

BLANKFEIN: BULL IN GOLDMAN'S CHINA SHOP?

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Beyond Business as Usual



EXIT

As graying CEOs dominate the industry—the average age among top bankers is 58—succession plans are becoming more critical. Deal with it.

(strategy)

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With regulators pressing financial firms to create succession plans, banks realize the day of the omnipotent CEO is over. Today, it's about having a flexible management team and a workable succession plan. But one-third of banks surveyed by the ABA don't have a formal strategy. Boards' and CEOs' reluctance to anoint successors worries shareholders and jeopardizes long-term profits. What are they waiting for?



STRATEGY

BY KAREN KREBSBACH

CITIGROUP'S ROBERT RUBIN, CHAIRMAN OF THE EXECUTIVE committee of the board, once was asked who would take over the behemoth if chairman and CEO Sandy Weill were to be hit by a truck. His response: "Citigroup's executives keep Sandy away from trucks." Heavy machinery notwithstanding, risk avoidance is no longer an adequate succession plan for banks.

For many strong CEOs, crafting a succession plan is, well, like writing a will. It's often the last thing on their minds, but analysts say it should be among the first. "Such plans give banks some line of sight into the future for sustaining his quality of leadership, whether those are technical or cultural qualities," says Warren Cinnick, director of leadership and succession planning services at Saratoga, a PricewaterhouseCooper unit. "It also allows you to focus on the development of leaders of those assessed to be your best. Plus you get speed if you're trying to fill jobs in the event of illness, death, disaster or retirement."

A smooth transition, which is every successful CEO's hopeful legacy, demands a detailed blueprint. "Succession planning should be a routine management practice," observes John A. Davis, a Harvard Business School professor who specializes in succession planning. "Even if you're a young chief executive and you plan to be in office for the next 25 years, you should be thinking about a contingency plan. ... Ideally, you want the CEO to be naturally inclined to be thinking about the organization's needs. So why don't boards require executive teams to address this in a more systematic way?"

Although no law requires succession plans for banks, a section of the Sarbanes-Oxley law of 2002 calls for boards of public companies to provide oversight on compensation, which usually means detailing a chain of command. Moreover, regulators have become increasingly focused on all elements of risk management and business-continuity planning, including key personnel issues. "Boards are feeling increasingly in the public eye regarding their relationships with CEOs," says Cinnick. "Shareholders and analysts like it when firms have a sustainable leadership plan. It's in the public interest and it's a safety issue."

Not that banks seem to believe that. A recent American Bankers Association survey reports that nearly one-third of financial institutions don't have a formal succession plan. Denial is rife in other industries, too. A recent PricewaterhouseCoopers study of 364 CEOs indicated that fewer than 50 percent have addressed the issue meaningfully, with 19 percent not addressing it at all. When it comes to a CEO's successor, only 39 percent have a likely replacement in mind and 33 percent of those choices aren't prepared to take over immediately.

Since graying CEOs dominate the financial industry, succession planning is becoming more of a necessity than an option. The average age of CEOs at the largest 44 public banks is 58, according to a recent Moody's Investors Service review. Moreover, 13 of those leaders are 60 or older, including Bancorp South CEO Aubrey B. Patterson, 63; Fifth Third Bancorp CEO George A. Schaefer Jr., 60; and SunTrust Banks CEO L. Phillip Humann, 60. CEO turnover in the next five years will be the "largest generational change" in two decades, with more than half of major banks changing top bosses, predicts Mark Watson, a Moody's corporate-governance analyst. Some banks have mandatory retirement ages of 65 or 70, but they are far from the majority.

"CEOs are definitely more focused on this issue today," observes Linda Barrington, research director of management excellence at the Conference Board, whose recent survey found that 50 percent of executives of public and private firms of all sectors rate the issue as one of their greatest concerns. "What's driving this, to a large

degree, is age demographics and older management teams. But these days, we don't know if 'retirement eligible' is 'retirement-prone.' And you also never know when someone is going to walk out the door. ... Increasingly, the tenure of CEOs is getting shorter. If you think your CEO is leaving within three years, you need a succession plan."

Add to that the risk of a key manager being affected by illness, accident, natural disaster or terrorism, and it's clear that planning ahead just makes good business sense. "All of these forces are making life more uncertain and unpredictable," she says. And banks without a management-succession plan can quickly find themselves the subject of unwanted overtures for acquisition. "Going through a succession plan makes you vulnerable—before, during and after," says Davis. "It makes you susceptible to being bought, to losing customers, of not innovating properly, of not watching what's going on because eyes are turned more inward. If you have a big bulge of CEOs in their 60s in this industry, there will be a lot of good opportunities for takeovers."

Most managers have heard the horror stories of not planning for the future: High Point Bank and Trust, a family-owned institution in High Point, NC, has twice had its top executive die unexpectedly; in each instance, the bank needed months to hire a non-family successor because no plan had been formulated. In 1976, Goldman Sachs senior partner Gustave "Gus" Lehmann Levy suffered a stroke and died—without ever uttering a syllable about who should succeed him.

Less dramatic, but no less important is California's Golden West Financial Corp., whose septuagenarian co-CEOs Herbert and Marion Sandler have frustrated analysts with their refusal to pen a succession plan. They skipped the issue altogether by agreeing in May to sell the bank to Wachovia.

Why are CEOs so resistant? "I do think it's about ego, and ego tends to get its way," muses Cinnick, who has only had four financial-services clients in the past 11 years ink formal succession plans. "At the very top of many of these organizations are very strong deal makers—and they believe that's not a learnable skill, so they're not sophisticated about developing the talent underneath them."

Carrie York, a bank recruiter at York & Associates in Newark, OH, says few banks believe they can afford to create a plan, given the dearth of talented up-and-coming bankers, particularly in the Southeast. "It's a buyer's market," she says, pointing to the recent rash of de novo banks sapping the cream off the top. "Most banks don't have the luxury of thinking that far into the future. It's only the really good banks that have succession plans." Moreover, few banks make changes when they're unprofitable, for fear of rocking the boat, she says.

Resistance is particularly strong in closely held companies with long-standing CEOs, says Cinnick. "The CEO believes, 'I am not replaceable. There is nobody behind me,'" he says. "But when they do retire or get ill, it's evident there's a vacuum of skills. And that company often struggles." To that end, lack of succession planning is the No. 1 reason why third-generation family-owned companies fail, he says.

Moreover, CEOs who are 55 and 60 "don't think that's old," notes York. That's doubly true of CEOs who have the "founder mentality," says Watson. "Some CEOs just don't want to let go," he says, pointing out that some fret that a successor chosen today may not have the CEO qualities the bank needs tomorrow. There also may be a bit of superstition in naming names. "No question about it: I have run into CEOs who think, 'What are they going to do with this plan? Will it be executed? Is the board planning to get rid of me earlier?'" says Cinnick. He urges new CEOs

to craft a succession strategy within their first year as a message to the board that "he's self-confident enough to say, 'This isn't just about me. We need a substantive plan going forward.' It takes all the political air out of the balloon."

Plenty of financial services firms have seen the value of looking ahead. Bank of the Sierra, a \$1.1 billion-asset institution in Porterville, CA, had its head in the sand for years until four top managers retired within a three-year period. By 2003, president and CEO James C. Holly, 65, who founded the bank in 1978 with 16 other investors, began to ponder the bank's future without him. "Until then, I thought I would live forever," he muses. "We had this sense of invulnerability. We had always viewed this as a build-to-own bank, not one to sell. We were a high-performing bank for a long time and we wanted to perpetuate what we had." Averaging 21 percent annual returns for more than two decades isn't an easy act to follow, but Holly was determined to find a candidate.

The management team identified 18 managers, but narrowed the list down to seven employees, judging them on performance, leadership strength and Predictive Index score, a management tool. "I had a bullpen approach," he recalls. "I didn't necessarily need a crown prince, but I wanted a number of contenders with different talents and abilities. ...The primary candidates knew who they were, and that kept everybody on their toes." The winner: Kevin McPhaill, who was promptly named chief banking officer, a new title, replacing CFO Ken Goodwin, who retired in early 2005.

MARTY RESNICK, 60, WHO COFOUNDED RESNICK FINANCIAL Advisors in Westport, CT, with two other partners two decades ago, began actively screening successor candidates in 2000. As a 75 percent owner, he knew he had primary search responsibility. "It's always been on my mind, and I've seen so many blowups for companies at the transition point," he says. "People don't realize how important succession planning is to the client. It's important to me, but it's really important for them. When I'm gone, I'm gone. But they're wondering: 'Is the cash flow okay? Does someone know about the money they're supposed to receive?'"

Richard W. Smith III, president of Capital Advisory Group of Richmond, VA, created his succession plan by first creating a stock-redemption plan for top managers in 2001. "Succession planning is something that needs to be done," he says. "The problem with firms like ours is that they're highly entrepreneurial and usually run by one or two very strong leaders. And there's not a single person who can simply do it. It takes a team of people. The key to me is: Who's the team?" In January, after 15 months of negotiations, high-end wealth manager Focus bought a split interest in Capital, and Smith found his logical successor there. "I started thinking about an exit strategy for myself in 1997," he says, noting that it took him years to transfer client relationships, build redundancies and expertise, ascertain an achievable level of profit, manage platforms' transferability and build a team of leaders. "I wondered: 'How do I extricate myself gracefully? What are the dangers and opportunities? ...My peers are all pathologically independent. You'd be surprised at the level of denial.'"

But once CEOs get past that roadblock, it's all downhill, says Cinnick, who notes that the average plan takes three to six months to finalize and should be reviewed at least annually. The most comprehensive ones identify the bank's key jobs, as well as the skills, competencies, characteristics, cultural elements and management styles that might distinguish that bank from its peers. "And then you

evaluate the people in the organization against those characteristics," says Cinnick, who notes that many banks may realize at this point that they need to reach outside for high-level candidates because no internal employees have the right stuff for the top job.

Who gets the top job can be very controversial. Given the complexity of financial businesses, a top manager would ideally have spent time toiling in many divisions, so an outsider is often not an option. "Most have this notion that if they need a new president, they'll go out and hire one," says Bank of the Sierra's Holly. "When we try to hire senior executives, we've noticed the labor pool is really shallow. There's not a lot out there. Relying on the fact you may hire someone from somewhere else may be a convenient excuse [not to plan ahead], but we like to train our own."

Resnick echoes that concept, underscoring the importance of grooming one's own replacement. "It's a huge plus," he says. "It's a complicated process. If you have someone who can't manage people well, you don't have a company. You need layers of people, divisional responsibility and feedback. It's a management chore." Most organizations may end up hiring the No. 2 and No. 3 managers from outside, and nurturing them as they move up the ladder. That's because few banks take well to outsiders at the top. "Sustainability of the institution is not well served when you go outside the firm," Cinnick warns.

In any case, most banks realize the hazard of hiring an unknown quantity. "It's a risky thing for a CEO to hire from outside," notes Watson. Cinnick agrees, saying boards and enlightened management teams "believe you can't allow random chance to be your guide. The regional banks clearly do steal their people from the big players, so there's a belief that there's always someone we can borrow or steal, but it's not a great long-term plan to rely on a good recruiter. You've got to grow some of your own."

Bank executives fret, however, that revealing to key players where they fall in a succession plan only raises their market value, thereby heightening the risk of defection. "Yes, that's true, but at least you're doing it with their eyes wide open," says Cinnick. "You can retain them longer and show them through compensation that you meant what you said." But the other fear, equally valid, is that a plan identifies which players aren't ripe—and may never be—for promotion. "You have some expectations to manage," he says. "And not all institutions are set up to grow those expectations."

But a succession plan is a living, breathing thing, and tipping one's hand to a group of heirs apparent may not be in a bank's best interest. "You want to make the process clear and open, but not too soon," cautions Harvard's Davis, who suggests banks wait five years before a CEO's presumed exit to publicly announce successors. "The object is to make the right choice, without disappointing or embarrassing someone in the process," he says.

Doing the right thing may not come naturally to many CEOs, cautions Smith, who notes that there are two kinds of CEOs of financial firms: Leaders who don't care what happens to the company after they leave, and those who want to perpetuate the success of the bank after their tenure. "Most people don't want to do an estate plan, either, because they think it may never really happen," he says. "With a succession plan, you're planning for something that will happen. It's the inevitability of it."

In the end, however, the CEO who takes succession planning seriously is the one who understands the importance of his own reputation. "My legacy is not that I helped to build a billion-dollar bank, but that I groomed a successful successor team," muses Bank of the Sierra's Holly. "That would be a better legacy."