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INVICTUS
Bank Insights

Regulatory Focus on Strategic Planning Means New Analytics for Approval

While regulators are increasingly urging banks to focus on careful strategic planning, community banks need to know that traditional analytics won't get their plans approved. Comptroller Thomas J. Curry made that clear in an **address** earlier this month when he advised community banks to "make sure that your capital plan remains aligned with your strategic plan."

The Federal Reserve has also advised community banks that capital planning should be coordinated with strategic planning to give a more "holistic view" of the bank's needs. In **"Capital Planning: Not Just for Troubled Times,"** Jennifer Burns, Senior Vice President, Supervision, Regulation and Credit, Federal Reserve Bank of Richmond, wrote that a capital planning process "consistent with the bank's risk levels and growth plans helps the board and management plan more effectively for both capital and business line decisions."

Invictus Consulting Group chairman and founder Kamal Mustafa said in today's regulatory environment "you have to change your analytics to do a strategic plan." The reason: Regulators can no longer extrapolate a bank's future performance based on how it did in the past. They learned that lesson after the recession, which disrupted both the right and left sides of a bank's balance sheet. While many banks have worked out much of their troubled loans, those workouts have taken place during an artificially low interest rate environment and jobless recovery. And that portends problems in the future, when those new loans again come under pressure.

"Historical analytics that used a constant base are no longer valid," Mustafa noted. "The whole base has changed and the fundamentals have changed."

The only way to get a forward-looking view – which is what regulators now require—is to put plans and balance sheets through an extensive capital stress test. The results can help community banks customize their regulatory capital requirements and determine how much FreeCapital™ they have for discretionary use. Unlike the process for larger banks, community bank stress testing is relatively simple.

The stress test enables a bank to make sure that its strategic plan is, as Curry said, aligned with its capital plan. It is that element that has taken stress testing out of solely being a risk management function and put it squarely in the boardroom.

Three Basic Steps for Strategic Planning

1. Identify realistic goals
2. Commit resources
3. Measure performance

Source: **FDIC presentation**

The message that banks should focus on strategic planning has come from every federal regulator in recent months. The OCC listed it as a main priority in its semi-annual **risk perspective** in June, noting that examiners would focus "on banks' strategic business and new product planning to ensure appropriate risk management processes are established."

The FDIC has mandated written "realistic, comprehensive strategic plans" in its recent consent orders, according to a review of 2014 enforcement orders. Most of those orders call for the banks to come up with new financial goals, "including pro forma statements for asset growth, capital adequacy and earnings."

Careful strategic planning is the best way for community banks to get on a path toward success, Curry said in his Oct. 1 speech. "Strategic planning can help define how you want to position your business and service activities, identify your best opportunities, and provide guidance when you need to make hard choices about the unknown and uncontrollable," Curry said.

The OCC's **final rule** mandating heightened standards for large banks offers an outline for strategic planning that smart community banks would be wise to follow.

The final rule calls for the large banks to come up with a three-year strategic plan, noting that plans covering shorter time periods would be insufficient to manage longer-term risks. Boards must evaluate and approve strategic plans and monitor management's implementation efforts at least annually. *[Continued on Page 2]*

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[Continued from Page 1] Under the rule, the CEO is responsible for development of the plan, with input from front line units, independent risk management and internal audit. The plan should contain:

1. An overall assessment about risks the bank faces – or could face – during the life of the plan, and how those risks would affect the plan.
2. A mission statement and strategic objectives, including how the bank would achieve them.
3. A detailed explanation on how the bank would update its risk framework to account for changes in the bank's risk profile projected under the strategic plan.

The rule also notes that banks need to review and update the plan if the risk profile or operating environment changes in unanticipated ways. ▪

Leading the Board of Directors through Effective Strategic Planning

Invictus Consulting Group executive director Thomas P. Rideout, a former bank CEO and past volunteer president of the American Bankers Association, has guided many bank boards through effective strategic planning discussions. He says the key is making sure that bank directors are committed to the process, and know how to oversee it from planning to execution.

Rideout says there are five key questions board members must ask and answer:

- ✓ What is our mission?
- ✓ Who is our customer?
- ✓ What does the customer value?
- ✓ What are our results?
- ✓ What is our plan?

Once the bank board identifies the answers to those questions and identifies its strengths, weaknesses, opportunities and threats, it must then set a timeline to implement the strategic plan. It must also complete a forward-looking strategic financial planning review, which in today's environment should also include a capital stress test. It should review the results against peers in the bank's geographic footprint and build a financial plan and budget to implement initiatives based on priority rankings, Rideout advises.

What it Takes for Smart Strategic Planning

1. Develop a vision with the right people and careful execution
2. Attract and cultivate board-level expertise
3. Keep your plan, but evaluate it and revise when conditions or risks change

Source: Federal Reserve's *Community Banking Connections*

Strategic planning can be a waste of time if the bank fails to focus on substantive issues, such as independence, the bank's business strategy, capital allocations, ownership, marketing, technology issues and the current business environment, Memphis attorney Jeffrey Gerrish, a former FDIC regional director, advises at industry conferences. Gerrish writes in handouts that planning sessions should be fun and they should end with a clear action plan and lines of accountability.

OCC Comptroller Thomas Curry said in a recent **speech** that the strategic planning process is about increasing the odds of success, knowing that there will be difficult tradeoffs to make. "In the most straightforward narrative, your strategic planning process and execution should help find answers to the following questions: "Where are we now? Where do we want to be? How do we get there? How do we measure our progress? And, what adjustments are necessary to meet our goals?"

Invictus senior partner Adam Mustafa outlined timely questions boards should also be asking in the August issue of ***Bank Insights***.

Regulators emphasize that an essential aspect of strategic planning includes a careful assessment and evaluation of the bank's staff and leadership. "It is important to critically evaluate if the folks that got the bank to 'here' are the best ones to get you 'there'," Curry said in the Oct. 1 speech.

"Educating and engaging board members can be valuable in the strategic planning process. Conversely, jumping into a new product or business line without effective challenge from board members can result in future headaches," **writes Cathy Lemieux,** executive vice president of supervision and regulation at the Federal Reserve Bank of Chicago, in *Community Banking Connections*.

A good strategic plan considers risks that come from "within, without or via new or modified products and services," the FDIC **instructs**.

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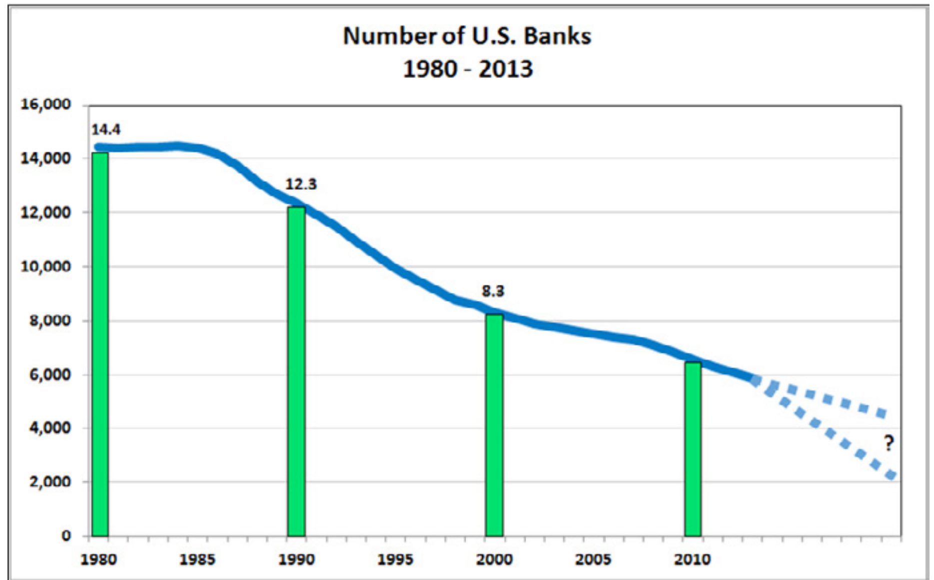
To make sure that a strategic plan can be executed the right way, a bank must have the right people in place in both management and on the board, the Fed warns.

The board has a fiduciary responsibility to maximize shareholder value. "When you are doing strategic planning with the board, make sure they know who the shareholders are and what they want," suggests John T. Reichert, an attorney with Godfrey & Kahn in Milwaukee.

Strategic planning has become crucial in today's era of low interest rates and industry consolidation, as the chart to the right shows. "Status quo is not a viable strategic plan. In this low rate environment, you need to continually find ways to reinvent yourself," he said. ■



THE CEO CORNER
Why Strategic Planning is So Important to Community Banks

By Vito Nardelli

FDIC statistics show that many community banks have earnings difficulties. I suspect that a good number of these banks are attempting to get to safe ground and are trying to avoid regulatory criticism.

They are falling victim to the utility school of bank management, which says that you accept slow or low growth, pay a modest dividend and wait till this regulatory cycle ends. The problem with doing that is many banks won't survive to see the next cycle.

Others are spending money and precious management time on the wrong processes and programs. Unfortunately, there are some institutions that are now beyond repair and whose only hope is to be sold.

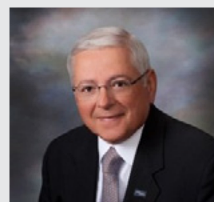
The cost component cannot be left out of the analysis: It is the number one killer of most failed businesses, and banks are no exception.

The Invictus approach to this new banking environment is efficient, focused, and calibrated to maximize a bank's returns, while minimizing costs and aligning the regulatory compass. Banks are spending money to comply, but are they getting the desired result? The old way of dealing with regulatory change is the wrong way. These regulations are here to stay, and you can't jaw bone your way out.

The regulatory discussion must include not only capital and credit, but also improve earnings.

Management and their respective boards must be willing to demonstrate that they are prepared to make the right strategic decisions to chart a new course for their banks. ■

About the Expert



During his 30-year financial services career, Vito Nardelli has excelled at building and maintaining excellent relationships with regulators. He served as the President and COO of OceanFirst Financial Corp. and as President of OceanFirst Bank in New Jersey. Previously, Mr. Nardelli served as the Senior Vice President and Retail Banking Director for Trust Company Bank, and held several leadership positions at First Union National Bank, including president of the Central New Jersey region. He has also served as Executive Director of the New Jersey Economic Development Authority in the 1990s, and was a Lieutenant Colonel in the United States Air Force Reserve. He received his BS and JD degrees from Fordham University and has an MBA in Executive Management from St. John's University.

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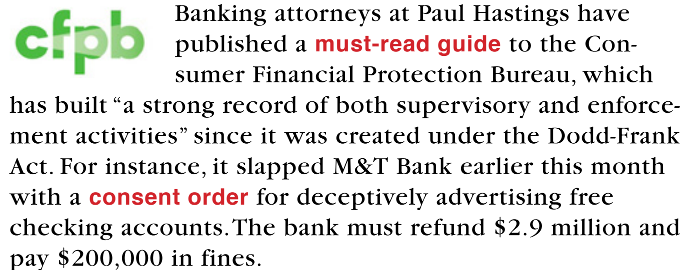
Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

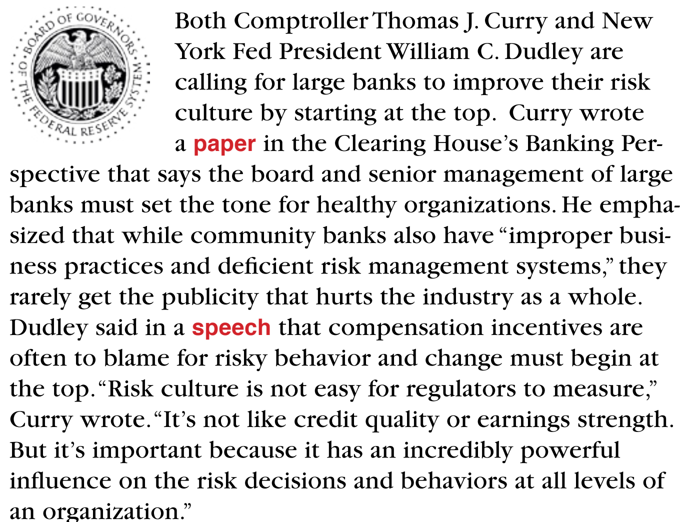
Just in: Must-Read Guide to CFPB



Banking attorneys at Paul Hastings have published a **must-read guide** to the Consumer Financial Protection Bureau, which has built "a strong record of both supervisory and enforcement activities" since it was created under the Dodd-Frank Act. For instance, it slapped M&T Bank earlier this month with a **consent order** for deceptively advertising free checking accounts. The bank must refund $2.9 million and pay $200,000 in fines.

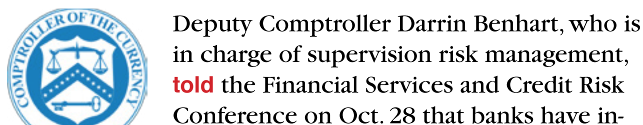
The lawyers stress that the CFPB's enforcement attorneys provide input to the supervisory examination process, routinely meeting with examiners and giving advice. So when should a bank cooperate with the CFPB, which has levied millions in civil money penalties and other fines against banks and other financial service providers? For one thing, the lawyers say, respond to requests for information as fast as possible. That can reduce a civil money penalty, if one is issued. The lawyers caution not to go over CFPB staff to senior officials, except "in truly exceptional circumstances."

A Strong Risk Culture Starts – and Ends – At the Top



Both Comptroller Thomas J. Curry and New York Fed President William C. Dudley are calling for large banks to improve their risk culture by starting at the top. Curry wrote a **paper** in the Clearing House's Banking Perspective that says the board and senior management of large banks must set the tone for healthy organizations. He emphasized that while community banks also have "improper business practices and deficient risk management systems," they rarely get the publicity that hurts the industry as a whole. Dudley said in a **speech** that compensation incentives are often to blame for risky behavior and change must begin at the top. "Risk culture is not easy for regulators to measure," Curry wrote. "It's not like credit quality or earnings strength. But it's important because it has an incredibly powerful influence on the risk decisions and behaviors at all levels of an organization."

Could Auto Loans Surpass HELOC Risks?



Deputy Comptroller Darrin Benhart, who is in charge of supervision risk management, **told** the Financial Services and Credit Risk Conference on Oct. 28 that banks have increased auto lending, but they are often focusing more on monthly payments than the overall debt of the borrower. "The results have yet to show large-scale deterioration at the portfolio level, but we are definitely seeing the signs of increasing risk," he said. One indication of trouble to come: Bank charge offs for bad auto loans increased 12 percent in 12 months. While regulators have warned of a HELOC crisis, Behart said banks and thrifts have taken the risks to heart, reducing their exposures by $43 billion. Still, he said, much remains to be done, which is why the banking agencies issued **guidance** in June on how banks should handle end-of-draw challenges.

Examiners See Signs of Strategic Vulnerability

Regulators from the Fed, the FDIC and the OCC recently told New Jersey banks that they are increasingly seeing signs of strategic vulnerability among community banks. Banks are seeking alternative ways of increasing shareholder value, and even institutions with more than $1 billion are looking at mergers and acquisitions, hoping for economies of scale. Competition on lower pools of loans is putting pressure on deals and products, which is hurting margins. Banks are giving up yield to protect against rising interest rates. Staying liquid and having a tighter margin is a prudent approach, one regulator said.

Fed President Blasts Community Bank Regulation

Kansas City Fed President Esther George criticized the state of community bank regulation in her keynote **speech** at the recent Fed/CSBS conference. She said rules "are increasingly prescriptive and complex' and even capital rules were too complicated for community banks. "For community bank supervision, the substitution of rigid rules for examiner judgment has altered the supervisory process without adding value and has instead created higher costs of compliance," she said. ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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