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After the Perfect Storm - Strategic Execution

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Emmett Daly, the Sandler O'Neil Investment Banking Principal recently categorized banks as the "Haves" and the "Have-Nots." The "Haves," according to Daly, are banks with sufficient size and scale, a viable and relevant franchise, a scalable operating platform, credibility with regulators and investors, and access to capital through multiple sources. Daly said the "Have-Nots" are banks with a lack of funding diversity, significant asset quality issues, problems accessing capital and not enough scale to deal with the changing operating and regulatory environment.

We would add the "Small Haves" as those smaller banks that are being built with visionary leadership and focused strategic execution – "even great banks start small."

In our article earlier this year, "*After the Perfect Storm – Transitioning to a Tough, New World*," we identified a challenging environment in the combination of an anemic economy, slowing demand for loans, and the game-changing impact of regulations E, Q and the Durbin Amendment. Visionary CEOs are responding by improving profitability through a combination of: increasing revenues by capturing market share from less effective rival banks; and more cost effectively delivering products and services to customers to minimize attrition and improve margins.

Attempts to improve returns can be approached in two principal ways:

1. The parallel initiatives approach: a) cut costs in areas with low profitability, identified through activity based costing; and b) increase revenues through pricing and new products aimed at demographically-defined customer segments.
2. Strategic execution: design strategically across the bank, building a viable franchise through organic and acquisition-driven growth. This results in a combination of business approaches, processes, infrastructure and talent that begins to breathe and grow through a scalable operating platform.

The latter is a far more sustainable source of shareholder value.

Parallel initiatives to cut costs and increase revenues

Broad-based cost cutting programs represent an easy way of getting positive results in the short term. However, it is often a one-time benefit that cannot provide ongoing earnings momentum and sacrifices staff loyalty and commitment as employees "wait for the other shoe to drop."

Now that banks have more or less navigated through the credit quality issues after the perfect storm of 2008, they are beginning to focus on efficiency and cost control. Many banks are closely examining branch closings as a way to meet these goals. An article in the American Banker of May 6th pointed out that 9 % of 5,800 Wells Fargo branches and 27% of 180 First Horizon (Memphis) branches were running at less than breakeven and likely to be considered for closure this year. The same article pointed out that money center banks such as JP Morgan Chase are opening branches in areas where regional banks rule the roost, such as central New Jersey, adding to efficiency pressures on smaller banks.

What is the impact of such cost cutting? In March of 2009, Old Second Bancorp, as part of a cost-cutting program, reduced its work force, eliminated 2009 management and officer bonus plans and cut profit-sharing accruals. The overall expense reduction also called for cutting other overhead expenses and reducing assets that make up the lower earning portion of its balance sheet. Old Second Bancorp closed low-performing branches resulting in staff reductions that were projected to lower salary and benefit expenses by more than 10%. The results two years later are not what they might have hoped: an efficiency ratio up from 62.3 in March of 2009 to 75.6 in March of 2011, and core ROAA of .16 in March of 2009 down to (.58) in March of 2011.

Taking the pure cost-cutting approach as a short-term response to the challenges of the current market will often effectively destroy long-term value.

Revenue initiatives developed through segment-focused pricing and new products solutions can provide limited on-going earnings improvement in specific areas. However, the solutions are often piecemeal, not organization-wide in their application, and not focused on customer value, resulting in limited benefits.

Currently, banks are working hard in response to the pricing constraints on deposit products and services arising out of regulation E, Q and the Durbin Amendment. One favored method is to find ways of retaining current revenues through marketing or lobbying: marketing to get customers to “opt in” and/or buy new segment-targeted products with the expectation of replacing lost revenues; lobbying to get Congress and the Federal Reserve to go easy on the Durbin Amendment.

Such product design and pricing is often driven by geographical demographics and rough assumptions of customer behavior. Deposit and credit pricing targeted at regional segments without doing an end to end design for delivery does not ensure sustained earnings. Since the customer segments defined in such an approach are often arbitrary with ad hoc deposit / income / revenue limits, the process of developing and delivering targeted products for them may prove expensive and risky.

The product-segment profitability approach may help identify inefficient products, departments and activities. However, the new rules of the game require focus on product bundling, total relationship profitability and cost effective delivery across deposit and credit products. A more limited approach may lead to false conclusions and poor strategic decision-making.

Strategic Design and Execution

The alternative to the parallel initiatives approach is strategic design and execution that transforms an organization to make it a dynamic earnings engine, responsive to changing market and competitive conditions. True strategic design leads to phenomenal, sustained earnings performance predicated on the development of highly scalable and customer-centric operating platforms. Let’s look at three client examples from Aston’s last twenty years of design:

In 2003, Aston facilitated a strategic design at First Niagara Financial Group that focused on honing First Niagara’s strategy as they transitioned from a mutual savings bank to a publicly traded financial services institution. Putting the customer at the forefront of their approach, First Niagara has made outstanding progress since implementation and continues to reward shareholders through industry-leading growth and financial performance.

In the six years that have passed since the implementation of the strategic design program, First Niagara has grown from $3 billion to $29 billion in assets, and has delivered 438% total return to shareholders while the S&P bank index has lost 2%. First Niagara is in excellent position to continue outperforming the overall market and is rated a “buy” or a “strong buy” by ten of the twelve analysts covering the stock. They have taken notice of the pragmatic operating disciplines which provide the foundation for continued strategic growth and sustained investor confidence.

Similarly, in 1999, Aston joined forces with Bank of Hawaii for a strategic design of their operations and to re-focus their strategy from a broad pan-Pacific to a concentrated approach focusing on core markets in Hawaii.

Specific initiatives that underpinned Bank of Hawaii’s success included differentiating the retail branch network, dedicated offerings to small business customer segments and the refinement of the trust and private banking sales and service platforms. By reflecting customer value in interest-based and noninterest pricing, Bank of Hawaii was able to both deepen share of wallet and increase profitability dramatically, resulting in an incremental $46 million in recurring revenue and a $47 million reduction in operating expense. All of this while enabling the bank to restructure its loan portfolio and geographic footprint. Their stock price has increased 176% since announcement of the design vs. an overall market decrease of 29% in the comparable period.

When we began our work with Star Banc in 1992, it was their goal to grow into a US financial services leader and avoid a "bear hug" from Fifth Third. Through a hugely successful design and a series of well-timed strategic acquisitions (the most notable being Firstar in 1998 and then U.S. Bancorp in 2000) their asset growth has been phenomenal.

Key to their sustained success has been growth both organic and through acquisitions. One example of organic change is the design of their nationally recognized 5-Star Service Guarantees, which isolates 5 specific core customer services and measures the value customers receive relative to the price they pay. In order to translate the success of such a program into sustained earnings requires an end to end design with the appropriate components of infrastructure, process and skills. U.S. Bancorp also excelled in the systematic integration of acquired organizations, including careful expense management and special consideration of customer service and satisfaction along the way.

These initiatives have led to a continually improving efficiency ratio (from 63% to 44%) and, outstanding returns to shareholders, with stock price appreciation of 843% from January, 1992 to May, 2011 (compared to a 55% decline in the S&P Bank Index over the same period).

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To sum up, we agree with Emmett Daly's assertion that 2011-2012 will separate the longer term successful banks, the "Haves" from the "Have-Nots." An early mark of these winner banks will be whether their leadership team embarks on strategic design to respond to the game-changing environment of new regulations, soft demand and increased competition. This will enable them to differentiate themselves from those banks that are surviving on a quarter-to-quarter basis by narrowly managing their costs and financial engineering including provision management.

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