THE KAFAFIAN GROUP INC.
...helping banks perform better™

Performance Measurement | Strategic Management | Profit & Process Improvement | Board & Management Advisory Services | Financial Advisory

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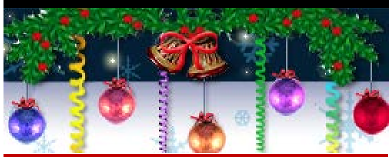
TKG Perspective



The Kafafian Group wishes all our clients, business associates and friends a Happy Holiday Season!

Events

Teaching & Speaking Engagements

Financial Managers Society
Union League
Philadelphia, PA **March 12**
Financial Industry Overview

Washington Bankers Association
Washington Athletic Club
Seattle, WA **March 12**
Executive Development Program

Utah Bankers Association
Wasatch Retreat & Conference
Utah, NV **March 14**
Executive Development Program

Conferences, Conventions & Other Events

New York Bankers Association Economic Forum
Waldorf Astoria
New York, NY **February 12**

AMIfs
Annual Profitability and Risk Conference
Renaissance Las Vegas
Las Vegas, NV **March 19-21**

New Jersey Bankers Association Annual Convention
Marco Island Marriott
Marco Island, FL **April 30–May 4**

Pennsylvania Bankers Association Annual Convention
The Ritz Carlton
Naples, FL **May 14-17**

Lessons from Management Reviews

By: George W. Millward, Managing Director

Over the past three years, TKG has been engaged by a significant number of banks to provide an assessment of the capabilities of management to operate the bank in a safe and sound manner. Most, but not all, of these assessments have been required by regulatory requirements, expressed either in formal enforcement actions or through more informal processes. Many of these reviews have also included a review of the effectiveness of the Board of Directors.

All of these studies have raised the "anxiety quotient" within the banks and their boards. At times their outside advisors suggested that the requirement for a management review should be interpreted as a "heads must roll" mandate from the examiners. In those cases where the Boards have engaged TKG without an examiner mandate, management generally perceived the review request as a "no confidence" vote in their work.

When management has been deeply engaged in attempting to address the bank's issues, the introduction of a management study is often felt by the management team as an affront to their efforts to turn the bank's performance around. Consequently, reducing this anxiety is critical for the review to be helpful to the Boards and management teams.

However, the most important and overriding issue is how a bank can succeed in today's environment. Much has been written on the strategic issues banks face. Clearly the work required to operate a profitable institution in a safe and sound manner is becoming much more difficult given the pressing forces from outside each individual bank and the industry as a whole. But throughout the last five years, some banks have not only just survived but thrived. Others competing in the same markets have purposefully laid the basis for their future growth. But some banks – again, serving the same markets – have not done either. So while external forces are important factors to strategic success, they do not explain why some banks succeed and others do not.

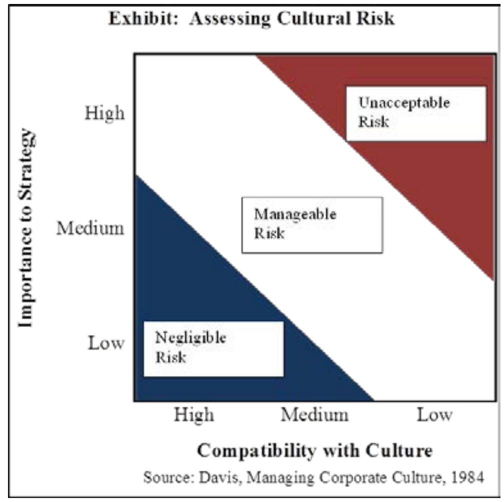
The management reviews suggest some answers. In keeping with TKG's advice to our clients to focus on a few critical strategic issues, the following are the top five observations regarding factors for success selected from our management reviews:

First, "Plan your work, work your plan." Many of the community banks that have been the subject of our management reviews have had a strategy of "just existing as a community bank". In other words, no one in the bank (management or Board) knew why they are in business or the type of business they wished to run.

Setting a direction that is relevant to the market and can be easily communicated within and outside the bank is essential for any community bank to survive. An annual review of strategy enables the Board and management to confirm the bank's direction, scope and pace of implementation. However, such a review should not imply that strategy needs to change annually. But, realizing that the current strategy will not work in a changing environment requires the Board and management to have the courage to re-assess and change.

Many of the banks we reviewed knew that their direction was leading them into trouble, but failed to make the difficult decisions to change course. Finally, having a clear focus on the key measurements for success is essential. Successful executives "manage processes and measure results". Some of the banks that have experienced difficulty changed this focus to "managing results" – especially looking to manage the metrics of ROE, ROA and EPS. Doing so led to "reaching for earnings" either through purchasing more risky investments, extending credit to marginal borrowers and/or engaging in fee-based businesses that were outside the bank's core expertise.

Second, understanding the culture is critical to success. A key step in TKG's process in conducting a management assessment is developing an understanding of the corporate culture. "Corporate culture" is a pattern of shared beliefs and values that provide the members of a bank the rules for behavior in their organization. Cultures drive where responsibility and accountability for decisions rest, either with the CEO, executive management or within the organization. Examples include the dominant CEO; a "de novo" environment where responsibility is not clearly delegated but rather everyone is involved in everything; a personality-driven organization where a dominant Board member or executive is seen as the final arbiter of all activity; or a lender-centric bank where credit decisions are the sole purview of the lending staff.



As displayed in the Exhibit a mismatch of strategy and culture can elevate risk. For example, delegating the development of a new business to a third-level manager in a personality-driven culture will fail. So will expecting lower level employees to call the bank's "whistle-blower" hotline in a CEO-dominated bank. The desire of many banks to develop fee-based businesses typically fails to account for the differences in the cultures of those businesses as compared to the traditional community bank model. The Exhibit provides a graphical approach to connecting the strategy and culture issues, but to make it useful will require the Board and especially the management team to be honest about the set of shared beliefs and values that characterize the organization.

Third, operating a solid bank takes skill, dedication and effort. Matching the leadership, manager and staff to the strategy and culture is essential for a successful organization. Indeed, part of the Board's assessment of the CEO should include a review of the CEO's ability to attract and retain a team that can implement the strategy within the agreed-upon culture. A culture that values growing leaders from within has a much greater chance of thriving. In addition, leaders, managers and staff need to "go to work" every day. Going to work every day does not necessarily imply a sober, "no fun" atmosphere. It does imply that everyone within the bank understands the bank's strategic direction; knows how their skills, motivations, behaviors contribute to achieving the overall strategy; and has confidence that their contribution will be rewarded.

Fourth, a risk oversight discipline will be essential for success. This is old news – experienced bankers have always had an intuitive sense of the balance between risk and return across the various dimensions of risk. Perhaps this sense was developed through a long apprenticeship or through structured management development programs. Neither exists in today's banking world as they once did. So now we have the emphasis on "Enterprise Risk Management" which documents a bank's risk appetite and assesses the status of the various categories of risk against the banks strategy and operations. This work seems to us as an attempt to make more explicit, objective and quantitative the intuitive skill of experienced bankers. Implementing a risk oversight discipline is important, however, many bank board members regret that they did not have a clear understanding of the risks – credit, interest rate, liquidity, price, operational, strategic, reputation or compliance – that their management team had assumed. Board members will need to be able to ask management (and expect informed answers) to the question: "if this or that happens, then what will we do?"

So, **finally**, board members have to apply themselves as well. A great deal of confusion around the appropriate role of the Board remains despite the best efforts of the banking associations and other groups such as the American Association of Bank Directors ("AABD") and National Association of Corporate Directors ("NACD") to help define Board roles and educate Board members. Joining a bank Board for the local prestige and the need for only being "present" at Board meetings are both long passed. Management processes that involve director action need to be reconsidered, for example, involving directors in the approval of loans. The new imperative will be the investment of significant time and effort in both Board meetings and outside individual development initiatives. Directors will need to hone their skills in the five crucial areas of board responsibility:

- Selection, evaluation, compensation and success of the CEO;
- Strategy development, implementation oversight and performance assessment;
- Risk oversight;
- Community involvement; and
- Management of the Board or corporate governance (board membership, committee structure, and board culture).

There really is nothing new in all of this. A focused strategy, executed in a culture that supports the taking of considered risk, performed by engaged, committed members of the Board, Management and Staff sets the stage for success. The new world of banking will continue to be more difficult than that we have experienced, but it will also be capable of deep satisfaction in the delivery of products and services which support the communities in which we operate.