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TOMORROW'S BANKING: FOUR PERSPECTIVES

The New Director

by JOSEPH F. DiMARIO, National Service Director for Banking, Pittsburgh

In tomorrow's business environment, every industry, including banking, will be subject to increased scrutiny. This development has been prompted by a variety of circumstances, from illegal corporate acts to the bankruptcy of major businesses, including some banks which were once considered stalwarts of the business community.

How are banks responding to these developments? What role will be played by the bank director? What are some of the specific issues that the director will face as he evaluates his position vis-a-vis the bank and the community? Finally, what is the broader picture, given that neither corporate statutes nor the courts have clearly defined what directors should or should not do?

The picture is unclear. As a result, a bank director today must largely define his own role. He must not "meddle" with day-to-day management, yet he must know what is going on and make his influence felt. What he must keep in mind is that his responsibility lies with the shareholders and the public at large, rather than directly with management. Therefore, he must be alert to possible inappropriate action by corporate officers. In many respects, he walks a fine line between his degree of involvement and the broader responsibility of establishing corporate policies and monitoring adherence to those policies. This, in turn, has made his responsibility more arduous and hazardous.

What degree of involvement should a bank director assume? In recent years, various suggestions that affect his role have been made to banking corporations:

- Appoint a full-time, compensated board whose members spend a significant portion of their time on bank matters—similar to the method used in Europe.
- Assign a corporate officer to the board of directors whose sole responsibility will be to assist in answering questions, performing studies and analyses, and so on. The officer would function much like an internal audit department which reports to the board, but his responsibilities would encompass *all* aspects of the operation and cross-functional lines extensively.
- Create audit committees to improve communications with the outside auditors and highlight the need for diligence in financial matters.
- Organize an outside group of experts to counsel the board from an independent, objective viewpoint.

It is evident that these proposals lead to a situation in which the bank director knows more, becomes more involved, and asserts his authority more often and with more meaning. Indeed, the courts have now held that a heightened awareness is required by directors on the matter of company operations and the detection and correction of wrongdoing.

Where does that put today's potential bank director? How will his actions change in the future if today's environment continues?

The Bank's Responsibility

First, it is imperative that the bank's management recognizes the board's increased activity and provides assistance to its members. The sometimes historic reasons for being a board member—i.e. influence in the business community, significant business relationships, community recognition—are not the only criteria. Management must respect the fact that the bank director has a first obligation to the shareholders and public at large, and must apprise the board of all operating matters of significance.

Many banks today are developing ongoing programs for their directors. The subject matter has included:

—A history and perspective of the individual bank.
—What banks can and cannot do according to law.
—What directors can and cannot do.
—Areas of directors' liability.
—Measures taken by the bank to limit day-to-day problems.

The Board's Responsibility

New bank directors must have the interest and available time to cope with their new assignment. They will obviously ask more questions of management prior to accepting a board position. They will weigh the bank's economic environment and the integrity of its management. In effect, the potential board member will be interviewing the bank as well as the bank interviewing him.

When approached, a potential bank director should evaluate:

—The background, interests, and involvement in bank operations of other directors.
—The bank's history in conforming with laws and regulations, and its

current policies, including conflicts of interest, loan charge-offs, and review of associated controls.
—The strength and integrity of management, its background and experience.
—The frequency and content of board meetings and subcommittee meetings, and their respective responsibility.
—The relationship between the community and the bank.
—The degree and quality of outside professional advice including accountants, attorneys, underwriters, and others.
—The status and history of litigation linked to bank activity.
—The degree to which the bank has met reporting requirements of regulatory agencies, banking authorities, the SEC, shareholders, and others.
—The number and distribution of shareholders, and the degree of concentration of ownership.
—The amount of disclosure a board member must make of his outside financial interests and their relationship to the bank.
—The time available to be an effective bank director, as well as the knowledge required, and the contribution that is necessary.

Mutual Responsibilities

■ Inevitably, the bank board member is going to become less and less discernible from management. This will come about because he will have more responsibility, thus require more information, thus will gain more knowledge, and, as a natural conclusion, become more "involved" in the activities of the bank.

■ More involvement will naturally lead to an increase in the frequency of meetings and the creation of subcommittees for specific tasks. It will also require more preparation before meetings. This increase in activity will prompt an increase in the fees the bank pays, just to attract good people to its board. Increased fees will also reflect the increased responsibility and liability of directors.

■ It has been traditional that bank officers serve on boards of their customers, other corporations, and nonprofit organizations. However, banking institutions are beginning to re-examine the role that officers should have in their community.

New bank policies will evolve which will define circumstances where such a position is desirable. The most significant emphasis will be on the possibility, indeed the reality, of conflicts which were not of concern in the past but will be of paramount importance in the future. Can the bank officer serve his bank, its customers, and outside corporations as a director and be completely independent in all "insider" respects?

There is no doubt that the role and responsibility of bank directors will continue to change. They will have to weigh the commitment necessary for their "outside" activity against the primary responsibility of their day-to-day work. Thus, the selection and acceptance process will be more rigorous, the degree of involvement will be greater, and the need for awareness and knowledge will expand. In this environment, banks will need to re-examine (1) the role of their own management in relation to the board, (2) the degree of constant communication necessary, (3) the relationship of board members to other economic entities, and (4) the acceptance of closer scrutiny and monitoring. Once this trend "settles down" to an acceptable norm, the effectiveness of bank boards, the integrity of management, and the confidence of outside influences will be retained.

The Change in Structure

by EDWARD A. KANGAS, National Service Director for Savings and Loan, Kansas City

Pads and pencils in hand, bankers are becoming organization planners. Wrestling with such questions and pondering their answers occupies more time than ever in management meetings and at banking conventions. The most common concerns are:

■ Why do I have the organizational problems that face me?

■ What are the symptoms of these problems?

■ How do I plan a more effective organization, and where does it fit with other aspects of management?

■ Am I really ready to face up to the difficult personnel questions that accompany organization change?

Tough questions—and they need answers.

Why Do I Have Problems? This is the easiest to answer. We start with several basic premises, and the more applicable each of these premises is to an industry, the greater the likelihood of organizational problems and the resulting need for organizational planning. The most important of these premises are:

—As regulatory or competitive pres-

sures force change, the need for organization planning grows.

- —As an institution grows, so does the need for sound organization structure.
- —As an enterprise increases in complexity or expands its products and services, the need grows for organizational change.
- —As the profit margin tightens, sound organization and reward mechanisms become important.

When we consider the magnitude of the changes being discussed by financial institutions, it is easy to understand why they are faced with organizational problems.

What Are The Symptoms? One must recognize the difference between symptoms and actual problems. What can be more frustrating than resolving a symptom and leaving the original problem untouched? The more obvious symptoms are overlapping responsibilities, poorly defined positions, and inadequate authority and responsibility. In most cases, however, the symptoms are more subtle:

- —Increased personal conflicts.
- —Strained working relationships.
- —Control and error detection problems.
- —Deteriorating efficiency.
- —The suspicion that no one knows what to do next.
- —Lagging competitive position.
- —A sense of losing control.
- —Awareness that people are being outgrown.
- —Difficulty in telling who is really doing a good job.
- —Goals not being achieved.
- —Certain people and departments "marching to a beat of a different drum."
- —Increased conflict with board of directors and owners.
- —Increasing numbers of problem loans.
- —Increased turnover.

> *In 1933, 4004 banks failed or were found unfit to reopen after the bank holiday. In 1934, failures fell to 62, only nine of which were insured. Eleven years later, in 1945, failures in all of the United States was down to one. The anarchy of uncontrolled banking had been brought to an end not by the Federal Reserve System but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation.*
>
> —BY JOHN KENNETH GALBRAITH

A growing bank in a competitive market area is likely to face these types of issues on a more regular basis today than ever before. If attacking the problems results in only temporary improvement, a fresh look at organization planning is probably necessary.

How Do I Plan? Organization planning is not a strategy, but a tactic. Unless this is understood, it will meet with mediocre results. Unfortunately, many executives attack organizational problems by taking out a piece of paper and arbitrarily charting new organization options. If implemented, these structures will dictate the nature of business operations in the future. To the extent that the results do not reflect strategic goals, the planning effort has been a failure.

The first step in organization planning is to analyze the bank's plans and service strategy for the next four or five years. If such a plan does not exist, it should be prepared before organization planning is conducted.

Once long-range plans are agreed upon, the organization structure which can best support the strategy is developed. Typically, the first step is to chart both the organization structure today and what it will have to be in four or five years. These two charts, laid side by side, make clear the extent of organization change that is needed. With the clear understanding that the bank must initially work with what it has, organization charts for each of the next five years can be prepared. Using these organization charts, the banker can identify new positions, identify training and recruiting requirements, and evaluate how personnel resources will be acquired and developed.

Am I Really Ready? Organizational change, especially for a business which has experienced little change in the past, can be a frightening proposition. Long-term, loyal employees, if not demoted, may be forced to live with promotions given to younger or new employees. Personal rivalries, symptomatic of the need for organizational change, will rise to frightening levels as individuals contemplate the change. Internal politics, loyalties to board members, and connections with major bank customers—all may be strained if they are used to insure favored treatment. Faced with implementing significant organization change, one can learn from the following observations of those who have succeeded:

- —Encourage middle and top management to participate in the development of corporate tactics, including organization structure.

—Prepare everyone for constructive self-analysis and criticism.
—Advise the organization that change will become a continuous process in the future.
—Use the turmoil of organization change to judge people who have proved difficult to evaluate.
—Capitalize on the opportunity to increase the overall tempo of business activity.
—Do not play favorites.

Each time a major reorganization occurs, a unique opportunity exists—the opportunity to change the thinking and mode of operation of employees. It stimulates self-analysis, rededication to goals, and reinforcement of the fact that performance does affect promotion and compensation.

Some Surprises

There are always unexpected results to planning and implementing organizational change. They include:
—The shock of just how many people must be recruited and trained. For instance, in a $200 million bank growing at the rate of 10 per cent per year, approximately 240 new people will need to be hired and trained during the next four years.
—Even though frightening to some, organization change can be an exciting stimulus to a bank.
—Operational efficiency, clerical accuracy, and goal fulfillment do not suffer in the short-run because of personnel changes resulting from reorganization. In fact, each of these areas typically improves for several months after the change—apparently the result of fresh thinking, elimination of carelessness that follows job monotony, and the extra motivation associated with a new challenge.

Financial institutions have typically been stable, conservative, and cautious. As a result, organization change has occurred infrequently and organization planning has usually not been exercised. As a result, bankers today are often frustrated in dealing with organizational change. But faced with increasing competition, rapidly changing technical requirements, exploding service opportunities, and more aggressive thinking in executive suites, the banker as an organizational planner has become a reality.

The Challenge to Productivity

by C. TODD CONOVER, National Service Director
for Banking, San Francisco

The United States is facing a productivity crisis, and the challenge facing bankers is to do something about it. The problem is that capital, labor, and natural resources are all more scarce and more expensive.

A common productivity measure is output per man-hour. Although our country's total productivity is the highest in the world, our growth in output per man-hour lags behind that of other countries. Moreover, capital investments and research and development expenditures comprise a smaller portion of our GNP than in other industrial nations. Should this continue, the US will lose its productivity advantage over the rest of the world.

We need a central institution, of a purely technical and non-political character, to aid and support other international institutions concerned with the planning and regulation of the world's economic life.

—JOHN MAYNARD KEYNES

Higher productivity implies increased profitability, more output, lower costs, less waste, and better products and services. How can bankers contribute to this? One obvious step is to make increased productivity a goal of every aspect of their business. A second, more difficult and more challenging task is to use their role as financial intermediaries to stimulate productivity gains in the rest of the economy.

The Bank's Productivity

Most banks can improve their own productivity in two ways: first, by minimizing the proportion of non-earning assets on the balance sheet; second, by maintaining a tight control over headcount. More earning assets means higher revenues, and better control over headcount should reduce personnel expenses.

The major non-earning assets on a bank's balance sheet are cash, bank buildings, and equipment. Often regarded as uncontrollable, they get too little attention from management.

Cash and due from banks generally represents about 10 to 15 percent of total assets. Some banks have reduced their cash account and added to funds available for investment by

sending checks directly to other banks for settlement, establishing special procedures for processing large items, centralizing mail deposits, or changing cut-off times in order to meet clearinghouse or Federal Reserve deadlines. The key is to review the entire check processing function periodically, to ensure credit is obtained as quickly as possible.

Major correspondent bank relationships (both due from and due to accounts) should be reviewed periodically. The profitability of these relationships should be determined in the same way it is for large commercial customers—that is, by taking into account collected balances, reserve requirements, volume of activity, unit charges, and earnings allowances. Target balances should be set and procedures for maintaining them established. Finally, the Federal Reserve account should be reviewed, for it should maintain no more than the required balance.

Bank premises, furnitures and fixtures generally account for nearly 2 percent of total assets. Net occupancy expenses, shown on the income statement, are often about 3 percent of total operating income. In recent years, the stampede to construct large multi-story headquarters buildings has taken its toll on more than a few income statements. Unfortunately, it is difficult to reduce such costs once the expenditures are made.

Fortunately, branch offices no longer need to look like giant vaults so that customers will feel that their savings are adequately protected. Some leading banks are using "store front" branches that offer limited services and have special hours designed to meet the needs of customers. Others are using automated tellers, which offer the potential of branch banking at a lower cost. Another approach is to build modular branches; the building may be expanded as business grows.

Since banking is a labor intensive business, a second major way for a bank to improve its productivity is to focus on personnel costs, its largest controllable expense. A reduction in staff of one person (annual cost: $7,700) can have the same impact on pre-tax earnings as an increase in deposits of $900,000. ($900,000 less $135,000 reserve requirements × an assumed 1.0 percent pre-tax return on earning assets = $7,650 pre-tax earnings.)

During the past 10 years a number of laws have been enacted requiring banks to make greater disclosure to their customers and security holders, and in recent months there have been several significant attempts in Congress to breach the confidentiality of the supervisory process. These events mark a serious departure from tradition with respect to banking matters, and both bank regulators and bankers must come to terms with these changing attitudes.

—ARTHUR BURNS

Many banks could do a more effective job of controlling personnel expenses. The amount of deposits per $1 of employee expense varies significantly among banks, even within the same geographic area. In fact, it could range from $30 for poor performers to over $100 for better performing banks. Another measure, deposits per employee, shows the same divergence. Since large reductions in personnel costs are possible at many banks, and since personnel expenses represent 15 to 30 percent of operating income, the impact on earnings could be significant.

Total personnel costs have two elements: compensation and headcount. Most of the divergence in the ratio of deposits to employee expenses is caused by differences in the latter.

To control headcount:

1. *Compare productivity to other banks.* Bankers should calculate their deposits per employee, average compensation per employee, and deposits per $1 of employee expenses. By comparing these measures with those of other banks, they can determine their relative position and the reductions required to match the better performing banks.

2. *Determine productivity measures and performance standards.* Some specific measures might be number of accounts per employee, account activity per employee, number of checks processed per employee, or number of teller transactions per day. Work methods should be reviewed and improved, and standards should be set for both branches and operating departments.

3. *Establish target staffing levels.* They may be developed by using industrial engineering techniques or such information as the teller staffing guides published by the Bank Administration Institute. The key is to match staff requirements as closely as possible to expected workloads on specific hours and days.

4. *Make it difficult to add employees.* A strict approval process should

be followed so that managers may not add to their staff without documented justification and approval by the next higher management level.

5. *Develop better information on personnel costs.* Once measures and standards are developed, a periodic reporting system should monitor them closely. Top management should receive information on personnel costs, headcount, and productivity measures.

6. *Continue the thrust toward automation.* Productivity generally increases as machines replace people. Moreover, computers are essential to the development, marketing, and operation of new products and services. Banks ought to try continuously to improve the processes by which they shuffle paper.

The Customer's Productivity

To stimulate productivity in other companies is a more difficult but potentially more rewarding challenge for bankers. Because of their relationships with customers, banks are in a unique position to influence the productivity of other companies. Specifically, their influence can be felt through both the services they provide and the manner in which they handle the credit granting function.

Banks should help their customers perform more effectively the functions of collection, investment of short-term excess balances, disbursement, and account management. Leading banks are already offering such services as lock-boxes, wire transfers, depository transfer checks, zero balance accounts, payable through drafts, payroll services, and account analysis and reconciliation. Some banks have cash management teams that work with customers to determine the services most appropriate for their needs. Finally, banks should help customers determine the periodic information they need to manage their cash, accounts receivable, and accounts payable functions more efficiently.

Unlike some who may be quite happy with the recent bogging down of the Financial Reform Act, I do not think this question is going to just go away. The momentum . . . may be presently checked by election-year pressures. However, I think it is only a matter of time before what I see as progressive forces can get their act together. Then we will see some action.

—THOMAS E. KAUPER, 1976

As credit grantors, banks are in a position to influence the productivity of their customers by the manner in which they make loan decisions. Specifically, they can emphasize loans to companies considered to be productive, and they can make loans to support investments that will help customers to improve their productivity. To meet this challenge, bankers should:

1. *Understand the sources of productivity.* The accepted sources of productivity are capital, labor, technology, and management. Productive companies are often characterized by:

—Effective use of available capital.

—A program for technological improvements in products or processes.

—Constructive utilization of human resource capabilities.

—An organization structure that stimulates productivity.

—Adherence to a well-communicated management philosophy.

2. *Develop ways to measure and evaluate the productivity of individual companies.* Traditional measures of business success—e.g., EPS growth, ROE, ROA, return on sales, sales per employee, and output per man-hour—are generally inadequate measures of productivity. All productivity measures should begin with the same concept: output per unit of input. However, both the inputs and outputs are hard to define and to measure. Thus, the businessman seeking productivity improvement often does not know how to measure productivity or what actions he should take to increase it.

Output can be defined in terms of the amount of work done, value of the product, or value-added. "Direct labor hours" is the most commonly used input measure. It is used because labor is required for all levels of production, and direct labor hours are readily available. Yet, managers generally agree that output per direct labor hour is inadequate as an overall measure of productivity. For example, new equipment may improve labor productivity, while total productivity actually declines.

Since productivity measurement is a difficult and complex task, different measures may be appropriate for different industries. Bankers should invest both time and talent to developing the proper way to measure the productivity of each customer.

3. *Make productivity evaluation part of the loan granting process.* The sources of productivity and ways to measure it should be understood by

both executives who establish loan policy and loan officers who make individual lending decisions. Moreover, banks should publicize their efforts to foster productivity improvements and introduce the subject of productivity into their regular discussions with customers. Lending officers and loan approval committees should also question the impact of loan proceeds on the productivity of the borrower. Finally, bankers should favor productive companies and loans that will be used to improve productivity.

Conclusion

The specific ways that individual banks can improve their own productivity and influence the productivity of their customers will vary. Although many questions on measuring productivity and determining how to improve it have yet to be answered, the challenge to the nation's banks is to take a leadership role in this effort.

The New Communications

by CHARLES M. SOCHOWICZ, Partner, New York,
and PHILIP E. STRAUSE, National Service Director, Banking, Atlanta

It's 9:30 a.m. on a Tuesday morning and Ken Parkinson, corporate cash manager of RCA Corp., has completed his morning review of yesterday's cash receipts and disbursements. He is instructing Jane Sowells, his assistant, to initiate money movement both between RCA's banks and between specific accounts at his lead bank, as well as to initiate payments to several major vendors.

But Jane's next actions are not what we might expect. She moves to a computer terminal. She dials up RCA's lead bank, types in a special password identification, and begins to transmit instructions and verify account balances.

Science fiction? Hardly. Telecommunications systems such as Fed Wire and Bank Wire have moved money from one institution to another for many years. What banks, with businesses, are now doing is seeking methods to reduce paper handling and speed the accurate transfer of funds. While the idea of such a network directly serving the increasingly sophisticated corporate cash manager does present certain obstacles for banks and their corporate customers, the opportunities have long-range significance. Some of the major potential benefits are summarized below.

Customer Benefits

By having ready access to the banking community's telecommunication networks, corporations will enjoy improved speed and accuracy in transfers, balance inquiries, and transaction verification. Essentially, corporate customers will have a tool to tighten control over money movement and short-term investment, while having assurance of positive audit control. In addition, other sophisticated cash management activities, like zero or target balancing, will become more commonly used.

Thus, less executive time will be spent on telephone contacts and paper shuffling. With fewer people handling each transaction, the human error may be significantly reduced and storage and filing problems become less dramatic.

Bank Benefits

The banks benefit, too. Human resource needs in the operations and the customer service area will be reduced, since electronic equipment can replace staff. Fees could be substantial, but additional fees could be generated—using the same terminal—from still other offerings, like investment services, special reporting packages, or foreign exchange.

A problem faced by many banks is customer dissatisfaction over the level of transaction errors and the difficulties in identifying and correcting such errors. With banks able to move the bulk of the cumbersome transaction responsibilities to the corporate customer, the error problems would no longer be a concern to a bank. This could forseeably please both the bank and the customer.

Hurdles to Change

In developing such dramatic change to the basic processes used today, many hurdles must be overcome. Product development costs will be significant and the training necessary for corporate money management personnel will be vital.

Additionally, banks must cooperate with each other, and the fear of losing their individual deposit bases must be overcome. And obviously, communication form and content will require greater standardization. But if banks are to continue a strong partnership with the corporate world, they must be prepared to offer services like the one discussed in this article—or face continued encroachment on their corporate business. △