Rethinking Operating Philosophies and Strategic Goals

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The current legislative, regulatory, economic and interest rate environments threaten the traditional community bank earnings model and necessitates that bank directors re-examine historical operating philosophies and strategic goals.

The profitability of community banks is under severe pressure. Quantitative Easing (QE) by the Federal Reserve has caused yields on earning assets to plummet and has lowered bank funding costs to close to zero. This trend is expected to continue until the Federal Reserve is comfortable that the economy has recovered and unemployment has been significantly reduced. QE policies will continue to compress net interest margins at the same time that new regulations are placing upward pressure on operating expenses and reducing opportunities to generate fee income for services provided.

Those pressures on bank profitability combined with weak loan demand and the regulatory demands for higher capital ratios necessitate that bank boards rethink operating philosophies and modify strategic goals and expectations.

Operating Philosophies

Community banks have traditionally focused on their role in the communities in which they conduct business. They are usually supportive of their communities with both personnel commitments as well as financial contributions. They have always been aggressive with branch expansion to improve service to existing customers as well as to attract new relationships.

With the profitability model under siege, banks need to plan for the future with the expectation that current trends will probably continue and that income may not return to prior levels any time soon. They need to project these trends over a three- to five-year horizon and determine the actions that may be required to reduce or contain operating costs at levels that will be affordable based upon income projections. These actions may include strategies that in the past would not have been considered. They might include, but not be limited to:

- closing or reconfiguring branch locations,
- restructuring operating departments, deferral of expansion plans,
- more aggressive fees for services,
- increased investment in or improved use of technology to reduce/contain costs,
- outsourcing of functions,
- staff reductions/early retirement programs, and
- Re-evaluation of employee benefits.

Strategic Goals

At the same time as operational changes are being considered, bank directors must also consider changes in the strategic positioning and goals. Historically, the strategic planning process established goals for profitability and growth.

Financial goals often focused on benchmarks of 12 to 15 percent return on equity, 1 percent return on assets and 12 to 16 times leverage of capital (a capital ratio of 6 to 8 percent). For most community banks, these traditional targets are unrealistic.

If the current economic, interest rate and regulatory environment continues for another two to three years, an ROE of 7 to 8 percent will probably be a reasonable expectation.

Similarly, planning for the future should also include reasonable expectations for growth. Historically, if a bank grew deposits, it could always find assets in which to invest that provided a nice earnings increase without significant increases in risk. *This is not true today!*

Loan demand is weak and competitive pricing is intense. At the same time, investment yields and risk/return tradeoffs are unattractive. In the current environment, and for the foreseeable future, excess deposit growth over what is required to support the existing balance sheet should probably be reconsidered. This growth puts pressure on capital ratios, is negative for net interest margins and may cause the bank to take unreasonable risks if deployed in the investment portfolios in an attempt to cover the costs of acquisition.

In summary, the current environment that threatens the traditional bank earnings model requires directors to rethink both operating philosophies and strategic goals. Traditional thought processes and strategies will not be adequate to ensure future success.

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