Strategic Planning:
The Banker's "Crystal Ball"

By Jack R. Salvetti and Nancy D. Schell

Before de-regulation, the planning focus was on internal operations. In the present de-regulated environment, Regulators now stress strategic planning over their "bread and butter" requirements such as policy formation. However, in reality, strategic planning as a management tool remains foreign to many bank managers, who continue to plan focusing on internal operations and transactional thinking. For them, strategic planning remains an internally focused activity driven by SWOT analysis and other "blue sky" exercises that seem best suited for group discussions.

Today, dynamic institutions view strategic planning as the primary management activity and thus an on-going event. Institutions that employ this approach are characterized by their sharp market focus, commitment to staff development, and their ability to consistently manage net interest margin and predictable diversified income streams. Generally, their ROE and growth rates greatly exceed competitors', and the marketplace rewards them with a superior price/earnings ratio. They have satisfied their customers and attracted new ones – rewarding shareholders – rather than succumbing to aggressive market competition. In effect, they have pleased all of their stakeholders.

Discovering The Planning Gap[sm]

Employing these planning techniques creates the first inkling of a Planning Gap. What's the Planning Gap? It's the difference between the current operating trends and the desired performance levels. The Gap can be described as "business as usual" versus a look into the future. Strategic planning should create a vision of a superior future. Therefore, it is crucial for an organization to determine its potential by measuring this Gap. Effective managers realize that quantifying the vision of the future is more meaningful than searching for new adjectives to describe it such as "bigger," "greater," or "more effective." Measuring this Gap is a critical component in the planning process.

Similar to a military operation, the Planning Gap describes the objectives and measures the distance and time it takes to achieve desired financial targets.

The Planning Gap transforms a "blue sky" planning process into a realistic window on the future, reaching beyond standard accounting exercises. The starting point is to identify the magnitude of the Gap, which requires the quantification of key performance drivers for your company.

The primary strategic goal of any company is to achieve superior financial performance. Assessing the Planning Gap identifies "what" the company needs to accomplish to achieve the desired level of performance.

Figure 1 (below) illustrates the relationship between the current and future levels of performance. The base line represents the "current performance level", which is a simple projection of eight or ten financial drivers depicting a declining profit picture with zero growth.

The "desired performance level" is represented by the rising line, which is determined based on a three-year projection of the same financial measures used in the base line. By first determining growth rates, companies can translate them into real – and measurable – values, which will lead to two very significant results. First, the financial values are the "crystal ball" that allow companies to peer into the "murky future."

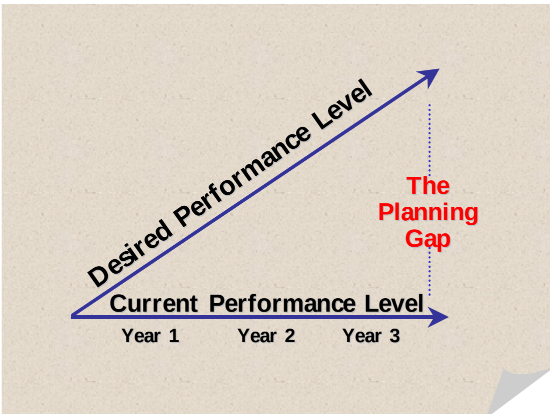

Figure 1

Second, firms gain a new and significant insight into the future, which can be measured in dollars.

By calculating earnings requirements, capital management, balance sheet mix and diversified income streams, companies can determine a specific asset growth target – a key benefit of assessing the Planning Gap.

This growth target is an extension of the "what" aspect of the plan. Another benefit of quantifying the Planning Gap is to determine a three-year planning horizon. One of the main challenges for strategic planners is to move beyond a one-year focus. Companies can easily be singularly driven by quarterly or annual financial performance expectations, rather than a longer planning horizon.

With our Planning Gap process, companies can actually measure the amount of change required for each financial indicator and view this change over an extended period. The amount of change needed to arrive at the target performance is the "Planning Gap."

Why is the Planning Gap important? For many companies, a common strategic goal is the desire to remain independent. But, how will this goal be achieved? A better approach is to project the internal growth rates of assets, earnings and market capitalization. By clearly defining objectives, the company can compare internal growth rates to other capitalization opportunities, such as a potential acquirer. Why? Because market capitalization and franchise values are driven by earnings levels. Identifying financial planning targets and developing specific strategies to achieve those goals will quickly bring your plan to life, revealing the profit potential for all players in the organization.

Filling The Gap

Once the Gap has been identified, the next step in the process is to select strategies to effectively bridge the Gap, which is the "how." Using an outline to focus the group may be helpful. The following five key categories should be addressed:

- Shareholder value
- Growth and market expansion
- Diversified income
- Human development and management succession
- Technology requirements

These categories are the "how" choices for constructing a strategy to achieve the desired growth.

<u>1. Shareholder Value</u>

Shareholder value issues begin with a target ROE and the underlying components of earnings and equity capital leverage. The efficient use of a bank's capital base is a principal strategic driver. Pegging a capital level builds consensus about the balance between shareholder returns and regulatory ratings.

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Another key planning tool is the calculation of sustainable growth rate: "SGR," computed as:

(ROE x Earnings Retention Rate)

SGR dictates the acceptable level of asset growth that can occur without reducing the tier 1 capital ratio. Using the Planning Gap, organizations can project the impact of these factors over the three-year planning horizon.

2. Asset Growth and Market Expansion

Asset growth and market expansion have always been favorite strategic planning topics for discussion, often for the wrong reasons. Talking about branch locations has created an interesting debate that often lacks facts and details. Asset growth is vital to creating future income and ROE. As ROE is the result of ROA multiplied by the leverage of equity capital, the ROA component is driven by asset growth. Many financial institutions have a high level of fixed expenses, so asset growth often can occur with nominal increases in operating expenses. The result is a high level of marginal ROA on the asset growth as depicted in figure 2 (below). The notion of asset growth as a principal driver of earnings often surprises management, who traditionally think of earnings as the antithesis of asset growth.

The fundamental difference between profitable and unprofitable growth often depends on whether the organization is asset or liability driven. While asset growth tends to be profitable, liability-driven growth is not. When intelligent pricing decisions are made, the cycle of loan demand, funding requirements, pricing and deposit market share provide the necessary directional flow for profitable asset growth. See figure 2 (below). In an asset growth environment, the strategic next step is to ask, "Where will the loan growth come from?" The answer to this question will help decide how to fill the Planning Gap.

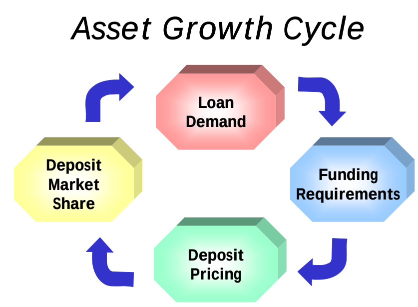

Figure 2

3. Diversified Income Sources

Financial modernization has created some attractive opportunities for additional income. Beyond the fact that additional income opportunities are now available, these are the types of services that customers value most. The American Bankers Association published a consumer survey, *Customers Speak*, in September 2001. The survey ranked consumers' six most important financial goals as follows:

- Money for retirement
- Developing a financial plan
- Saving for an education
- Money for a major purchase
- Advice on investing
- Financing or re-financing a home

Relief from net interest margin pressures by diversification of income makes strategic sense based on its tight alignment with consumer needs. Developing the competencies and a cogent business model to excel in these areas must be factored into the Planning Gap process.

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4. Human Development and Management Succession

An excellent customer experience mirrors employees' satisfaction. Providing effective training and development to enable staff to excel is the critical starting point. This investment in the organization's principal resource, its people, is overlooked in many organizations. Staff development begins with recruiting and orientation and continues on through retirement. The most direct path to differentiating your organization's customer experience is directly proportional to the investment in time and resources invested in the staff. Only in this way can organizations hope to understand the customers' perception of relationship value and their own role in meeting those needs. The commitment to building such an organization is clearly a top-down strategic management decision, and progress in this area can be defined and measured in the Planning Gap.

> **"Strategic planning should create a vision of a superior future."**

5. Technology Requirements

Perhaps one of the primary threats to the community banking industry is the required investment in progressive, rather than maintenance, technologies. This is an area where economies of scale work against a smaller organization's ability to compete. The Planning Gap effectively measures both the technology requirements and time frames needed. Building a meaningful technology plan makes little sense if it is not directly aligned with the strategic plan. The successful coordination and integration of these planning activities is crucial to maximize the return on the technology investment.

Communication: The Lynchpin To Implementation

Once the Planning Gap has been quantified and the key categories for asset growth have been aligned to the strategic plan, what's next? Since strategic planning is all about making informed choices to differentiate a company in the marketplace, the next key strategic question to ask is, "Why should someone do business with you?" While the initial answer to that question likely reflects only an internal perception, the value of customer and non-customer feedback surveys and focus groups should not be overlooked.

The ability to make the difficult choices required in strategic planning will develop over time. A solid strategic plan will clearly articulate an organization's grasp of their business and what goals are to be achieved (or not). Making these choices ultimately fills the Planning Gap, marking the incremental and strategic direction for desired growth.

However, management cannot arrive at the desired destination alone. It takes the entire team, all rowing in the same direction. Lateral, as well as vertical, communication is crucial. An executive summary in booklet format is an effective approach. An annual meeting of the entire staff for the purpose of presenting the plan achieves "buy in" and seals the CEO's commitment to the plan.

Scoring outcomes will help keep the organization on track. A monthly tracking report or "scorecard" should be prepared for the board and management, and it should include the financial drivers identified during the Planning Gap process, as well as any strategic objectives (measures).

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The final step is setting implementation goals, planning for the "who" and "when" needed to achieve success. The mature strategic planning process only demonstrates its true value when it is used to make decisions and to keep the company focused on achieving long-term success.

After all, it is in the acting out of strategy that has any value at all. ♦

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