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Management and Staffing Challenges

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INTRODUCTION

Community banks are known for their personal service and strong customer relationships. They are an important source of working capital for small businesses and act as engines of economic growth for their communities. If they are to continue in these roles, community banks must be able to attract strong, competent management and dedicated, capable staff.

Lagging profits at some small District community banks and declining communities where many operate, however, might make it difficult for them to get the high quality personnel they need.[1] Poor profit performance, largely the result of more intense competition and poor market demographics, may mean these banks cannot offer the necessary salary and benefits to attract/retain qualified candidates. Further, poor market demographics may mean stagnant asset growth with few advancement opportunities for employees. These market limitations may also mean smaller labor pools and fewer job candidates from which to choose. Additionally, communities that are home to many of these banks may not provide the quality of life (public services, shopping alternatives) required by many of today's workers, making employee recruitment from outside the community more difficult.

Against this backdrop of profit pressures and declining markets, we asked Tenth District bankers if they will be able to meet their management and staff needs and what personnel challenges they see ahead.[2] This article reports their answers to our questions. The first section recounts bankers' views on meeting future official staff needs. Highlighted here is what the respondents told us about their management succession planning and the challenges they see in the years 2001–2005 in attracting and retaining official staff. The second section focuses on outside directors (i.e., non-officer directors). Summarized here are characteristics respondents look for in directors and the challenges they see in keeping directorships filled with committed, qualified people in the future. Also in this section is a summary of governance practices at District banks, including discussions on such matters as board size, board composition (the balance between inside and outside directors), and director compensation and evaluation. After that, the focus shifts in the third section to clerical and administrative staff, recapping what District bankers see as challenges in meeting this resource need. The last section offers concluding observations on staffing at District community banks and thoughts on personnel issues deserving of further attention.

OFFICIAL STAFF

The overall management and ultimately the fate of community banks, in fact all banks, rests in the hands of their active officers and boards of directors. Accordingly, an important ingredient for the future success of community banks is the ability to attract and retain competent leadership. Lagging profitability and declining communities, however, may make this job more difficult.

In this regard, our examiners have noted a general aging of senior management at many of the banks they visit. The careers of these management officials spanned the banking troubles of the 1980s and the deregulation and good times of the 1990s. They successfully guided their banks through the turmoil of the last 20 years, and the loss of their experience would leave a significant management void if no plans were made for passing the baton to the next generation of bank managers. Yet, many times examiners found that management vacancies at community banks were not being filled in a timely manner or that small rural banks were finding it difficult to attract and retain staff for key positions. These circumstances raise supervisory concerns regarding bank management and management succession.

With anecdotal examiner information in mind, we asked District banks for age and experience information for their senior officers—chief executive officer (CEO), senior lender, and cashier/operations officer.[3] We also asked if these individuals had retirement plans. Table 1 summarizes the information we received. It shows that one-half of those filling senior management positions had 10 years or more experience. It also shows that the management of District banks is tilted toward older individuals, e.g., one-half of CEOs are between the ages of 53 and 93. A good number of them, especially CEOs (20 percent), plan to retire during the next five years. Factoring in age information taken from the survey and assuming a hypothetical retirement age of 65, the potential exists for as much as 30 percent turnover in the top executive post of District banks during the next five years. As much as 12 and 18 percent turnover, respectively, could occur in senior loan officers and cashier/operations officers in District banks.

What will District banks do to replace this loss of senior personnel? Have they established written succession plans to smooth management transition? Will they fill empty official positions by promoting from within or fill them from outside the bank? If they hire from outside, what challenges do they face? These are questions for which we sought answers.

Management succession

Banks may renew their management in a number of ways. One approach is to do nothing. Another is to sell the bank and give the management problem to someone else. In some instances, this may be tantamount to the same thing.

> …the success or failure of community banks will depend on their capacity and willingness to attract resourceful executives…most community banks seeking an affiliation or merger are not prompted by unsolicited offers or the prospects of receiving two times book. Generally,…the board of directors has neglected to prepare a management succession plan. Unable to find a competent successor within the bank and unwilling to retain an "outsider" with no social or cultural ties to the bank or its community, the directors fall back on the sale-or-merger option.[4]

The "do nothing or sell" strategies were not the scenario envisioned by most (92 percent) banks responding to our survey. Management of these banks thought it was likely their ownership/structure would remain unchanged during the 2001–2005 time period covered by the survey. Since an ownership/structure change isn't planned for most small District community banks, inclusion of management succession in their strategic planning is important to their continued success. Yet, only about 30 percent of those responding indicated their banks had written management succession plans.[5]

The absence of written succession plans at our survey banks, however, may understate their succession planning. As noted in the introductory article, 74 percent of banks responding to the survey are family owned. For these banks, management succession may be handled through agreements among family members. Survey information provides some support for this idea. Recall that information in Table 1 showed that 20 percent, or 95 CEOs, plan to retire within the next 5 years. Of these, 88 are retiring from survey banks where ownership is unlikely to change within the next 5 years. There are written management succession plans at 26 of these banks. At another 25, a family member or a member of the bank's control group is slated to replace the CEO.[6] When these other arrangements are factored in, some form of management succession planning is in place for 51 of the 88 banks (about 60 percent) with CEOs planning retirement between 2001–2005. That means 37, or approximately 40 percent of the 88 CEOs, are in banks without some form of succession plan, leaving unresolved an important management issue at a time when many may be entering a period of significant management turnover.

Table 1

Senior Officer Age, Experience Level, and Retirement Plans

Management official	Years in position Min	Years in position Med	Years in position Max	Age Min	Age Med	Age Max	Percent planning to retire within 5 years
Chief executive officer	1	13	58	24	53	93	20
Senior loan officer	1	10	45	28	48	73	8
Cashier/ operation officer	1	11	50	23	47	78	14

Source: 2001 Survey of Commercial Banks in the Tenth Federal Reserve District.

Filling officer vacancies

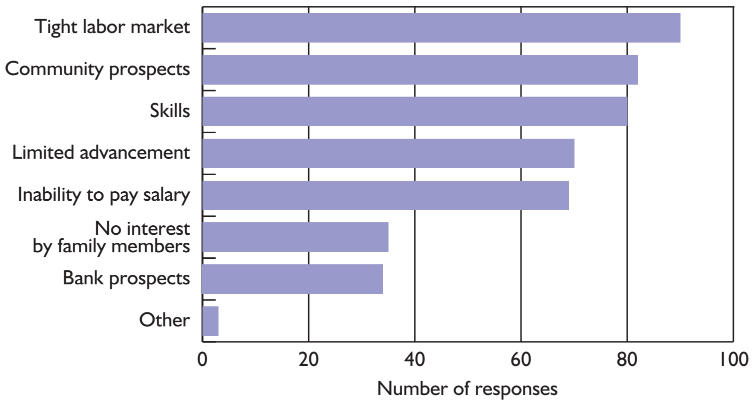
Besides specific matters pertaining to senior management succession, we asked District bankers about the methods they generally use to fill officer vacancies. In this regard, we asked them if they typically fill vacancies internally or hire externally. The former, we believe, can be interpreted as one indicator of management depth, a pool of talent developed by management to be drawn upon to meet a bank's needs. The latter indicates an ability to successfully compete for bank management when needed. Both are important, especially in an environment when management turnover is expected, and both methods are used.

The favored practice for a small majority (53 percent) completing our survey was to fill their official vacancies internally. This implies that a good number of banks may not have that valuable internal pool on which to draw to fill officer positions and, as a result, must fill vacancies with outside hires.[7]

Hiring from the outside to fill officer vacancies, however, can present challenges, especially if bank earnings are weak or the community where the bank is located does not appeal to job candidates. Because of this, we asked survey respondents to indicate if they saw any challenges ahead in hiring from outside. About 1 in 5 said they did. Those that did tended to be moderate-size banking organizations (bank holding companies with $300 million to $1 billion in total consolidated assets). They generally operated in larger communities in the District's western states—Colorado, New Mexico, and Wyoming. Often, they operated where government was the primary economic support for the community.[8]

For those seeing problems ahead, the greatest challenges to filling officer vacancies appear to be

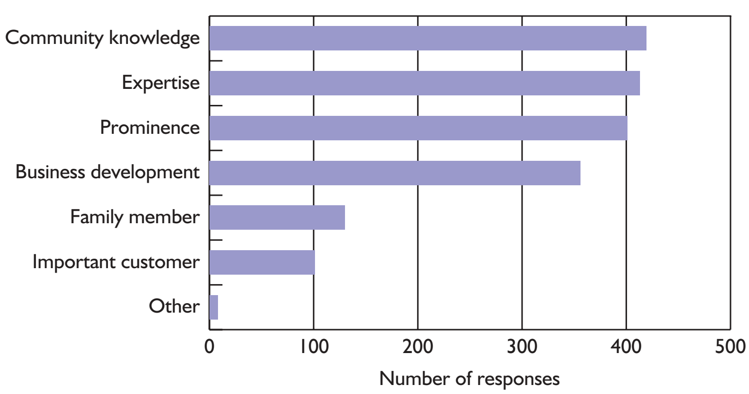
Chart 1
Challenges in Filling Official Vacancies
Very important and important responses*



*Includes data from 106 surveys indicating a problem hiring official staff.

Source: 2001 Survey of Commercial Banks in the Tenth Federal Reserve District.

Chart 2
Factors Considered in Recruiting Outside Directors
Very important and important responses



Source: 2001 Survey of Commercial Banks in the Tenth Federal Reserve District.

factors external to their banks, e.g., tight labor markets, poor community prospects, and inadequate job skills (Chart 1). The ability to pay competitive salaries or offer positions with advancement opportunities, factors more internal to banks, were still significant in number but of lesser importance. Thus, it may be the challenge of location, not profitability, which will preclude some District banks from successfully competing for the official staff they need.

OUTSIDE DIRECTORS

The board of directors, more particularly outside directors (directors that are not also bank officers), is the other part of a bank's management team. Outside directors are independent voices on a bank's board, representing the interests of its shareholders and providing counsel to its management. Because of the important role they play, our survey asked bankers what factors they considered in selecting outside directors. We also asked if they foresaw problems filling director vacancies during the next five years, and if they did, what were the particular problems they saw.

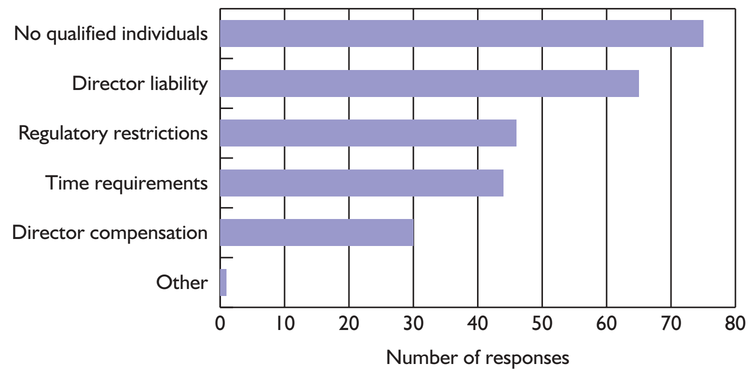
Filling director vacancies

Traditionally, individuals are asked to serve as outside directors because of their independence, diversity, and technical qualifications. Additionally, they may be asked to serve because of their position in the community or their relationship to a bank, e.g. important customer, large shareholder, or member of a controlling family. More recently, emphasis is being given to a business development role for directors, and some individuals are asked to serve for this reason. Chart 2 summarizes factors considered important to survey banks in their selection of outside directors. The emphasis placed on community knowledge and expertise brought to the board table by outside directors highlights the importance of their consultative role to bank management. Business development abilities tended to be a secondary consideration.

Will banks have trouble in obtaining valuable outside director advice in the years ahead? An overwhelming majority of survey respondents (82 percent) did not think so. This stands in stark contrast to the 41 percent that answered our 1994 survey who saw no problems ahead. The lessened concern over attracting and retaining outside directors in our current survey undoubtedly reflects, among other things, banking's strong performance since our last survey and the improved financial condition of banks.

Those that did see problems ahead (they tended to be headquartered in slightly larger communities—20,000 to 99,999) noted a lack of qualified individuals to serve as outside directors and director liability as the biggest obstacles to attracting and retaining directors (Chart 3). These were also the big issues noted by respondents to our 1994 survey. Of the two, the lack of qualified individuals is of particular interest. First, it reinforces the point made earlier on the value placed on the consultative role played by outside directors. Second, the difficulty in finding individuals qualified to fulfill this role may place some banks at a competitive disadvantage to those with ready access to such individuals.

Chart 3
Challenges in Recruiting Outside Directors*



*Includes data from 83 surveys indicating a problem recruiting outside directors.

Source: 2001 Survey of Commercial Banks in the Tenth Federal Reserve District.

Corporate governance

Our inquiry pertaining to directors, however, did not stop here. Over the last several decades, there have been evolutionary changes in boards of directors to make corporate governance—the system by which business corporations are directed and controlled—more effective and to provide higher investor returns.[9] Included among these many changes are smaller board size, greater outside director representation, and more director compensation given in some form of company stock.

Banking supervisors champion good corporate governance and assess board practices and effectiveness as part of their review of bank management during the course of bank examinations. Yet, outside of confidential examination data and reports filed by publicly traded banking organizations, little information is available on bank boards of small, closely-held, family-owned banks like those that dominate Tenth District banking. With this in mind, we asked District bankers to tell us about the size and makeup of their boards and forms of compensation paid to outside directors in order to compare their board practices with those of others and to establish benchmarks for subsequent assessments of small-bank board trends.

Many District community banks are small and, because of this, their boards tend to be small. The average board size of banks responding to our survey was 7.4.[10] By comparison, the average board size available from 1998 Moodys information for publicly traded banks was 10.2.[11] From a 1998 survey of bank and savings institutions done by American Association of Bank Directors (AABD) the average was 11.[12]

The board size for survey banks ranged from 3 to 24 directors.[13] Outside directors equaled inside directors at one-half of these banks, i.e. the median bank had at least 50 percent of its board composed of outside directors.

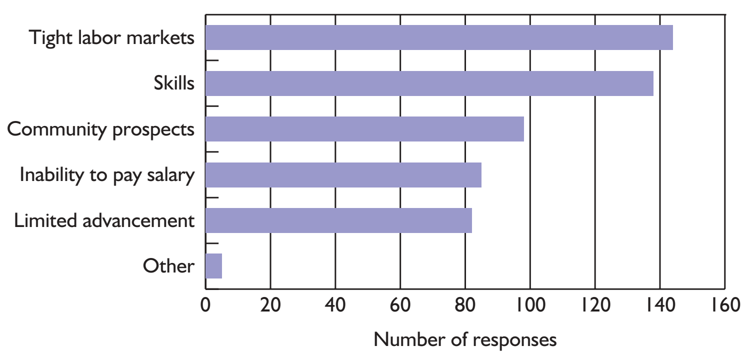
Ownership and size, however, played a role in determining board composition. For example, outside directors are more prevalent on the boards of non-family owned and larger banks (Table 2), constituting 60 percent or more of the boards at one-half of these banks. In comparison, recognizing there are firm size differences, the median in one

Table 2
Median Outside Directors to Total Directors By Family Ownership and Asset Size

Ownership structure/ asset size	Outside directors to total directors (%)
Family owned	50
Not family owned	64
Assets less than $150 million	50
Assets greater than $150 million	60

Source: 2001 Survey of Commercial Banks in the Tenth Federal Reserve District.

Chart 4
Challenges in Hiring Non-official Staff*
Very important and important responses



*Includes data from 157 surveys indicating a problem hiring non-official staff.

Source: 2001 Survey of Commercial Banks in the Tenth Federal Reserve District.

survey of Standard and Poors 500 firms was 80 percent.[14] If these firms represent some sort of standard, District community bank board structure, at least in terms of composition, greatly lags this level of outside director representation.

Compensation to board members is another governance area undergoing change. Today, corporations are encouraged to make greater use of performance-based compensation and greater share ownership to better align the interest or incentives of directors with those of shareholders. Few survey respondents (eight percent), however, provided such incentives to their directors—18 percent of respondents to the AABD survey offered stock options or warrants to directors, few incented directors with performance-based fees.[15] Instead, remuneration to Tenth District directors was primarily fixed cash payments. The minimum fees paid to directors, calculated on a monthly basis, was $30, and the maximum was $4,800. The median was $300.

One last governance matter covered in our survey was director performance evaluations. Greater use is being made of these evaluations to ensure outside directors are meeting expectations and to help determine when director change may be needed to improve board performance. Few survey respondents (nine percent), however, periodically reviewed outside director performance. This was similar to the 10 percent figure from the AABD survey.[16]

CLERICAL AND ADMINISTRATIVE STAFF

In addition to their observations regarding bank officers, examiners have noted instances of understaffing at smaller banks. Because of this, we asked survey respondents about their current staffing levels, their ability to attract the staff they thought they would need during the next five years (2001–2005), and their thoughts on challenges they might face in obtaining staff resources. Current staffing at banks completing our survey varied considerably. The smallest number of full-time employees was three. The largest number was 1,050. One-half of those answering the survey had 20 or fewer employees. Looking to the future, about twothirds (322 banks) of those responding to the survey did not foresee problems in attracting needed non-official staff during the next five years. Those (157 banks) that did tended to be located more in Colorado, Missouri, New Mexico, and Wyoming. They tended to be multi-state, multi-office operations. They were likely to be family owned, headquartered in communities with populations of 10,000 or more, or headquartered in communities whose primary economic support was services or government. For these banks, an important challenge to overcome was tight labor markets making it hard to hire employees and finding individuals with the necessary skills to fill staff positions (Chart 4). This was followed by problems associated with the future prospects of the communities in which they were located. As it was for official staff, the inability to pay sufficient salary or to offer jobs with advancement opportunities was a less important impediment to meeting future personnel needs. Instead, it appears the demographic factors associated with where Tenth District community banks operate will be the greater hindrance to their future ability to attract and retain non-official staff.

CONCLUDING OBSERVATIONS

This article focused on management and staffing issues at Tenth District banks. Many of these banks face competitive pressure on profitability and operate in communities experiencing population decline, raising questions about their continued ability to attract/retain the personnel resources to remain successful competitors. Looking forward over the next five years, a significant majority of District community banks believe they can attract and retain the directors, officers, and staff they will need. In those instances where bankers saw problems ahead, invariably it was factors beyond the bank's control—lack of qualified individuals, poor community prospects, or tight labor markets—that were seen as stumbling blocks rather than banks' inherent inability to pay a competitive wage. Thus, it is the demographics of the marketplace rather than the competition of the marketplace that weighs more heavily on the future of those that see problems in getting directors, officers, and staff for their banks.

The fact that market demographics is viewed as an important challenge does raise a concern that in some instances survey respondents may be overly optimistic about the problems they might face in meeting future official staff needs. For example, slightly more than 10 percent of those completing the survey filled officer vacancies by hiring from outside and were located in towns outside metropolitan areas with populations less 2,500. These towns depended upon agriculture for their primary economic support, and they had not grown in the last decade.[17] Although these banks indicated they foresaw no problems in hiring the officers they need, they may represent a group of banks that might be particularly susceptible to adverse demographics changes. These banks, when combined with those that saw challenges, represent about one-third of survey respondents that might encounter problems filling officer vacancies, making this an important future management issue for a good number of District community banks.

On a more specific matter, management succession may become an increasingly important issue for many banks as time passes. Many executives at survey banks plan to retire, and a good number will reach age 65, during the next five years. However, less than one-third of survey banks had written succession plans. Even taking into account family ownership and possible succession arrangements within families, many survey banks did not have some form of management succession plan in place, leaving them exposed to sudden officer loss and normal executive turnover at a time when officer turnover may increase. Succession planning becomes especially important for those banks that fit the profile of survey respondents who indicated future problems in obtaining the officers they need—moderate sized banking operations, banks located in larger communities or communities whose economic support comes primarily from government. For these banks, the search for senior executives may be more arduous, potentially limiting their activity for an extended period of time until replacements are found.

If survey results typify those for banks more generally, succession is an important management issue that deserves attention by bank management and bank supervisors before future turnover, expected or unexpected, occurs. For bank management, possible actions include reviewing existing plans for their currency and completeness and putting less formal arrangements, including any family agreements at family-owned banks, into written form. For bank examiners, who have always recommended written succession plans as a good management practice, this suggests further emphasizing the value of succession planning and recommending adoption of written plans. Under any scenario, the unrelenting pace of change in the industry requires that bank management give serious consideration to addressing their future human resource needs.

ENDNOTES

1 Forest Myers and Jinwoo Park, "Tenth District Banks: Who is at Risk?," *Financial Industry Perspectives*, October 1994, Federal Reserve Bank of Kansas City, p. 22. After the mid-1980s, the bottom line performance of the District's smaller banks, those with assets less than $25 million, began to fall behind that of larger banks. For the most part, this poorer performance has continued through year-end 2000.

2 For a detailed description of the survey methodology, see the first article in this issue of *Financial Industry Perspectives*, Forest Myers and Richard J. Sullivan, "The 2001 Survey of Commercial Banks in the Tenth Federal Reserve District: Changes and Challenges."

3 At year-end 2000, the number of officers at banks answering our survey ranged from 2 to 200. The median, or middle, was seven officers, meaning that one-half of survey respondents had 7 or fewer officers. These officers not only had responsibility for their banks' day-to-day operations and current condition but also for planning for their future, including providing for management succession.

4 Paul L. Simoff, "You Can't Hook a First-Class CEO By Fishing with a Second Rate Deal," *American Banker*, June 8, 1993, p. 8.

5 Viewed in the context of another bank survey, where 54 percent of banks indicated they had management succession plans in place, the figure for District community banks appears quite low. See "Results of the 2000 Community Bank Competitiveness Survey, How Does Your Bank Stack Up?" *Supplement to the ABA Banking Journal*, February 2000, p. S4. Care should be exercised in comparing ABA survey results with those from the Tenth District survey. For example, the average size bank answering the ABA survey is larger than that answering our survey. The authors of the ABA survey note that larger banks in their survey are likely to have management succession plans in place. Thus, the larger bank size in the ABA survey may help explain the higher incidence of management plans.

6 The number of senior loan officers and cashier/operations officers planning to retire in five years was 39 and 58, respectively. Of the senior loan officers, 18, or 46 percent, were in banks where no ownership change was planned and that had no written succession plans or family plans to replace the retiring officers. Of the cashier/operations officers, 35, or 60 percent, were in banks with no planned ownership change and had no written succession plans or family plans to replace the retiring officers.

7 Given staffing levels at many small banks, this is not too surprising. One-half of the banks answering our survey had 20 or fewer employees.

8 This profile of banking organizations most expecting to see challenges ahead was not totally expected. However, many of these banking organizations operate in growing markets, and tight labor supplies and accompanying stiff competition for qualified personnel seem to make it more challenging for them to find the official staff they need. Unlike smaller rural communities where the bank may be one of the town's few

nonfarm employers, these banking organizations tend to operate in larger places where there are more employment alternatives for potential official staff, making hiring more of a challenge.

9 It's unclear whether firms having higher representation of outside directors on their boards perform better than those that do not. Research on the subject is inconclusive. Sanjai Bhagat and Bernard Black, "The Uncertain Relationship Between Board Composition and Firm Performance," *The Business Lawyer*, Vol. 54, May 1999, pp. 922-963.

10 The median board size was 7, meaning one-half of the boards surveyed had 7 or fewer directors.

11 Average size of boards of directors for all companies (8,998 firms): 7.4 persons; average size of boards of directors for depository institutions (918 firms): 10.2 persons; average size of boards of directors for all other companies (8,080 firms): 7.1 persons. Moody's Company Data [CD-ROM], 1998.

12 *1998 Survey of Bank and Savings Institution Directors*, American Association of Bank Directors, Bethesda, Maryland, p.7. The average size bank in the AABD survey is larger than that of the Tenth District survey, and institutional size differences can influence survey results and lessen comparability. Moreover, the AABD survey includes savings institutions and this too can make comparisons with the Tenth District survey less meaningful.

13 Board size is not totally under a bank's control. State and federal banking laws may set range limits on bank board size. For example, under federal law…*notwithstanding any other provision of law, the board of directors, board of trustees, or other similar governing body of every national banking association and of every State bank or trust company which is a member of the Federal Reserve System shall consist of not less than five nor more than twenty-five members…* Section 31, Banking Act of 1933.

14 The survey included 484 of the 500 firms. Sanjai Bhagat and Bernard Black, p. 922.

15 *1998 Survey of Banks and Savings Institution Directors*, p. 21.

16 *1998 Survey of Banks and Savings Institution Directors*, p. 17.

17 See pages 2-5 of this issue for a detailed discussion of Tenth District demographics.