

Managing the Board of a High Performance Institution

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Exception! Exception! Exception! That is all I seem to do as a director. Govern by exception. I follow an agenda filled with reports about whether or not this policy or that procedure has been breached. Audit procedures, loan policies, compliance audits, technology audits, interest-rate risk parameters, peer performance reviews... yada, yada, yada. And once an audit has determined that such a breach has occurred, I'm consumed by auditing the process of fixing the exceptions in the original audit!

It is all, quite frankly, stultifying.

Lest you think me an irresponsible or cavalier board member, I am not. I regard seriously my duty to help set the framework for operating a safe, sound and compliant institution. I have judiciously attended any number of seminars, and viewed video tapes of "best practice" director education.

I am just not sure if what I am doing has anything to do with helping the financial institution achieve a status that can be described as "high performance." So I am going to propose an alternative mindset, a different framework for directors. A mindset based on a simple yet basic premise for a financial institution: **that it should attempt to maximize a sustainable flow of net income subject to a reasonable set of risk constraints.** A mindset that will also actively seek out those policies and procedures which will enable the institution to successfully meet the current and future set of competitive, financial, and marketing challenges.

Directors need to actively question whether or not the risk management practices and the policies and procedures which form the context for these practices allows management to:

- Encourage a competitive response to business and consumer demand for product innovation.
- Encourage management to identify and measure components of risk that can be priced, packaged, and marketed to businesses and consumers.
- Encourage management to measure costs of risk constraints to profit maximization.

To manage credit risk, do your policies encourage:

- Pricing based on estimated risk factors versus simply charging one rate for collateral type.
- Providing for loan losses based on segmentation according to risk factors versus simply providing for losses based on collateral type.

To manage liquidity risk, are you:

- Stuck on asset-based ratios versus expanding to dynamic liability-based measures.
- Limiting the institution to volatile funds ratios, dependency ratios, and loan-to-deposit ratios versus forecasting your sources and uses of funds.
- Setting policies carved in stone versus re-evaluating policies within context of your strategic plan and competitive markets.
- Using average cost for measuring the cost of alternative funds sources versus correctly identifying and measuring the marginal cost of these funds sources.

To manage the sensitivity of your income and equity to changes in interest rates, are you:

- Solely looking at cash flows from past management decisions (static gap analysis) versus forecasting the cash flows from current and future management decisions (dynamic simulation).
- Only doing sensitivity analysis to satisfy regulatory requirements versus using simulation as a regular ALCO tool to test the effect of pricing alternatives and other changes to management policies.
- Evaluating the sensitivity of the economic value of equity by only shocking the current balance sheet versus also shocking the forecasted balance sheet.

In order for their policies to be crafted to meet these challenges, directors need to grasp the basic realities facing the depository institution franchise. First, financial services and products are, in general, commodities. All of them, bar none, can be purchased by customers from non-bank, non-regulated retailers. You need not wait for Wal-Mart to recognize that the financial services business is being driven to the increasingly narrow margin business model of the retailer. The only way to take advantage of both short-run declining costs and long-run economies of scale is **growth**. Growth is the means by which a dynamic system can achieve the benefits of spreading costs over a larger asset base, thereby achieving lower unit costs produced by applying technology to the labor force and by applying the cost reduction available through outsourcing.

Next, we need to recognize that depository institutions, as a declining cost industry, must price cash flows at the margin. We need to recognize that not all “long-term” contracts actually describe the expected cash flows of the asset. A 20-year fixed term fully amortizing commercial mortgage made for a non-occupant income property investor may be justly considered to have an economic life of 5 to 6 years. Full service checking accounts represent liabilities with expected economic life of at least 3 to 5 years. Failure to recognize and price such loans and deposits based on their expected economic lives will jeopardize the ability of the financial institution to compete for the highest quality “A” customer relationship.

Furthermore, the cost of net new funds raised to support the yields of net new loans must be compared period to period going forward. Growth should be undertaken as long as it generates increases in net income regardless of the impact on financial ratios that describe the past activity of the institution.

Finally, directors need to have the help of energetic, talented management teams. These are the people who are being asked to develop the products and services required by the very competitive retail markets and to innovate using a rapidly evolving technology. When management brings products, services, tactics, and strategies to the board, management must be asked to provide suggestions as to how the director can best measure and monitor their performance.

Community banking is threatened in America. It doesn't have to be!