Today’s volatile interest rate environment has changed the banking industry’s earnings landscape. On one hand, with securities gains and fee income leading the way, the industry-wide net income level as of September 2003 was at a record high for the third consecutive quarter. On the other hand, given the combined effects of dramatically lower short-term rates, incredibly high prepayment speeds, and despite increased loan demand, net interest margins have been squeezed. By the end of September 2003, the average net interest margin for the industry reached a 12-year low.

Changes in interest rates not only impact a bank’s earnings, they also impact a bank’s equity value. We can measure this exposure by calculating an institution’s Economic Value of Equity (EVE) at Risk. EVE at Risk is a long-term measure of interest rate risk (IRR). It focuses on the value of the bank in today’s market rate environment and that value’s sensitivity to changes in market rates. (See Exhibit 1 on page 2 for a discussion of EVE.)

The level of EVE at Risk for banks has increased during the past several quarters. In September 2003 the average EVE at Risk for the industry was -13.28%, up from -11.78% in March 2002.

The number of banks whose EVE at Risk occurs in a rising rate environment (i.e., EVE exposed to increasing rates) is also increasing. In March 2002 the percentage of banks whose EVE was exposed to rising rates was 90.59%. This number percentage increased to 92.93% by September 2003.

There are two main reasons for these increases. First, there has been a tremendous amount of turnover in banks’ security and loan portfolios, and all new purchases are at new rates in this low interest rate environment. Secondly, banks have been extending the maturity terms of their portfolios to reach for higher returns. Both low rates and longer terms create added risk exposure to rising interest rates.

Resetting the Portfolio. Many industry analysts believe that the high premiums that once existed in a bank’s portfolio are gone. They further indicate that there has been a real decline in overall loan and security yields. High prepayment levels and calls have caused many bank port-
folios to reset and these actions have had a big overall effect on market value to equity ratios.

Accordingly, the lower market value to equity ratios are illustrated dramatically by the level of unrealized gain/loss (UGL) in a bank’s available-for-sale (AFS) securities portfolio. In just one calendar quarter this measure was cut in half. In June 2003 UGL on AFS securities was 1.60 percent; by September 2003 it was down to 0.80%. Industry pendants further indicate that the overall adjustment to equity for unrealized gains is beginning to erode. This indicates that, at some point, the cushion may be gone. In general, as rates rise, values fall, and these changes will have a negative impact on equity.

**Stretching the Term.** In September 2003 the industry’s average duration for total securities reached 2.8 years. This number has been increasing steadily over the past eight quarters. It is reflective of the behavior some examiners have called yield-chasing. To combat falling net interest margins, banks have invested in longer duration, higher yielding securities to reach for higher spreads. This behavior can also be observed by looking at the regulatory measure of long-term assets to total assets. In September 2003 it was 26.56%, up 5 percent from December 2001 when it averaged 18.56%.

While duration doesn’t specifically measure IRR, it does give some insight into the level and magnitude of risk. The inherent mismatch between the duration of a bank’s assets and its liabilities can help determine the exposure the bank’s EVE has to changes in interest rates. Banks with longer-term assets funded by shorter-term liabilities will generally have a duration gap that is positive. This means the EVE of a bank in this situation is likely to decline if interest rates rise. The greater the duration gap, the more exposed the bank’s EVE is to rising rates.

Industry data shows that, by stretching their security durations, banks have lengthened their overall asset duration. In December 2002 total securities duration was 2.6 years and total asset duration was 1.8 years. By September 2003 total asset duration had been pushed out to 1.9 years. In contrast, over the same timeframe, total liability duration remained basically unchanged at

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**EXHIBIT 1. DISCUSSION OF EVE**

- **Interest Rate Risk Measurements.** Interest rate risk (IRR) is the risk to earnings or capital arising from movements in interest rates. Practically, interest rate risk can be viewed in both a short-term and long-term perspective. To examine short-term interest rate risk we look at Earnings-at-Risk. Conversely, we use Equity-at-Risk to measure long-term IRR.

- **Earnings-at-Risk: Short-Term View of IRR.** By most definitions, accounting or otherwise, when we communicate something as short-term, we usually refer to a time frame of one year or less. When measuring IRR on an earnings perspective, this same concept applies. Short-term IRR is measured by initially establishing a one-year earnings forecast. This base forecast assumes that both the level and structure of market rates of interest are held constant from the last historical period. The balance sheet, in terms of overall size and mix, is constructed using a managerial forecast or a projection.

  IRR is a measure of possible loss caused by interest rate changes. Therefore the model introduces two instantaneous, parallel shocks to the base set of rates and then re-computes the expected earnings. It is a common practice in shock analysis to use +/-200 basis point (bp) movements in interest rates. The Earnings-at-Risk is the largest negative change between the base forecast and one of the shock scenarios. The measure is usually stated as a percentage change of either net interest income or net income.

- **Equity-at-Risk (EVE): Long-Term View of IRR.** As a means for evaluating long-term IRR, an economic perspective is necessary. This approach focuses on the value of the bank in today’s interest rate environment and that value’s sensitivity to changes in interest rates. This concept is known as Equity-at-Risk. It requires a complete present value balance sheet to be constructed. This is done by scheduling the cash flows of all assets and liabilities and applying a set of discount rates to develop the present values. The present value of equity is derived by calculating the difference between the present value of assets and liabilities. (Equity = Assets - Liabilities).

  Similar to Earnings-at-Risk, two instantaneous, parallel interest rate shocks are applied to the base set of rates and all present values are re-computed. Equity-at-Risk is the largest negative change in the present value between the base and one of the shock scenarios. This is usually stated as a percentage change from the base present value of equity.
1.3 years. This widening duration gap is a good indicator of increased EVE at risk.

**What Lies Ahead?** The value of longer-term assets can be very susceptible to changes in interest rates. Accordingly, some economists believe a very rocky road lies ahead. Long-term rates have been very volatile, as financial markets are trying to assess the uniqueness of the economic situation.

The average quarterly long-term yield curve rate moved up over 50 basis points in one quarter, from 4.30% in June 2003 to 4.87% in September 2003. The most dramatic shifts occurred in the 10-year treasury yield, which jumped from 3.33% in June 2003 to 4.45% in August 2003—a movement of +112 basis points.

Right now there are clues in the futures market which suggest a belief that the Fed will keep the Federal funds rate close to the 1% current target through most of the first half of next year. However, the yield curve is very steep and upward sloping. Although it’s been that way for over a year now, in general it suggests that we will see rates rising.

**Are You Prepared?** The IRR peer data shows that rising rates will have a negative impact on the EVE for most banks. Those institutions with equity to asset ratios above 10-11% may be adequately prepared to handle the drop. But what about the banks that don’t have high levels of capital? What about the banks that continue to invest in longer-term assets to support their narrow margins?

With the data and tools available today, are you adequately assessing your interest rate risk? Indications are that market rates will begin to rise again. The questions are when, by how much, and how fast the rates will rise. Is your bank positioned for rising rates? If not, how quickly can you reposition so that your bank can withstand a change in equity value?

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Merger Related Purchase Accounting and Intangible Asset Valuation

As the consolidation of the nation’s financial institutions industry is once again on the rise, the mix of many bank and thrift portfolios has changed to include a larger number of intangible assets. These commonly held intangible assets include patents, trademarks, trade names, software, royalty agreements, franchises, leasehold interests, and customer-based core deposits, as well as unpatented technology.

Banking executives who have historically relied on the appraisal process or cash flow projections to manage and control asset-based portfolios may be uneasy about managing a growing portfolio of intangible assets. This uneasiness reflects a general lack of understanding of intangible asset valuations. Such a misunderstanding frequently occurs because neither the methodology by which intangible assets are valued nor the process for establishing their useful lives are reflected in financial statements or regulatory filings. However, intangible assets can provide a substantial economic benefit to your bank by shielding income from taxation through the asset amortization process. In today’s economic climate, this after-tax cashflow enhancement can provide substantial cash management benefits.

For asset/liability (A/L) managers charged with monitoring, if not directly managing, these intangible portfolios, a keen understanding of intangible accounting is important. Furthermore, A/L management committee (ALCO) and lending committee knowledge of the process for underwriting intangibles as well as that of intangible asset valuation methods may provide insights to better manage the risks associated with growing intangible asset portfolios.

Intangible Asset Accounting. The allocation of an asset’s purchase price is recognized in both accounting literature and tax regulations. With regard to both tangible and intangible assets, this process involves the apportionment of the lump-sum cost involved in acquiring a group of assets, either directly or in the form of a stock purchase, to individual assets. In a typical asset acquisition, assets and liabilities are marked to fair value for financial reporting and to market value for income tax purposes. Assets acquired in a bank merger or acquisition are also reported at fair value and may be re-stated for tax purposes only if certain elections are made under the Internal Revenue Code.

Current tax treatment of intangible assets addresses the separate identification and appraisal of specific assets that are known to be of value to the bank and the ability to reasonably determine the usefulness of these assets. Market value is the premise of value used for tax purposes. Fair market value is typically defined as the price at which an asset changes hands from a willing buyer to a willing buyer when the buyer is not under any compulsion to buy and the seller is not under any compulsion to sell, and both parties have a reasonable knowledge of relevant facts.

Intangible Asset Classification. Intangible assets commonly include patents, trademarks and trade names, and software as well as licensing agreements. However, the number of intangible assets can be large and frequently includes customer lists as well as mortgage-servicing rights and core deposits.

Valuation Methodologies. The three valuation techniques, including cost, market, and income, that are used to appraise tangible assets, are also employed to value intangible assets.

The cost method values an asset on the basis of the monies required to offset the decrease in value due to normal obsolescence and the passage of time.

The market approach values an asset by studying recent actual or asking prices of similar property. After a careful assessment of such similarities, appropriate adjustments are made to the sales prices of comparable assets. Market sales are used as an indicator of the market value on the assumption that market transactions are conducted at arm’s length between a willing buyer and a willing seller. Mortgage-servicing rights are frequently valued using a market approach because the industry has developed a market for such rights.

The income method is the foundation of cashflow-based lending. It bases value on the future cash flows associated with a specific asset and considers the remaining useful life of the asset as well as the required rate of return. The future cashflows are discounted to their present values using an appropriate risk-adjusted rate of return. Unlike cashflow-based lending, which considers the total cash generated from the entire business operation, asset-based lending secured by intangibles focuses on the cashflow generated by specific intangible assets. This approach is similar to valuing income-producing real estate on the basis of capitalizing future cashflows. For example, an exclusive license agreement for a patent may provide for a fixed percentage of the gross sales of a licensee. Capitalization of the estimated future royalty payments by an appropriate discount rate would yield a value for the patent using the income approach.

Remaining Useful Life. The determination of the remaining useful economic lives of acquired intangible assets is a key issue for both financial reporting and tax
purposes because this time period will determine the amount to be amortized each year. An accountant and tax preparer must be able to ascertain the period of time over which an intangible asset should be amortized. The issue is equally important to appraisers using the income approach who, in addition to ascertaining the magnitude of cash flows generated by an intangible asset, must also determine the duration of these flows.

The remaining useful life of some intangibles is fairly easy to determine. For others, highly sophisticated actuarial-type turnover or mortality studies must be completed to make an accurate projection. For example, the remaining life of a favorable or below-market lease is simply the remaining lease term. In the case of a customer-based core deposit intangible, a study of the mortality of thousands of bank accounts may be required to generate a survivor curve that will indicate the rate at which existing depositors will close their accounts.

Occasionally the remaining useful life of unpatented technology cannot be determined through amortization. Because the life of such technology may not be arrived at with reasonable accuracy, a bank may be prohibited from amortizing this asset for tax purposes. Other intangible assets, such as trade names, may have a perpetual life. Of course, this doesn’t mean that each of these intangible assets has no value. Their value simply cannot be measured.

**Lending Against Intangibles.** Some intangible assets may have value only as part of an ongoing business, for example, work-force-in-place, goodwill, or other non-saleable intangible assets. Other intangibles may have values separate and apart from a specific business enterprise. For example, favorable leases or mortgage-servicing rights may be saleable intangible assets. Non-saleable intangible assets can be acquired only when an entire business is purchased, whereas saleable intangibles can be separately acquired.

Just as a distressed business can sell real estate, certain intangible assets can also be sold piecemeal. Often, such intangible assets as mortgage-servicing rights are sold apart from a business enterprise. By virtue of being separable from a going concern, saleable intangibles are far less risky than non-saleable intangible assets. The latter categories can quickly lose their value when adverse economic or industry developments affect the overall business.

Asset-based lenders can take a secured position against saleable intangibles by establishing a lien against specifically identified assets. In the event of default, a lender can take title to saleable intangible assets, sell them, and use the proceeds to satisfy the loan. Alternatively, for income-producing saleable intangibles, such as a patent with royalty payments attached, a lender could use the payments over the remaining useful life of the patent or royalty agreement to service the loan.

**Conclusion.** Intangible assets generally appear on a bank’s balance sheet only as a result of purchase accounting requirements. For many financial institutions, however, intangible assets represent an important consideration whether they are recorded on the balance sheet or not.

For tax purposes, amortizable assets can improve cashflow to the extent that they reduce taxes and increase non-cash charges. In addition, certain saleable intangible assets can serve as collateral for lenders.

Lenders and A/L managers need a thorough understanding of purchase accounting rules, tax law, and appraisal theory with respect to intangibles so that they can assess the ability of a borrower to repay loans and determine the value of intangibles serving as collateral. Consequently, bank officers should require the highest standard of care in valuing intangible assets and consider obtaining independent appraisals to assure an acceptable level of reliability and accuracy.

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**Assessment of Risk in Today’s Complex Environment**

The responsibilities of an asset/liability (A/L) manager touch on many areas of risk. However, three key areas are of strategic importance, including interest rate risk (IRR), liquidity risk, and pricing risk. This article provides a profile of each of these areas, and outlines how to address and properly assess each one.

**Interest Rate Risk.** IRR, the risk to earnings or capital that arises from movements in interest rates, can primarily be captured by four areas of sub-risk including basis risk, yield curve risk, repricing risk, and options risk. Basis risk addresses the ever-changing rate relationships among the various yield curves that affect bank activities, while yield curve risk arises from those changing-rate relationships across the entire range of maturities. Traditional repricing risk comes from reprice timing differences due to rate changes and cash flows, whereas options risk is the risk acquired due to the nature of embedded options within typical bank products. Options risk impacts both the asset and liability side of the balance sheet.

IRR is impacted not only by interest income, but also by non-interest or fee income that is sensitive to changes in interest rates. Liquidity risk also becomes a factor in measurement of interest rate risk as many assets, such as illiquid investments, hedging strategies, derivatives and so forth, can impact the practical behavior of IRR.

When assessing IRR, an asset/liability (A/L) manager must consider risk from both an accounting perspective
Bank Asset/Liability Management

including current and projected accrual earnings, as well as from the economic perspective, which typically includes the market or present value of the institution’s portfolio equity. If the institution manages an investment trading account, the A/L manager will also want to create an assessment of market or price risk as well. When preparing IRR reports for an A/L management committee (ALCO) meeting, the A/L manager should include copies of the institution’s A/L–IRR model output along with liquidity reports. A tool to utilize in comparing risk control is the Uniform Bank Performance Report (UBPR), an analytical tool created for bank supervisory, examination, and management purposes. The UBPR shows the impact of management decisions and economic conditions on a bank’s performance and balance-sheet composition. The performance and composition data contained in the report can be used as an aid in evaluating the adequacy of earnings, liquidity, capital A/L management, and growth management. Bankers and examiners alike can use this or similar reports to further their understanding of a bank’s financial condition.

Like other peer data, these comparative reports should be viewed in light of the composition of the individual institution’s balance sheet structure. A complex balance sheet will likely not reflect the same risk profile as identified in the comparative reports. Your institution’s risk profile should be clearly identified with appropriate limits set by the ALCO’s A/L management policies.

The ALCO should consider the current A/L mix, the net interest margin, any dependence on volatile liabilities, and borrowings. Trends in each category should be noted and addressed if adverse. Strategies utilized in IRR management should be clearly defined by policy and procedure. Issues to be considered in achieving the desired mix and maturities of assets and liabilities include maturity matching, investment portfolio make-up, product pricing, off-balance sheet positions, competitive issues in the service market, and any asset or liability sales conducted or contemplated.

When setting IRR limits within the ALCO for Board approval, make certain adequate flexibility is provided to adjust the A/L mix to manage IRR and respond to marketplace forces. Review the limits at each meeting to ascertain the institution’s operation within, and conformity to, the specified limits.

Liquidity Risk. Liquidity risk is identified as the risk to earnings or capital that arises from an institution’s inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk can arise from a failure to recognize or address changes in market considerations that may affect the institution’s ability to liquify assets expeditiously while minimizing any loss in value. From the liability side, liquidity risk must include the failure or inability to manage for unexpected decreases or changes in funding sources.

Liquidity risk, which has always appeared to be fairly straightforward, has become somewhat more complex in recent years. Increased alternatives for deposits, sophisticated off-balance sheet opportunities with complicated cash flow implications, derivatives, and a general increase in rate awareness among depositors and borrowers have all added to the complexity and importance of liquidity measurement. Since investment portfolio implications do impact liquidity considerations, liquidity risk can also be found in market or price risk.

When discussing liquidity risk in the ALCO meetings, the effective A/L manager must be certain that proper plans are in place to assure adequate liquidity and in determining if the institution has adequate sources of funds to meet anticipated or potential needs.

Specific ALCO measurements and guidelines should be developed to measure interest-sensitive monies along with the frequency and level of borrowings. Volatility of deposits should also be reviewed and measured along with the institution’s access to money markets or other ready sources of cash. It is important to know and understand the ratio and availability of assets that can be readily converted into cash.

Price or Market Risk. Price or market risk is identified as the risk to earnings or capital that results from changes in the value of the various portfolios of financial institutions. Though traditionally thought of as risk associated with broker/dealer departments and trading accounts, today’s participation in commodity and foreign exchange markets make price and market risk a much broader area of focus.

Many small community banks and thrift financial institutions participate to some extent in hedging and off-balance sheet activities that may or may not be derivative in nature. Market factors such as interest rates, liquidity, and economic volatility all impact price risk. Historically, only securities or securities-related activities tended to be considered under this risk category. Today, however, with all segments of the balance sheet available for sale, this risk category can be spread across the institution.

An example may be a mortgage loan pipeline. Although these loans may be sold in the forward markets, price risk still exits, though minimized. The contra-party may not be capable of performing due to credit risk, timely delivery may not be possible due to transaction risk, or delivery may be refused due to problems with internal reputation risk that may have arisen since the forward sale. These and other issues must be considered when assessing this category of risk.

The evaluation of price risk can be a lengthy process and must be weighed in light of other identified and mea-
sured risks. The source and components of the risk must be identified and assessed. Proper, accurate, and timely management information systems (MIS) reporting must be in place, with proper controls successfully implemented. An area often overlooked in this risk assessment is that of accounting. The ALCO must be certain that acceptable and appropriate accounting treatment is given to the areas impacted by market risk.

Other areas of price risk that must be addressed by the ALCO include the trend of earnings and capital at risk, vulnerability under probable rate scenarios and stress-tested environments, the ability to hedge a position, and the size and volume of current or anticipated positions or activities conducted in relation to the overall position of the institution. Obviously, a thorough knowledge of the investment portfolio, particularly those investments marked for trading or available-for-sale, should be rigorously reviewed at each meeting.

Although only the three areas of risk most applicable to the A/L function have been briefly touched upon, the A/L manager certainly comes in contact with most all of the other recognized areas of risk. Depending upon the institution’s activities, foreign exchange risk can also be a key area of risk measurement and monitoring for the A/L manager. Credit risk clearly impacts all three areas of risk on a continuing basis. Transaction risk, as discussed earlier, and compliance risk can impact the activities of the A/L manager as well.

**Conclusion.** In today’s complex economic and regulatory environment, the effective A/L manager must be prepared to address the various elements of risk within his or her organization. The increased corporate, regulatory, and oversight focus brought about by Sarbanes-Oxley and other disclosure-oriented legislation has further emphasized the need for adequate and full disclosure of all known and potential balance sheet risks.

Accordingly, this increased emphasis upon adequately assessing and disclosing the various elements of risk, to include sensitivity to market risk, may prove to be disquieting to A/L managers who do not have their financial institutions duly prepared to identify, assess, and report on the various elements of risk.

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**Key Steps in the Strategic Planning Process**

The process of strategic planning does not necessarily have to be complex and exhaustive. The more clearly a strategic plan is written and communicated, the better it can support the asset/liability management (ALM) and strategic planning processes necessary to achieve the future goals of the bank. The essence of the strategic planning process is simplicity and clarity. The more direct the relationship of strategic goals is with current needs and operations, the less likely the plan’s implementation will be problematic. Proper strategic planning provides many benefits, including the following:

- **Action.** Managers who focus in on a shared goal are much more productive, increasing the overall productivity and organizational effectiveness of the bank.
- **Communication.** The conflicts and misunderstandings that exist across departmental lines oftentimes get in the way of progress. Strategic planning penetrates barriers at all organizational levels, thereby reducing perceptual differences.
- **Cost and risk reduction.** High costs are inherent in operating in a reactive mode. These high costs equate with risk. However, a solid strategic plan involves a certain amount of risk, but focuses on advantageous and sound risks, as well as attempting to minimize costs involved in the implementation and execution of the plan.
- **Creativity.** Planning encourages new ideas and establishes new relationships, associations, and markets.
- **Direction.** A bank whose goals and needs are not clear cannot envision its place in the competitive mainstream in which it operates.

**Corporate Mission.** In formulating a strategic plan, management must possess a clear understanding of its financial institution’s goals. Understanding today’s dynamic business environment involves a thorough evaluation in relation to markets, products, customers, and profitability. Listed below are some of the key areas that a strategic plan should consider:

- **A/L growth.** Study growth factors before deciding to originate, buy, sell, or swap.
- **Customers.** Research your existing customer base. Obtain information on the size, type, and contribution to profits by differing customer groups. Is your institution ready to expand into a new customer base? Can you sustain the costs of this expansion?
- **Markets.** Evaluate your bank’s peers and make some comparisons. Become familiar with competitors; see what works or doesn’t work for them. Keep current on interest rates and economic conditions. Know when the climate is right for changes to the plan.
- **Operational support.** Study your bank’s systems network, branches, personnel, and internal and external dependencies. Is the support the entire bank needs present in the current support base?
- **Products.** Decide what to offer the customer base you want to attract. Mortgage lending, servicing, and consumer and commercial services represent a few possibilities.

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Profitability. Determine the present source of profits. Examine how much dependency exists on certain customer groups, in certain markets, and for certain products.

Regulatory environment. Determine whether it is restrictive or permissive.

A careful examination of these areas will establish where your financial institution is in terms of operations and profitability level.

Constructing a Financial Performance Plan. Another important step in the strategic planning process is the construction of a financial performance plan. This involves establishing objectives for the following:
- A/L balance;
- Investment portfolio;
- Liquidity;
- Return on assets (ROA); and
- Return on equity (ROE).

It is important that your objectives be:
- Implemented in stages so that milestones and dependencies for their attainment are clearly expressed;
- Prioritized, both from the perspective of ROA versus ROE and from different levels of ROA, given different circumstances; and
- Measurable, quantifiable, and identifiable as independent parts of the entire plan.

Implementation. The final step in the strategic planning process is implementation. It is extremely important that management and/or staff become familiar enough with the plan so that they feel comfortable executing selected strategies. Training is an important opportunity for bank staff to gain knowledge of the plan and its importance.

Another critical aspect of implementation is the ability to recognize when changes are needed. Adapt to market changes and changes in demands by your customer base. As previously mentioned, it is imperative to consider plan changes as the climate outside of the bank, which has an ultimate impact on the financial institution as a whole, changes.

A common, yet important step in the plan’s implementation is that of documentation. Document, in chronological order, the individual steps required to ensure the plan’s goal completion.

One executive should be responsible for the overall plan’s implementation. Furthermore, individuals in each unit who are responsible for parts of the plan directly affecting them should be designated to head up individual portions of the plan.

2003 ALM Compensation Survey

Included as an insert in this issue of BALM is a survey form to be completed by A/L analysts, A/L managers, and executives.

If your organization has more than one professional, please reproduce the survey form for your team members.

Fax or e-mail your forms as soon as possible to:
Mary Brookhart
704-541-0661
or
SECI@aol.com

The survey results will be published in the May 2004 issue of this newsletter.

If you have any questions, please call (704) 541-0489.
Thank you!

Implementation of the plan requires the proper tools, personnel, and expertise. Changes are inevitable, and it is important to adjust to them in a managed and controlled manner. Once the bank has a strategic plan, it is comfortable with its direction, and has leaders in control of specific responsibilities, the implementation process should function smoothly. Communication and clarity are key elements in the success of a strategic plan.

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