	6.13%	152,500	6.13%	152,500	6.13%
Owner Occupied CRE	152,500	6.25%	152,500	6.25%	152,500	6.25%
Construction	61,000	6.50%	30,500	7.00%	30,500	7.00%
Home Equity	61,000	5.00%	21,350	4.00%	21,350	4.00%
Consumer	30,500	6.00%	12,200	6.00%	12,200	6.00%
Commercial	30,500	6.25%	27,450	6.25%	39,450	6.25%
Yellow Metal Financing	-	0.00%	-	0.00%	50,000	6.89%
<b>Loans</b>	<b>600,000</b>	<b>6.05%</b>	<b>600,000</b>	<b>5.99%</b>	<b>600,000</b>	<b>6.13%</b>

**Remember:** Having the correct expertise is imperative to successfully executing any strategy!

How institutions diversify the loan portfolio will separate those that are able to sustain this economic downturn and those that will not. Shifting the mix into shorter duration loans will save the portfolio . . .



Rate Volume	2008		Unprepared 2009		Prepared 2009	
<b><i>Changing Loan Mix &amp; Add Expertise</i></b>						
Balance & Rates	600,000	6.05%	600,000	5.99%	600,000	6.13%
<b>Change in Interest Income due to:</b>						
Change in Volume from 2008		-		-		-
Change in Rate from 2008		-		(346)		828
<b>Loans Interest Income</b>		<b>36,282</b>		<b>35,936</b>		<b>36,764</b>
<b><i>Difference</i></b>				<b>(346)</b>		<b>828</b>

When lending it is also 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%	<b>3.00%</b>

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%	<b>3.20%</b>

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.

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	2008		Unprepared 2009	
	(\$000s)	Rate (%)	(\$000s)	Rate (%)
Non Interest Bearing				
<i>Traditional Non Interest Bearing Accts</i>	35,000	0.00%	35,000	0.00%
<i>Operating Accounts</i>	-	0.00%	-	0.00%
Transaction Accounts	105,000	0.50%	105,000	0.50%
Savings				
<i>Personal Savings</i>	105,000	1.50%	105,000	1.50%
<i>New Signature Savings</i>	-	0.00%	-	0.00%
Money Market	105,000	2.00%	105,000	2.00%
Retail Time Deposits	315,000	3.00%	315,000	3.25%
Brokered Deposits	35,000	3.25%	35,000	3.50%
<b>Total Deposits</b>	<b>700,000</b>	<b>2.11%</b>	<b>700,000</b>	<b>2.24%</b>

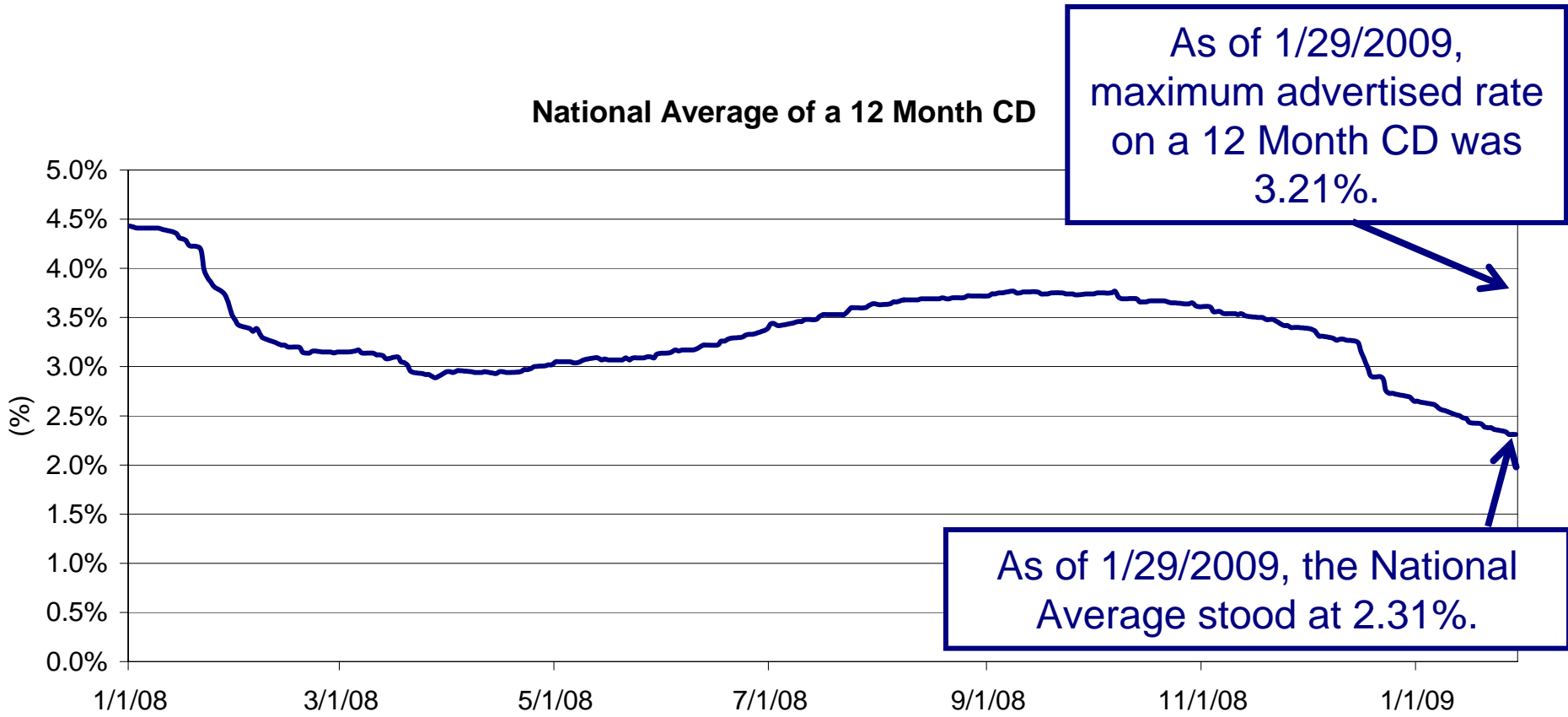
Instinctively, playing the “pricing game” will keep time deposits from running off and deposit levels steady, but this comes with a 13 bps increase in the cost of deposits.

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

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- 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	2008		Unprepared 2009		Prepared 2009		Prepared 2009	
	(\$000s)	Rate (%)	(\$000s)	Rate (%)	(\$000s)	Rate (%)	(\$000s)	Rate (%)
Non Interest Bearing								
<i>Traditional Non Int. Bearing Accts</i>	35,000	0.00%	35,000	0.00%	35,000	0.00%	35,000	0.00%
<i>Operating Accounts</i>	-	0.00%	-	0.00%	10,000	0.00%	10,000	0.00%
Transaction Accounts	105,000	0.50%	105,000	0.50%	105,000	0.50%	105,000	0.50%
Savings								
<i>Personal Savings</i>	105,000	1.50%	105,000	1.50%	105,000	1.50%	90,000	1.25%
<i>New Signature Savings</i>	-	0.00%	-	0.00%	-	0.00%	85,000	2.50%
Money Market	105,000	2.00%	105,000	2.00%	105,000	2.00%	105,000	2.00%
Retail Time Deposits	315,000	3.00%	315,000	3.25%	315,000	3.00%	270,000	3.00%
Brokered Deposits	35,000	3.25%	35,000	3.50%	25,000	3.25%	-	3.25%
<b>Total Deposits</b>	<b>700,000</b>	<b>2.11%</b>	<b>700,000</b>	<b>2.24%</b>	<b>700,000</b>	<b>2.07%</b>	<b>700,000</b>	<b>2.00%</b>

The two strategies of 1.) obtaining operating accounts from loan relationships and 2.) introducing a “signature savings” account can easily lower the cost of funds.

Institutions can lower their cost of funds by changing the deposit mix as well as segmenting their rate sensitive customers into a higher rate savings account and lowering the cost of all other deposits . . .

<b>Rate Volume</b>	<b>2008</b>		<b>Unprepared 2009</b>		<b>Prepared 2009</b>	
<b><i>Changing Deposit Mix &amp; Adding Products</i></b>						
Balance & Rates	<b>700,000</b>	<b>2.11%</b>	<b>700,000</b>	<b>2.24%</b>	<b>700,000</b>	<b>2.00%</b>
<b>Change in Interest Income due to:</b>						
Change in Volume from 2008		-		-		-
Change in Rate from 2008		-		875		(1,688)
<b>Deposit Interest Expense</b>		<b>14,788</b>		<b>15,663</b>		<b>13,975</b>
<b>Difference</b>				<b>875</b>		<b>(1,688)</b>

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

Borrowings	2008		Unprepared 2009	
	(\$000s)	Rate (%)	(\$000s)	Rate (%)
	Dec-08		Jan-09	
FHLB 12 Mo. Fixed Rate Advance	150,000	1.57%	75,000	1.62%
<b>Total Borrowings</b>	<b>150,000</b>		<b>75,000</b>	
Interest Expense:	2,355		1,215	

- 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.

## 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 . . .



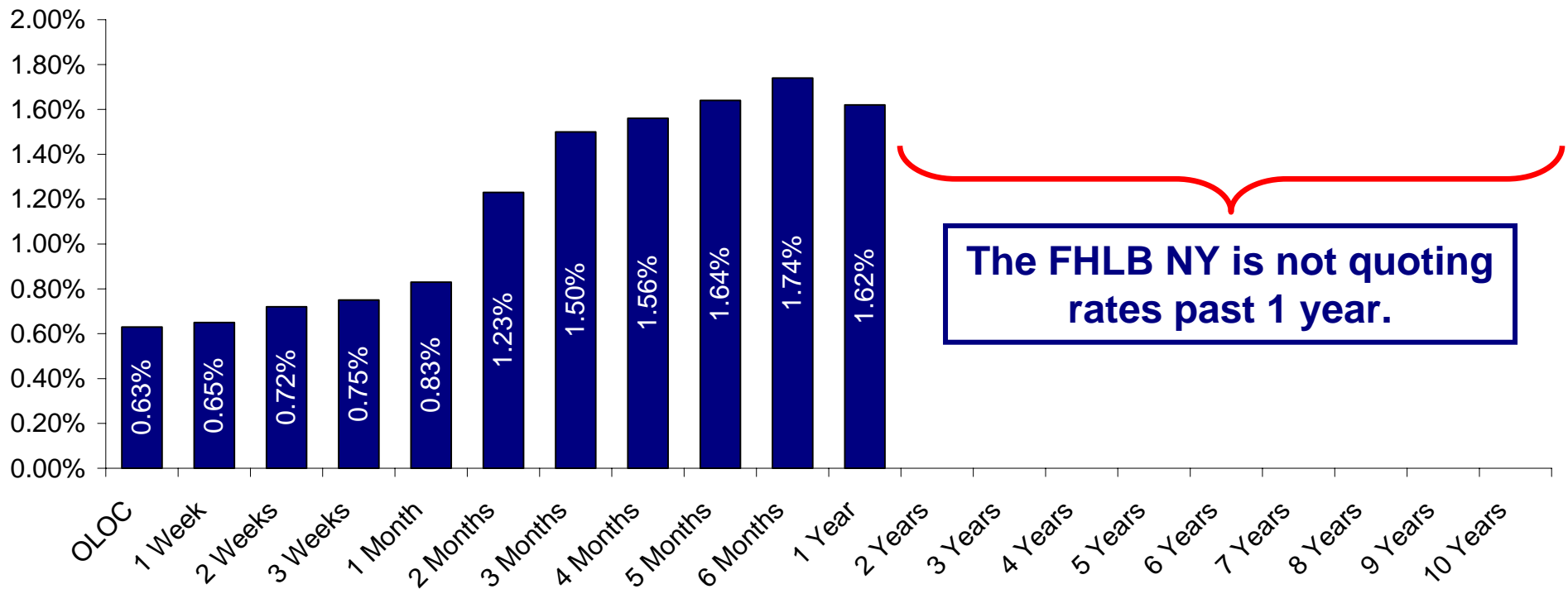
Liquidity can sink your ship quicker than anything else . . .



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 Rates on FHLB NY Fixed Rate Advances as of 01/30/2009



The FHLB NY is not quoting rates past 1 year.

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

Maintaining the borrowings levels allows for institutions to take advantage of funding rates that are often cheaper than time deposits . . .

Borrowings	2008		Unprepared 2009		Prepared 2009	
	(\$000s)	Rate (%)	(\$000s)	Rate (%)	(\$000s)	Rate (%)
	Dec-08		Jan-09		Jan-09	
FHLB 12 Mo. Fixed Rate Advance	150,000	1.57%	75,000	1.62%	150,000	1.62%
<b>Total Borrowings</b>	<b>150,000</b>		<b>75,000</b>		<b>150,000</b>	
Interest Expense:	2,355		1,215		2,430	

Taking a look at the “Prepared” deposit scenario, maintaining the borrowings levels and allowing “hot money” to run off can allow for significant savings . . .

<b>Borrowings vs. Deposits</b>	<b>(\$000s)</b>	<b>Rate (%)</b>	<b>Interest Expense</b>
<b>Scenario 1: Run off of Borrowings</b>			
Retail Time Deposits	270,000	3.00%	8,100
Brokered Deposits	-	3.25%	-
Borrowings	75,000	1.62%	1,215
<b>Total Non Core Funding</b>	<b>345,000</b>	<b>2.70%</b>	<b>9,315</b>
<b>Scenario 2: Run off of High Rate Time Deposits</b>			
Retail Time Deposits	<b>195,000</b>	<b>2.50%</b>	<b>4,875</b>
Brokered Deposits	-	3.25%	-
Borrowings	150,000	1.62%	2,430
<b>Total Non Core Funding</b>	<b>345,000</b>	<b>2.12%</b>	<b>7,305</b>
<b>4 bps FDIC insurance increase on all deposits</b>	<b>625,000</b>	<b>0.04%</b>	<b>250</b>
<b>Total Cost of Scenario 2</b>	<b>345,000</b>	<b>2.19%</b>	<b>7,555</b>
<b>Savings (Scenario 1 - Scenario 2)</b>			<b>1,760</b>

As borrowing rates decrease, they are still a viable funding option. Borrowings should be used to avoid funding via high cost deposits . . .

<b>Rate Volume</b>	<b>2008</b>		<b>Unprepared 2009</b>		<b>Prepared 2009</b>	
<b><i>Adjust Borrowing Levels</i></b>						
Balance & Rates	<b>150,000</b>	<b>1.57%</b>	<b>75,000</b>	<b>1.62%</b>	<b>150,000</b>	<b>1.62%</b>
<b>Change in Interest Income due to:</b>						
Change in Volume from 2008		-		(1,178)		1,215
Change in Rate from 2008		-		38		-
<b>Borrowings Interest Expense</b>		<b>2,355</b>		<b>1,215</b>		<b>2,430</b>
<b>Difference</b>				<b>(1,140)</b>		<b>1,215</b>
<b>Associate Cost Savings of Allowing High Rate Deposits to Run Off</b>						<b>(1,760)</b>
<b>Incremental Savings From "Unprepared 2009":</b>						<b>(545)</b>

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

<b>Total Assets</b>	<b>2008</b>	<b>Unprepared 2009</b>	<b>Prepared 2009</b>
<b>Cash &amp; Cash Equivalents</b>	<b>50,000</b>	<b>50,000</b>	<b>50,000</b>
Mortgage Backed Securities CMOs	75,000	101,250	51,250
Municipal Bonds	45,000	-	-
Gov't Agency Bonds	45,000	22,500	22,500
Corporate Bonds	75,000	78,750	53,750
New Asset Backed Sec.	60,000	22,500	22,500
	-	-	75,000
<b>Securities &amp; Investments</b>	<b>300,000</b>	<b>225,000</b>	<b>225,000</b>
Residential Mortgages	30,500	122,000	60,000
Multifamily Mortgages	81,500	81,500	81,500
Non Owner Occupied CRE	152,500	152,500	152,500
Owner Occupied CRE	152,500	152,500	152,500
Construction	61,000	30,500	30,500
Home Equity	61,000	21,350	21,350
Consumer	30,500	12,200	12,200
Commercial	30,500	27,450	39,450
Yellow Metal Financing	-	-	50,000
<b>Loans</b>	<b>600,000</b>	<b>600,000</b>	<b>600,000</b>
<b>Fixed Assets</b>	<b>50,000</b>	<b>50,000</b>	<b>50,000</b>
<b>Total Assets</b>	<b>1,000,000</b>	<b>925,000</b>	<b>925,000</b>

As prepared institutions de-lever, they will move into smarter funding sources, moving customers into core deposit accounts and taking advantage of low borrowing costs . . .

<b>Total Liabilities &amp; Equity</b>	<b>2008</b>	<b>Unprepared 2009</b>	<b>Prepared 2009</b>
Non Interest Bearing	35,000	35,000	45,000
Transaction Accounts	105,000	105,000	130,000
Savings	105,000	105,000	175,000
Money Market	105,000	105,000	105,000
Retail Time Deposits	315,000	315,000	170,000
Brokered Deposits	35,000	35,000	-
<b>Deposits</b>	<b>700,000</b>	<b>700,000</b>	<b>625,000</b>
<b>Borrowings</b>	<b>150,000</b>	<b>75,000</b>	<b>150,000</b>
<b>Other Liabilities</b>	<b>50,000</b>	<b>50,000</b>	<b>50,000</b>
<b>Total Liabilities</b>	<b>900,000</b>	<b>825,000</b>	<b>825,000</b>
<b>Equity</b>	<b>100,000</b>	<b>100,000</b>	<b>100,000</b>
<b>Total Liabilities &amp; Equity</b>	<b>1,000,000</b>	<b>925,000</b>	<b>925,000</b>

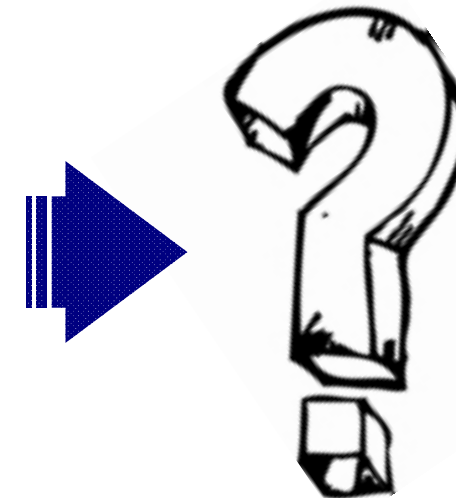
As a result of all the changes to the balance sheet, banks will experience significant changes to the income statements over the next several years . . .

## Income Statement

2008

(\$000s)

Interest Income	52,932
Interest Expense	17,143
Net Interest Income	35,790
Provision	2,000
Non Interest Income	8,000
Non Interest Expense	26,000
Net Income, Pre Tax	15,790
Taxes (33.0%)	5,211
Net Income	10,579



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

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1. Lower net interest income
  - I. Lower spread:
    - As competition for deposits increases, institutions should not expect the price for customers to 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 . . .

<b>Non Interest Income</b>	<b>2008</b> (\$000s)	<b>Unprepared 2009</b> (\$000s)	<b>Prepared 2009</b> (\$000s)
<b>Fee Income</b>	<b>8,000</b>	<b>7,000</b>	<b>7,000</b>
<b>Fee Income Ratio (NII / AA):</b>	<b>0.80%</b>	<b>0.76%</b>	<b>0.76%</b>

- 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
- 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
- Expect fee income to decrease across the industry, because nowadays you can bet someone is giving it away for free

## More nontraditional fee income . . .

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- 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

Managing operating expense is just as important as managing the balance sheet . . .

Non Interest Expense	2008 (\$000s)	Unprepared 2009 (\$000s)	Prepared 2009 (\$000s)
Total Non Interest Expense	26,000	27,500	24,050
Expense Ratio (NIE / AA):	2.60%	2.97%	2.60%

Expenses can easily balloon up to almost 3% of assets when deleveraging.

**It is important to shrink expenses while shrinking the balance sheet.**

- Areas to analyze include:
  - Consolidating branches
  - Reducing personnel
  - Revisit benefit packages
  - Renegotiate contracts for better terms
- Think: What can be outsourced for cheaper? Can the vendor grow with me?
- A **line by line analysis** must be completed at every institution. Reviewing every expense is the only way to eliminate all unnecessary costs.

The results is staggering when active planning and proper execution of strategies are employed . . .

Income Statement	2008 (\$000s)	Unprepared 2009 (\$000s)	Prepared 2009 (\$000s)
Interest Income	52,932	44,673	46,114
Interest Expense	17,143	16,878	16,405
Net Interest Income	35,790	27,796	29,709
Provision	2,000	2,000	2,000
Non Interest Income	8,000	7,000	7,000
Non Interest Expense	26,000	27,500	24,050
Net Income, Pre Tax	15,790	5,296	10,659
Taxes (33.0%)	5,211	1,748	3,518
<b>Net Income</b>	<b>10,579</b>	<b>3,548</b>	<b>7,142</b>

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

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1. Minimizing de leverage – We must hold size
  2. Detailed product planning to increase spread
  3. Restructure balance sheets to reflect new market realities
  4. Manage fee income but don't count on it as a strategic panacea
  5. Hold or cut expenses, the net between noninterest income and noninterest expense should be less than 2.00%

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 . . .

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- 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.

You can find details on FinPro's most current presentations at [www.finpronj.com](http://www.finpronj.com) . . .

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- *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

Without action, Banks will experience material shifts in their balance sheets and income statements over the next few years . . .

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### 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, and it's use punished by the FDIC
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