The Strategic Mindset of Tomorrow's Community Bank CEO

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Founded in 1957, the SW Graduate School of Banking (SWGSB) Foundation is a financial services educational institute whose mission is to deliver comprehensive education that will enhance the critical, analytical, and strategic thinking skills of current and emerging leaders in the financial services industry. Its programs include the SW Graduate School of Banking, the Assemblies for Bank Directors, the Workshop for Bank Directors, the ABA Commercial Lending School, the Bank Operations Institute, as well as IBAT’s Bank Marketing Institute. Through its superb dissemination of knowledge and expertise, the Foundation has become the nation’s most trusted source for financial services education and strategic planning. It is headed by S. Scott MacDonald, Ph.D., and based at the Cox School of Business at Southern Methodist University, Dallas, Texas.
What will a Successful Bank of the Future Look Like?

It will bring forward the best business practices from the past, leave behind the worst and embrace the new environment.

The rules have changed and we must adapt, overcome and improvise or leave. There would be no disgrace, the change in rules would scare the hell out of anybody!

--S. Scott MacDonald, Ph.D., with a few liberties from movies!!!

Building a Strategy in Uncertain Times

- The “New Rules:” They Are Here to Stay
- Economic Uncertainty Will Continue
- Higher Capital Requirements and Basel III
- Growth: Where to Get it and Are We Allowed!
- Concentrations: Loans, Products, and The Industry
- Branch Strategy: The Game Has Changed.
- A New Era in technology
- What Will The Bank’s Future Funding Model be?
- New Sources of Income.
- Long Term Cost Control: It is Our Future!

Adapt To an Ever Changing Environment:
Just Get Right With it.
The New Rules.

They are here to stay, at least for a while. The most important strategic objective is to learn how to live with them, or figure out how to change them.

But most importantly, quit whining about them!

Many of the new rules, since the financial crisis, have lowered bank franchise values. Are they permanent?

- Continued economic risk
- Weak economic conditions
- Higher effective capital requirements
- Less tolerance for loan growth
- Lack of loan demand
- Oversupply in the industry
- Increased competition for the best customers
- Higher compliance costs
- Attack on sources of income
- Too Big to Fail
Economic Uncertainty

“As long as you don’t know the rules and yields remain at near zero, the economy will continue to struggle.”
--S. Scott MacDonald, Ph.D.

The Fed must balance, chaos on the one hand and total disaster on the other!

As we have seen, any mention of slowing or stopping of QE, will have bond traders running for the hills.
QE too long and massive inflation will occur.
We talked our way into QE3+

“If you can’t lower interest rates anymore because they are at zero, what’s the next best thing? Promise never to raise them.”

—S. Scott MacDonald, Ph.D.

The Fed is now trying to talk us out of it!!

The Taper “Tantrum”

Bloomberg survey, July 18-22, indicates that over 50 percent of economists surveyed expect a September 2013 taper.
“I think, I am thinking about, thinking about letting off the gas”
-- Uncle Ben.

"If we see continued improvement and we have confidence that that's going to be sustained then we could in the next few meetings ... take a step down in our pace of purchases," said Bernanke.

"If we do that it would not mean that we are automatically aiming towards a complete wind down. Rather we would be looking beyond that to see how the economy evolves and we could either raise or lower our pace of purchases going forward."
May 2013.

That’s when the baby went into its tantrum.

The 10 year Treasury cried and increased to almost 3 percent.
Bernanke told congress last month, it is all up to them at this point…

“I emphasize that, because our asset purchases depend on economic and financial developments, they are by no means on a preset course,” he said.

“The pick-up in economic growth projected by most [FOMC] participants partly reflects their view that federal fiscal policy will exert somewhat less drag over time, as the effects of the tax increases and the spending sequestration diminish,” but the Fed may have to adjust its plans if Congress orders another round of near-term budget cuts or veers into another market-shaking budget crisis, he said.

“The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect, or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery.”

The exit strategy debate

• The exit strategy approved two years ago called for the Fed to sell its portfolio of mortgage-backed securities over three to five years,

• Minutes of the Fed’s policy-setting meeting in June (2013) show that most officials now believe the central bank should hold on to that debt.

• **Reason:** its to big to deal with?!?!?!?!?
  • **Problem:** they assume 30 year mortgages will pre-pay in 3-6 years, wrong. Extension will be much higher.
  • **Problem:** potential capital losses if the Fed holds the bonds.
  • **Problem:** potential significant inflation as banks begin to lend again.
QE has had a positive impact upon our 401k’s.

There will be higher capital requirements for those bad banks!

Source of quote: everybody!!
Successful banks of the future will manage their limited capital and have a capital contingency plan.

- How much capital is needed is driven by:
  1. Regulatory requirements
     - The old regulatory minimum, called well capitalized (5% leverage and 10% risk based) is much higher today (at least 8 and 12 percent).
     - Basel III
  2. Strategic requirements:
     - Future growth opportunities
     - Risk tolerance of the institution
     - Current and future earnings of the institution

### Basel III: Minimum Capital Levels

<table>
<thead>
<tr>
<th>Minimum Regulatory Capital Ratios and Capital Buffer</th>
<th>Current Treatment</th>
<th>Treatment in Final Rule</th>
<th>Section(s) in Rule Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common equity tier 1 capital (CET1) ratio</td>
<td>N/A</td>
<td>4.5%</td>
<td>Subpart B, § 10</td>
</tr>
<tr>
<td>Tier 1 capital ratio</td>
<td>4%</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Total capital ratio</td>
<td>8% (or 2%)</td>
<td>8% (no change)</td>
<td></td>
</tr>
<tr>
<td>Leverage ratio</td>
<td>4% (or 2%)</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Capital conservation buffer</td>
<td>N/A</td>
<td>Capital conservation buffer (composed of CET1 capital) equivalent to 2.5% of risk-weighted assets in addition to the minimum CET1, tier 1, and total capital ratios</td>
<td>Subpart B, § 11</td>
</tr>
</tbody>
</table>

CET1 = Common equity tier 1 capital; total capital ratio = CET1 + Tier 1 capital; leverage ratio = Tier 1 capital / Total assets.
### Basel III: Capital

<table>
<thead>
<tr>
<th>Definition of Capital</th>
<th>Current Treatment</th>
<th>Treatment in Final Rule</th>
<th>Section(s) in Rule Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>CETI</td>
<td>No specific definition</td>
<td>Common stock (plus related surplus) and retained earnings less the majority of the regulatory deductions</td>
<td>Subpart C.§206(b) and §22</td>
</tr>
<tr>
<td>Tier 1 capital</td>
<td>Common stock (plus related surplus) and retained earnings less the majority of the regulatory deductions</td>
<td>CETI plus non-cumulative perpetual preferred stock and guaranteed non-cumulative preferred and other securities, less certain regulatory deductions</td>
<td>Subpart C.§206(b) and §22</td>
</tr>
<tr>
<td>Mortgage servicing assets (MSAs), certain deferred tax assets (DTAs) arising from temporary differences, and certain significant investments in the stock of unconsolidated financial institutions</td>
<td>MSA and DTAs that are not deducted are subject to a 100% risk weight</td>
<td>These items are subject to more stringent limits and a 250% risk weight; amounts above the limits are deducted from CETI capital</td>
<td>Subpart C.§206(b)</td>
</tr>
</tbody>
</table>

### Basel III: Changes in Risk Weights

<table>
<thead>
<tr>
<th>Standardized Approach for Risk-Weighted Assets</th>
<th>Current Treatment</th>
<th>Treatment in Final Rule</th>
<th>Section(s) in Rule Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial real estate (CRE) loans</td>
<td>100%</td>
<td>100% for most CRE loans and 150% for high volatility CRE loans (HVCRE), which is a subset of CRE</td>
<td>Subpart D.§32(j)</td>
</tr>
<tr>
<td>Past due exposures</td>
<td>Risk weight generally does not change when loan is past due (except for residential mortgage exposures)</td>
<td>Generally, 150% risk weight (except for sovereign and residential mortgage exposures)</td>
<td>Subpart D.§32(k)</td>
</tr>
<tr>
<td>Conversion factors for commitments with an original maturity of one year or less</td>
<td>0%</td>
<td>0% if unconditionally cancellable at any time; otherwise 20%</td>
<td>Subpart D.§34</td>
</tr>
</tbody>
</table>
Capital is king, but regulators do not run your bank, although it might feel like it sometimes!

**Strategic Capital Needs are Driven by:**
- Current and future growth plans
- Loan quality / risk issues
- Concentrations in real estate
- Borrowed funding dependence
- Policy and procedure issues
- Operational controls

Regulators will focus on capital for some time to come.

We must have a strategic capital plan which includes a capital cushion and a contingency capital strategy.

Capital management and carefully planned strategic growth, not growth as a strategic plan, will be the “normal” for successful banks of the future.
How do we measure “success?”

In our most recent past, many participants measured “success” by how big we were, in terms of assets and footprint.

It is not growth that leads to success, rather the quality of the footprint we do create.

There is a delicate balance to growth.

We must all grow or die, but if we grow too fast we are a weed!
It is about the quality of growth!

• Growth in total assets and branches is not always the optimal way to grow. Can lead to:
  • A higher risk profile.
  • Too many branches
• Rapid growth of the recent past has resulted in some excess capacity:
  • Some will need to shrink to their core business.
• Increased regulatory burden, on the other hand, means that the minimum cost effective size of financial institutions is increasing:
  • Some smaller institutions must increase in size or leave the market.

*We can also grow in earnings, prestige, product innovation, meeting the needs of our existing customers, quality of our products and services, just to name a few. Asset growth does not guarantee success!*

Growth will be highly scrutinized in the future both by the regulatory community and investors as well.

**The real question is how have we grown?**

Chasing the same business?
With margin compression?
With more branches than we need?
Taking greater risks?
Concentrations in real estate?
Through borrowed funds?
Concentration Risks

We Have a Few Too Many Concentrations:
- Loan Concentrations (Real Estate)
- Funding Source Concentrations (Borrowings)
- Noninterest Income Dependence (Overdraft)
- The Industry (Too Big to Fail)

The real question is, how did/do we grow?

No longer is all about getting or keeping the business, rather the profitability and risk management of the business we choose to keep or obtain.
The Changing Banking Business Model

Mergers, branches, new technologies, concentration of assets, increased dependence on borrowed funds and a long-term decline in net interest margins.

A new “branching” order

- Branches
  - Can’t live with them, can’t live without them.
  - Long-term they are not needed.
  - The half life of a branch is 5-10 years.
  - Average branch deposits will fall from over 250 per day in 2001 to less than 50 in 2016.
- Competitive challenges in redefining the role of the branch and its impact on competitiveness and survivalability
Why do we need a branch?

Build core deposits?
Build core loans?
Billboard to increase brand awareness?
‘cause…everybody else is doing it?

Total banking offices appears to have fallen for the first time (2011) in over a half century!

Source: FDIC
We must strategically reassess our branching needs and operate with more productive branches.

- Develop a branching model to meet the needs of your customers
- Re-evaluate the strategic location of existing branches
- Use technology advances and reassess your true need for a branch
- The need for physical branches will continue to decline over time.

Impact of Technology on the Future of Banking

Dramatic technological changes are no longer “in the future” or “will be here soon.”

They got here a few years ago, we are just slow to adapt, overcome and improvise.

We are at risk of becoming “irrelevant!”
Technology will dramatically change the face of banking going forward.

1. Convergence of Mobile and Online Technologies
2. The Rise of Business Process Management and the need to manage big data
3. Goodbye Email, Hello Message Center
4. The ‘Tabletization’ of Banking and the User Experience
5. Security increasingly is A Moving Target
6. Integrating Toward a Brave, New Post-Channel Integration World, all delivery channels must be integrated.
7. Pushing Self-Service Products to Generate Revenue
8. Reaching the Next Level of Mobile Evolution, what will the payment systems of the future look like?


What will payment systems of the future look like?

- The banking industry has been losing control of the payment system for several decades.
- What risks to the system does this bring.
- Over 50 percent of adults own a smart phone and over 30 percent use a tablet.
- Non regulated payment parties.
- **Bitcoin.** Bitcoin uses peer to peer technology to operate with no central authority; managing transactions and issuing Bitcoins are carried out collectively by the network. Through many of its unique properties, Bitcoin allows exciting uses that could not be covered by any previous payment systems.
Where does the bank fit in?

- Google?
  - “Here’s a business who sells what you’re looking for.”
- Amazon?
  - “Buy whatever you’re looking for from us.”
- Merchants?
  - “Buy, Buy, Buy!!”
- Apple / ATT
  - There’s an app for that!
- Financial Institutions?
  - “We’ll help you decide whether, when, and where it makes sense to buy the stuff you want... in real time.

Source: Lee Wetherington, ProfitStars with additions

IT Risk: The Big Hack…

- Organized global threats
- Easy access often means “easy access.”
- Human error
- Use of voice recognition, good or bad!
Big Data

Data have swept into every industry and business function and are now an important factor of production, alongside labor and capital.

The amount of data being created is almost overwhelming

Surf’s Up
The amount of data coursing through the global Internet, annually. An estimate is one billion gigabytes of information.
Big data can create value, or create significant risks

- The more data, the likely we are to lose it!
- The more data, the more difficulty it is to manage it!
- More data can mean more opportunity:
  - The more data we have on our employees, customers and products, the more we can increase productivity of our employees, meet our customers needs or improve the quality of our products.
  - More data, allows us to customize the types of products and the methods of deliver.
  - The risk are the cost of storing and our inability to manage the massive quantities of data.

Non Core Funding is great, but too much of a good thing is not good!

- Many, if not most bank's that failed were overly dependent on borrowed funding.
- Borrowed funding is asset quality sensitive.
- Can often lead to over-risked and underpriced portfolios.
In the past, core deposits were a natural governor on growth.

New funding sources, such as FHLB advances, Internet deposits, CDARS, and brokered deposits are great for the industry, but still represent a source of liquidity that once used, are no longer available.

The bank’s source of funding changed Funding is not a "constraint" anymore. Core deposits are still a primary source of value today.

Source: FDIC
What will be the “new normal” with respect to loan deposit ratios?

Low loan demand, large banks dramatically cutting bank lending as well as an influx of deposits means our loan deposit ratios have fallen dramatically. Is this a return to normal?

Succession of management and boards

- Although aging management and boards has been a legacy problem in community banks, it could be worse this time.
- The talent gap is greater.
- Some bank’s have a less diversified talent pool.
- The shareholder succession gap is greater.
- The age and talent of some management teams and boards is problematic.
- Difficult to attract talented management and board members in smaller community banks!
New Sources of Income

Was Overdraft our Crack?
All that needs to be said!

We must develop new lower risk and higher value sources of income or enhance existing sources to meet the needs of their customers.

Margin compression and new regulatory requirements on existing sources of income require updates to our strategic plan.
New Sources of Income Can Take Many Forms

- By the bank staff having knowledge of existing products and how these products can help clients solve their financial needs
- By pricing our existing products more effectively
- By delivering upon the “promise” of value added products and services
- By diversifying our loan portfolio
- With strategic cost control
- By acquiring new income streams

At least quarterly, boards should ask, how do we make our institution more flexible going forward.

Accept that our future will be different and plan for our future needs today…

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- There will be “new” rules, plan for that today.
- Plan for your future talent needs today.
- Plan for your future customer needs today.
- Our margins are falling, plan for your new income sources today.
There is a reason the front windshield of a car is much bigger than the rear view mirror.

- We must be looking forward, not dwelling in the past.
- The rules have changed, and although it is easy to get caught up in the complaining about regulatory burden syndrome we must focus our efforts on how to be successful in an new environment.
- We must plan years in advance and failure to devote the resources will most certainly mean liquidation.
- Plan for the succession of our senior staff and board of directors
- Plan for the succession of our shareholders
  - Will our future shareholders stay with us?