Bank Director

The Flywheel of Banking

SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Dear Reader,

If you want to understand the changes underway in banking, a great place to start is the story of Washington Federal, the biggest bank based in Washington state.

A visit to its offices in 2003 would have been like traveling back in time. Typewriters sat on most desks. Employees didn't have email accounts. And the ledger for the bank's holding company was kept on a paper tablet. It was a quaint, yet lucrative, approach to banking. The then $7.5 billion savings and loan was three times as efficient and twice as profitable as the typical bank that year.

How things have changed! In less than two decades, Washington Federal has doubled in size and advanced to the vanguard of digital banking. It's investing in technology companies, experimenting with innovative digital products and designing middleware to integrate third-party solutions. The bank's vision of the future, unveiled by CEO Brent Beardall, is to be a "highly-profitable, digital-first bank."

The temptation in banking right now is to focus on the technological changes underway. But what banks like Washington Federal appreciate is that success in the future isn't solely about mobilizing digital distribution channels, it's also about running a superb operation. With this in mind, we structured the following report, sponsored by nCino, a provider of cloud-based services to banks, around six timeless tenets of banking: leadership, growth, risk management, culture, stakeholder prioritization and capital allocation.

The future of banking is hard to predict. There is no roadmap to reveal the way. But a mastery of these tenets will empower you to forge ahead with confidence.

Best,

John Maxfield

John J. Maxfield
Executive Editor
Bank Director

CONTENTS:

|BD|

SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Leadership

I

From September 2011 through June 2015, a study was conducted by the Intelligence Advanced Research Projects Activity, a government agency that supports the intelligence services. The study's purpose was to figure out whether certain people, or groups of people, can forecast the future more accurately than others. Previous research suggested this wasn't possible, finding that predictions made by experts in a variety of fields were about as accurate as a dart-throwing chimpanzee. But the IARPA came to a different conclusion.

The study was designed as a competition, pitting teams from elite universities against each other. They were tasked with predicting whether war would erupt in Korea, if then-ongoing protests in Russia would spread, or whether Japan's leading stock market index would eclipse a specific point within a predetermined period of time. In all, the study posed nearly 500 questions and vacuumed up more than one million individual predictions. The competition wasn't even close. In the first year, the leading team beat the control group by 60%. In the second year, it beat the control group by 78%. By the third year, the gap had grown so large that the other teams were dismissed from the study.

This is compelling evidence that foresight is real — that some people are blessed with the measurable skill of judging how high-stakes events are likely to unfold. But what is that skill? Where does it come from? "The strongest predictor of rising into the ranks of superforecasters is perpetual beta, the degree to which one is committed to belief updating and self-improvement," wrote Philip Tetlock, a professor at the University of Pennsylvania who helped organize and manage the winning team, in his book *Superforecasting: The Art and Science of Prediction*. "It is roughly three times as powerful a predictor as its closest rival, intelligence."

"There are a few defining things in leadership," says Rene Jones, chairman and CEO of M&T Bank Corp., a $120 billion bank based in Buffalo, New York, that ranks first among publicly traded banks based on the compound annual return of its stock since 1980. "If I put it into a word, the differentiator is judgment, which comes from a deep commitment to always learning, always getting better in the interest of others." The former chairman and CEO of BB&T Corp., John Allison, echoes this point in his insightful, though provocatively titled book, *The Leadership Crisis and the Free Market Cure*. "The most distinguishing characteristic of masters is the ability to learn from life experiences," Allison wrote. "Masters use a combination of the broad principles that can come from formal education and both modify and apply those principles based on their life experiences."

The banking industry is dominated by a pair of unique peculiarities. The first is the immense leverage employed by banks — three or more times that of a typical company. The second is the near-limitless demand for credit, the principal product provided by banks. These qualities are benign in isolation, but their combination yields a volatile mix. Leverage leaves little margin for error while the unusual demand dynamics incentivize error in the pursuit of growth. "The banking business is no favorite of ours," wrote Warren Buffett in his 1990 shareholder letter, an invaluable distillation of banking. "When assets are twenty times equity — a common ratio in this industry — mistakes that involve only a small portion of assets can destroy a major portion of equity. And mistakes have been the rule rather than the exception at many major banks."

> ***"What separates the most successful people from others? In my mind, it's their constant quest to learn."***
>
> **Michael "Mick" Blodnick,**
> CEO of Glacier Bancorp from 1998-2016

It takes a special type of leader to profit, not perish, from these peculiarities. The archetype calls for more competence than charisma, less tenacity than temperance. No one personifies this better than the late Robert Wilmers, the chairman and CEO of M&T Bank from 1983 until 2017. "Bob was calm and asked more questions than anybody I've ever met," Jones says. "There was a lot of deep knowledge behind that. He was a ferocious reader, ferocious collector of facts, very deep thinker. Yet, when you met him, he didn't come across that way. He put you at ease

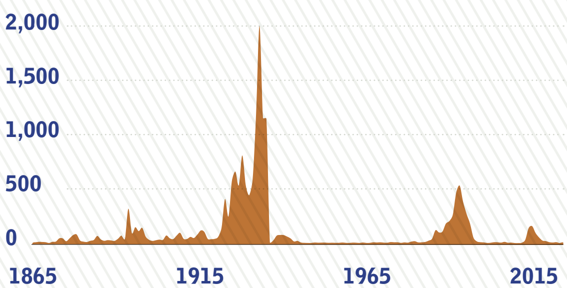
"There are a few defining things in leadership. With respect to a bank, if I put it into a word, the differentiator is judgment ... which comes from a deep commitment to always learning, always getting better in the interest of others."

Rene Jones,
chairman and CEO of M&T Bank Corp.

THE CYCLES OF BANKING

Annual bank failures since 1865

Source: Federal Deposit Insurance Corp.



and asked questions. I think he had such a deep understanding of the history of banking and other things because he never assumed that he knew the answers."

The chairman and CEO of Bank of America Corp., Brian Moynihan, embodies the archetype as well. Moynihan is a study in contrasts. He has relentlessly propelled Bank of America's improbable turnaround with a quiet and subtle manner. He's intense but speaks in a near whisper. And while he doesn't flaunt his intelligence, he's a voracious reader with a vast appetite for information. "Something we talk about a lot is intellectual curiosity and passionate objectivity," says Geoffrey Greener, chief risk officer at Bank of America. "To me, Brian is the embodiment of those things. Nobody is more curious. Nobody is more willing to question the next day something he believed yesterday. It's always about getting to a better place."

A mastery of banking is, of course, essential for anyone who leads a bank. This presupposes an appreciation for the philosophical principles of banking, the history of the industry and the operational practices of top-performing banks. Yet, a mastery of banking is not enough.

"The degree of homogeneity that exists in banking means that studying other banks can sometimes be less fruitful than you would imagine," says Patrick Gaughen, president and chief operating officer of Hingham Institution for Savings, a $2.6 billion bank based in the Boston metropolitan area with a history of outstanding performance. "There's high consultant reuse so the transmission mechanisms for a lot of operational processes and approaches are common. The regulatory schema also provides a strong homogenizing influence, driving banks toward common standards and practices."

An effective way to counteract the homogeneity in banking is to study other industries. Wilmers was renowned for doing so. "If you ran a flower shop, Bob would sit down with you and by the time you left he'd know everything about being a florist," Jones says. Executives at Bank of America say the same about Moynihan. "Brian has a deep knowledge because he wants to learn about different things, not just about banking," says Dean Athanasia, president of consumer and small business at Bank of America. "He looks across every single industry. He's looking at Amazon, Walmart, the brokerage firms. He's looking at all these companies and breaking them down."

Ingrained in all of these leaders is a genuine sense of humility. It's not that they don't have egos, because they do. Everyone does. It's rather that they choose not to project them. The confidence that accompanies mastery renders an artificial veneer unnecessary. "The humility required for good judgment is not self-doubt — the sense that you are untalented, unintelligent, or unworthy," Tetlock wrote in his book about the IARPA study. "It is intellectual humility. It is a recognition that reality is profoundly complex, that seeing things clearly is a constant struggle, when it can be done at all, and that human judgment must therefore be riddled with mistakes."

Leadership is a complex topic calling for an array of innate abilities and learned skills. But underlying all of these, especially in an industry as complex and dynamic as banking, lies perpetual beta. "What separates the most successful people from others?" asks Michael "Mick" Blodnick, the former CEO of $13.7 billion Glacier Bancorp, the Kalispell, Montana-based bank that alone rivals M&T's record of value creation. "In my mind, it's their constant quest to learn."

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Growth

II

It's tempting to think that the financial crisis of 2008-09 was the most consequential event in banking over the past half century. It wasn't. That distinction goes to a U.S. Supreme Court decision issued in 1985.

Thirty years earlier, in 1956, Congress passed a law forbidding bank holding companies in one state from acquiring banks or banking holding companies in another state. The law was designed to prevent large concentrations of capital, which have long been viewed with suspicion. But there was a catch. An amendment to the law allowed interstate acquisitions so long as they were expressly permitted by state law. The question before the Supreme Court was whether state laws passed pursuant to this amendment in Connecticut and Massachusetts violated the U.S. Constitution. It found that they didn't.

The decision marked an inflection point in banking. It ignited consolidation in the industry, enabled the birth of regional (later national) banks and gave depository institutions a new way to grow. Nearly 14,000 mergers and acquisitions have closed since then, leaving a much more concentrated industry. There are one-third as many commercial banks today as there were in 1985. And the five biggest banks alone now account for a combined 43% of the industry's assets.

How long can this continue? At what point will the calculus change to favor organic growth powered by digital distribution channels? The answer depends in large part on a bank's size and location.

The biggest banks have already changed their growth strategies out of necessity. Because JPMorgan Chase & Co., Bank of America and Wells Fargo & Co. each control 10% or more of domestic deposits, they are prohibited by law from buying other banks. In lieu of this, they've concentrated on digitally driven organic growth.

Bank of America has been particularly transparent with its strategy. It relies on a three-pronged playbook to enter new markets. First, it focuses on markets where it already has a critical mass of single-product customers — those with mortgages, auto loans, credit cards, brokerage accounts, etc. Second, it goes in "digital first," says Chairman and CEO Brian Moynihan, by aggressively marketing its digital banking capabilities. Finally, it constructs a core branch network, staffed predominantly with specialists and relationship bankers. Bank of America has used this strategy to more than double its share of deposits in Denver over the last five years. And it opened 10,000 digital accounts in Pittsburgh before building a single branch in the city.

Superregional banks are following suit. "To acquire a customer 20 years ago, what did you need? You needed a physical presence," says Andy Cecere, chairman and CEO of U.S. Bancorp, a $495 billion bank based in Minneapolis. "Today you don't necessarily need the same level of physical presence and you can still acquire customers."

It's worth emphasizing that this doesn't mean branches are obsolete, because they aren't; but they are certainly less important than they used to be. "If you want to have the primary relationship with your customers, you still need a physical presence," says Greg Carmichael, chairman and CEO of Fifth Third Bancorp, a $169 billion bank based in Cincinnati. "What you don't need is the same network depth. Because 70% of financial transactions are now going through digital channels, you don't need as many branches. You don't need the same proximity to the client because they're traveling there less often. You don't need a big branch with three drive-up windows. What you need are smaller locations with lower costs to operate and more self-service options."

> ***"To acquire a customer 20 years ago, what did you need? You needed a physical presence. Today you don't necessarily need the same level of physical presence and you can still acquire a customer."***
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> **Andy Cecere,**
> chairman and CEO of U.S. Bancorp.

Digital-first growth strategies have proven to be effective, but they have limitations. The approach is most economical in large metropolitan areas. It's also a more gradual way to enter new markets. Five years ago, Bank of America controlled 1.15% of the Denver deposit market. That has since climbed to 2.91%.

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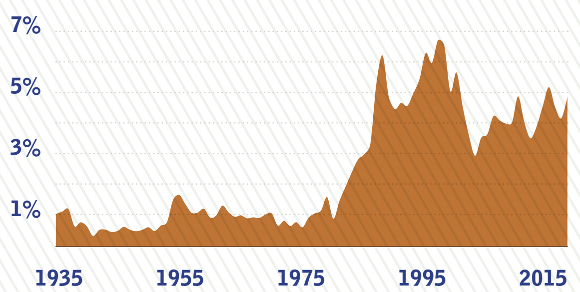
Greg Carmichael,
chairman and CEO of Fifth Third Bancorp

BANK MERGERS & ACQUISITIONS

As a percent of total commercial banks

Source: FDIC



By contrast, Wells Fargo entered Denver through a predecessor company's acquisition in 1990 of United Banks of Colorado, one of the biggest locally based banks at the time. That translated five years later into a 15.81% share of the deposit market.

This is why not all superregional banks discount the value of mergers and acquisitions as a viable growth strategy. In 2019, BB&T and SunTrust Banks announced a merger of equals to create Truist Financial Corp., the nation's sixth biggest bank by assets. The year before that, Fifth Third acquired MB Financial. The deal moved Fifth Third from 10th to fourth place in market share of deposits in the Chicago area.

It's at smaller regional and community banks, in turn, where mergers and acquisitions still serve as the primary vehicle for growth. A total of 266 deals were completed in the industry in 2019, marking a four-year high for bank mergers and acquisitions. More than 90% of those deals involved sellers with less than $1 billion in assets. This additional avenue for growth gives small banks an advantage over their larger peers. But the challenge is to grow through acquisitions without sacrificing value, which is easier said than done. The general rule of thumb is that two-thirds of bank acquisitions impair an acquiring bank's value as opposed to catalyze it, says Second Curve Capital Founder and CEO Tom Brown, a respected industry observer.

The most effective acquirers use one of two strategies. The first is to acquire troubled institutions in a crisis. M&T Bank has been especially adept at this, making acquisitions in every major crisis since the early 1980s. It did so in the 1987 stock market crash, in the aftermath of the Savings and Loan Crisis in the early 1990s and following the financial crisis of 2008-09. The second strategy is to pay reasonable prices for well-run banks and then accelerate the acquired bank's revenue growth and cost savings. Glacier Bancorp has been an especially effective proponent of this strategy. It has completed 28 acquisitions since 1990 to expand from a handful of locations in the Flathead Valley of northwest Montana into one of the leading banks throughout the Rocky Mountain region.

Increasingly, digital distribution channels provide a new way for community banks to expand their addressable markets as well. These channels also bolster the products that smaller banks can offer, as well as the efficacy of their marketing efforts. And the cost to access technology is coming down. "It used to be that a bank had to buy its own equipment from IBM, operate its own data centers and employ its own IT staff," says Patrick Gaughen, president and chief operating officer of Hingham Institution for Savings. "Whereas now, a lot of those things are available from a wide range of vendors, and you can generally consume them on a variable-cost basis."

As the banking industry continues to consolidate, the time will come when organic growth over digital channels will be the predominant way to acquire new customers. In some parts of the country, where just a handful of locally owned banks remain, that point has already arrived. But for the majority of banks throughout the rest of the country, the full range of growth strategies are still available. The key is to avail oneself of the options with discipline.

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Risk Management

III

If you drive west from Dallas on Interstate 20 you'll find yourself after about three hours in Abilene, one of just a few cities dotting the vast inhospitable expanse of West Texas. The area's claim to fame, aside from its proximity to the oil-rich Permian Basin, is that it hosts the world's largest rattlesnake roundup. Participants in 2016 caught a record 24,262 pounds of rattlesnakes. That equates to about 10,000 snakes. Yet, while this is about as close to the Wild West as one can get, it also happens to be home to the most highly valued regional bank in the country.

Shares of First Financial Bankshares, an $8.3 billion bank based in Abilene, trade for more than four times book value. No other bank its size or larger comes close. The median bank on the KBW Regional Banking Index, a collection of 50 regional banks with between $7 billion and $53 billion in assets, trades for less than a third as much. This gives First Financial a potent advantage: When it makes acquisitions using its stock as currency, as it often does, it effectively pays half price.

What's behind this gilded valuation? It isn't profitability; First Financial ranks fourth on the index for return on equity. Nor is it dividends; following a recent stock split, the yield on its stock ranks closer to the bottom of the index than the top. The answer lies instead in the consistency of First Financial's performance. Its return on equity has fluctuated less over the past 15 years than any other major bank — a period encompassing the highs of the housing bubble, the lows of the financial crisis and the turbulence of the European sovereign debt crisis. When it comes to bank valuations, the proclivity to limit losses is just as important as the ability to generate revenue.

At the heart of banking lies a fundamental paradox: A bank must grow to create value, but if it grows too fast it risks insolvency. It's a matter of cognitive dissonance — the struggle to simultaneously balance contradictory beliefs. "The real challenge is to communicate to people that we have to grow, no excuses, but we have to do it the right way, with the customer, and we've got to do it on a sustainable basis," says Brian Moynihan, chairman and CEO of Bank of America. "You're asking people to think about conflicting possibilities and resolve them in order to drive a company accordingly."

The peculiar demand dynamics of banking complicate this delicate balance. A bank can grow as fast as it wants in the short term simply by easing its credit standards. This is especially tempting at the top of a credit cycle, when competition and complacency are in abundance and less prudent peers are capturing market share. Warren Buffett refers to this as the institutional imperative: "the tendency of executives to mindlessly imitate the behavior of their peers, no matter how foolish it may be to do so." Buffett was writing at the time about a commercial real estate crisis plaguing banks in the early 1990s. But this is hardly a new phenomenon.

> ***"Everybody says that our valuation comes from our consistency, that we're constantly doing what we say we're going to do. We do the same thing every quarter that we've historically done, which is to raise our earnings for 32 consecutive years."***
>
> **Scott Dueser,**
> chairman and CEO of First Financial Bankshares

"The 'sound' banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him," wrote economist John Maynard Keynes in 1934.

No bank is spared from these pressures. Not even M&T Bank, which has emerged over the past four decades as one of the most revered banks in the country. Much like First Financial, M&T's success is rooted in consistency. Over the past three cycles, it has grown slower than the industry at the top of the cycle and faster than the industry at the bottom of the cycle. By doing so, it has compounded an enormous amount of value. Of the 100 biggest banks in 1980, only 23 remain today; of those, M&T ranks first in terms of stock price growth. Nevertheless, at an industry conference in November 2018, as its loan growth trailed the industry, CFO Darren King observed that, "The narrative around the industry is that M&T has forgotten how to lend."

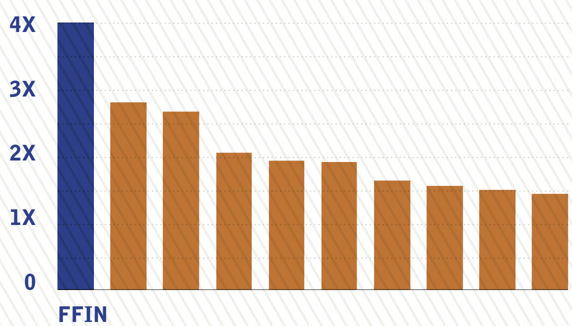
Combatting the institutional imperative demands an alignment

"There are always going to be cycles in banking, and we think the down cycles give us an opportunity to propel ourselves forward. Having a big investment in the company plays into this because it gives you credibility with institutional investors. We never meet with an investor that our family doesn't own at least twice as much stock in the bank as they do. When we tell them we're thinking long-term, they believe us."

Joe Turner,
CEO of Great Southern Bancorp

HIGHEST VALUED BANKS ON THE KBW REGIONAL BANKING INDEX

Price to book value
Source: YCharts



of interests between management and shareholders. This may seem like an academic explanation. Yet, the importance in particular of skin in the game — equity ownership by executives and directors — can't be overstated. It's cited more frequently than any other factor by the leaders of top-performing institutions as the source of their success.

"There are always going to be cycles in banking, and we think the down cycles give us an opportunity to propel ourselves forward," says Joe Turner, CEO of Great Southern Bancorp, a $5 billion bank based in Springfield, Missouri, that ranks near the top of the industry in terms of total shareholder return over the past 40 years. "Having a big investment in the company plays into this because it gives you credibility with institutional investors. We never meet with an investor that our family doesn't own at least twice as much stock in the bank as they do. So when we tell them we're thinking long-term, they believe us."

Other CEOs make the same point. There was a time when 51% of M&T's ownership could sit comfortably around the coffee table in former Chairman and CEO Robert Wilmer's office.

"When you're lending your own money, you have a tendency to do it differently than if it's someone else's money."

Robert Gaughen,
chairman and CEO of Hingham Institution for Savings

"When it came down to being patient, not worrying about one decision and how it'll affect our quarter, being able to say, 'This is the right thing to do over a given time period,' that's really unique," says Wilmer's successor Rene Jones. And at Hingham Institution for Savings, another historically high-performing bank, lending authority is concentrated in the executive committee of the board, the members of which are all heavily invested in the bank. "When you're lending your own money, you have a tendency to do it differently than if it's someone else's money," says Hingham's Chairman and CEO Robert Gaughen. "It's a very effective means of risk management."

It's not just stakeholder alignment that matters, of course. The tactical aspects of risk management spring from knowledge and experience. Effective credit cultures entail lending within a bank's geographic footprint, staying within executives' circles of competence, getting close to customers and stubbornly refusing to diverge from established credit policies in order to compete with less-prudent peers. Knowledge and experience also bestow a reverence for the unforgiving vicissitudes of the credit cycle. The chairman and CEO of First Financial, Scott Dueser, points to his memories of the acute banking crisis in Texas in the 1980s as one of the main reasons his bank weathered the financial crisis of 2008-09 so well. "The 1980s were an incredibly valuable experience, but I didn't want to live through it again," he says.

Getting risk management right is easier said than done. But the benefits that flow from doing so extend beyond the ability to weather the irregular but not infrequent corrections in the credit cycle. "From what you show and what we know, everybody says that our valuation comes from our consistency, that we're constantly doing what we say we're going to do," Dueser says. "We do the same thing every quarter that we've historically done, which is to raise our earnings for 32 consecutive years."

The Flywheel of Banking

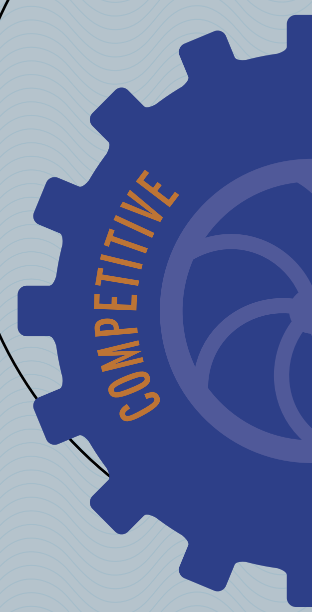
Success in banking doesn't boil down to just one thing. Rather, it stems from multiple self-reinforcing factors that collectively gain momentum over time. You can conceptualize this as a flywheel, a round mechanical device that stores and accumulates momentum from each successive application of force. The key is to direct all of the tenets covered in this study to apply force to this flywheel.

NO.6 SCALE

This growth feeds on itself. It allows a bank to invest more in technology, thereby accelerating digitally driven organic growth. Also, with scale comes economies of scale, which further fortifies efficiency and powers a new revolution of the flywheel.

NO. 5 ACCRETIVE GROWTH

A bank that avails itself of these benefits can grow in ways that are accretive to existing shareholders. It can acquire vulnerable peers facing insolvency at the bottom of a cycle. Or, if it's a publicly traded bank, it can use its premium valuation as currency in acquisitions irrespective of timing.



NO. 4 LOWER LOAN LOSSES

The indirect benefits of efficiency are most noticeable when credit costs climb at the bottom of a business cycle. A bank that parlays efficiency into higher credit quality will earn more money through a full cycle. Also, its performance will be less volatile, a key factor influencing valuation.

The starting point in the flywheel of banking is efficiency, the principal source of competitive advantage in a commoditized industry. Efficiency in banking is expressed as a ratio of expenses to revenue — the efficiency ratio — with the typical bank striving to spend no more than 60% of its net revenue on expenses.

NO. 1 EFFICIENCY

NO. 2 DIRECT BENEFIT

A bank benefits directly from a low efficiency ratio because more of its revenue falls to the bottom line. This translates into higher profitability and a premium valuation.

NO. 3 INDIRECT BENEFIT

A bank benefits indirectly from a low efficiency ratio because it can earn its cost of capital while assuming less risk. There are two reasons for this. First, efficiency enables a bank to compete aggressively on loan rates, thereby attracting higher quality borrowers. Second, efficiency eases the ever-present pressure to artificially inflate profitability by cutting credit standards.

Higher Profitability

More Competitive for Higher Quality Credits

Less Incentive to Reduce Credit Standards

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Culture

IV

For seven consecutive years after the financial crisis, U.S. Bancorp was the most profitable bank on the KBW Bank Index, a collection of the two dozen biggest banks in America. It also had the highest credit rating in the industry, which acted as a powerful magnet for attracting low-cost deposits. This success sprung in part from U.S. Bancorp's frugality. Because efficient banks like it can earn their cost of capital without stretching on credit quality, they tend to perform well even through corrections in the credit cycle. But while efficiency helps explain U.S. Bancorp's success, it's not the whole story. For that, you need to understand its culture.

You can trace the origins of U.S. Bancorp's culture back to Harry Volk, the president and later chairman of Los Angeles-based Union Bank & Trust from 1957 to 1980. Volk came from the insurance industry. He had been a vice president at Prudential Insurance Co. of America, where he spearheaded decentralization efforts and helped introduce family life insurance plans. He then brought his playbook to banking in 1957. He decentralized Union Bank's organizational structure, introduced daily compounding of interest, pioneered the one-bank holding company and was an early proponent of the tectonic cultural shift that brought bankers out from behind their desks and into the community.

Above all, Volk's most lasting legacy was as an incubator of talent. Union Bank produced 17 future bank CEOs during his tenure. This included the legendary Carl Reichardt, CEO of Wells Fargo from 1983 to 1994, as well as the infamous Jack and Jerry Grundhofer, a pair of brothers who followed Reichardt to Wells Fargo before becoming CEOs of separate Midwestern regional banks in their own right. It was the merger of the Grunderhofers' banks in 2000 — Milwaukee-based Firstar Corp. (run by Jerry) and Minneapolis-based U.S. Bancorp (run by Jack) — that created the U.S. Bancorp we know today. That's the tie to Volk. It's his philosophy of driving efficiency through lower costs and, especially, higher revenue that still serves as the starting point, though certainly not the ending point, to understanding U.S. Bancorp's culture and success.

Culture is a simple concept that's hard to perfect. It's a shared set of values and assumptions about how to run a business, including how colleagues interact with each other, how decisions are made and how to take risks. If you ask the same questions to different people at a company with a strong culture, you'll get similar responses. This cohesion acts as operational lubricant. "If you take the concept of efficiency and operational leverage and go one step beyond just the efficiency ratio and financial statements, a team with strong alignment around how they treat each other and make decisions can perform with greater leverage by pushing decision-making and operational functions down in ways that make a company nimbler, more efficient and more responsive to customers," says Patrick Gaughen, president and chief operating officer of Hingham Institution for Savings.

> ***"We actually do a correlation analysis between employee engagement and client satisfaction scores in different departments, and it's amazing the correlation between engaged employees and happy clients."***
>
> **Kevin Riley,**
> CEO of First Interstate BancSystem

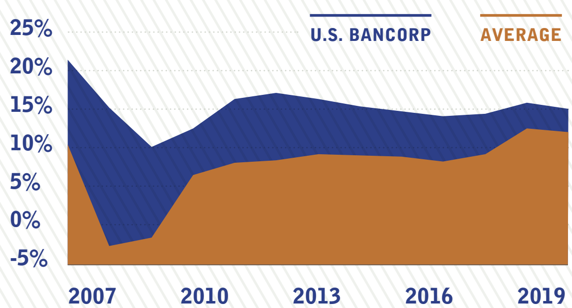
The benefits of this alignment have never been more important than they are today, given the accelerating pace at which decisions must be made in the digital age. Look no further than U.S. Bancorp. Its executives cite cultural alignment to explain how they've been able to leverage agile decision-making teams so effectively to become one of the most innovative banks in the industry. "Our agile studios couldn't exist at the scale and operate at the pace we're now operating them at if we didn't have the cultural foundation of being a bunch of nice Midwestern people who want to work together and get things done," says Tim Welsh, vice chairman of consumer and business banking at U.S. Bancorp. "I don't say that at all jokingly. It's a real advantage. When we talk to other institutions about what we've done, they're astounded at how quickly and the scale at which we've gotten our agile teams up and running."

An appealing culture also helps attract the talent needed to navigate the industry's digital transformation. "Too many times we talk about technology being the differentiator when, in fact, *"Our agile studios couldn't exist at the scale, and we wouldn't be operating them at the pace we're now operating them at, if we didn't have that cultural foundation of being a bunch of nice Midwestern people who want to work together and get things done."*

Tim Welsh,
vice chairman of consumer and business banking at U.S. Bancorp

U.S. BANCORP VS. KBW BANK INDEX AVERAGE

Annual return on equity
Source: YCharts



I think it's really technologists — programmers and engineers," says Rene Jones, chairman and CEO of M&T Bank. "It's all sorts of people with discipline that are the differentiators. What this means is that the institutions that produce the best quality environments — where the creative class likes to perform their craft — are going to have a strategic advantage because talent is mobile. It's more mobile than it has ever been."

The best cultures in the banking industry are rooted in mission, purpose, vision and value statements. The most effective of these are simple declarations that tap into fundamental elements of human nature. M&T Bank's purpose is to "make a difference in people's lives." BB&T's mission, prior to its merger with SunTrust Banks to create Truist Financial, was to "make the world a better place to live." Statements like this are easy to dismiss as trite, but the logic behind them is compelling. "Communicating [a company's] purpose with clarity to all major constituencies is essential for excellence," wrote John Allison, the CEO of BB&T from 1989 to 2008, in his book, *The Leadership Crisis and the Free Market Cure*. "It is particularly important that the employees understand the purpose in a way that is both self-actualizing and self-correcting. Employees who truly understand the purpose of the organization and are vested in the accomplishment of the purpose require far less management."

Simply promulgating a series of principles is not enough; they need to be reinforced with consistent communication as well. Jones spends months crafting M&T Bank's annual shareholder letter. Bank of America Chairman and CEO Brian Moynihan regularly revisits the pillars of responsible growth that he first articulated in 2014. And First Financial Bankshares, the highest valued regional bank in the country, enlisted Horst Schulze, the brainchild of Ritz-Carlton Hotel Co.'s customer service philosophy, to teach the bank's employees about excellence. Out of this came a series of 21 "service non-negotiables" that First Financial printed on wallet-sized foldout cards, distributed to employees throughout the organization, and which inform meetings conducted across the company every morning.

Ideally, these communication channels enable information to travel both up and down an organization. If there was one management lesson from the financial crisis, it was that the banks that got into the most trouble tended to be those that stifled the upward flow of information about unsavory business practices and questionable credit quality. First Interstate BancSystem facilitates the flow of two-way communication by conducting annual employee engagement surveys. "What we're trying to accomplish is what I call our drive chain. If we have happy employees, and they are highly engaged, then they're going to take care of our clients, which should translate into higher net promoter scores," says First Interstate CEO Kevin Riley. "We've actually done a correlation analysis between employee engagement and client satisfaction scores in different departments, and it's amazing the correlation between engaged employees and happy clients."

It's easy for banks to assess their performance using metrics reflecting efficiency, profitability and credit quality. But a one-dimensional approach like this will gloss over the common denominator of extraordinary banking: culture. It's the wellspring from which superior performance derives. "When I think about our company and what makes us successful, it would be things like we're action oriented, we're very collaborative, and accountability is a big part of our culture," says Terry Dolan, CFO of U.S. Bancorp. "That translates into financial results and corporate social responsibility."

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Stakeholder Prioritization

V

At a hearing before the House Financial Services Committee on Apr. 10, 2019, Bank of America Chairman and CEO Brian Moynihan, along with the CEOs of six other large banks, was asked an odd question by a member of the committee. "Are you a socialist or capitalist?" asked Rep. Roger Williams. This wasn't the first time Williams had asked this question. He had done so a month earlier at a hearing on the National Flood Insurance Program. What made it unusual this time, however, was that Moynihan and his peers lead some of the biggest and most profitable companies in the world. Of course, they are capitalists, each of them said. But while their answers pacified the mood at the hearing, the episode marked the beginning of a broader conversation about capitalism, not the end.

Moynihan revisited the topic two months later in a speech at the Economic Club of New York. It seemed as if he wanted to finish a thought. Yes, capitalism is the best economic system, he explained, but it leaves some people behind and doesn't adequately address a number of important societal issues like climate change. The solution isn't to throw capitalism out, Moynihan continued, but rather to mobilize it to solve these problems. "What I believe strongly is that these issues can only be solved if the great companies in the room and other companies in the private sector are involved and, in fact, driving it," he said. "Capitalism is the system to solve the concerns. But it has to be done the right way."

It's easy to dismiss statements like this as a product of a public relations campaign. But that would be a mistake. Leaders across the financial industry are signaling in unison that the role of corporations in society, and thus capitalism itself, is evolving.

It has long been accepted that corporations exist for the primary purpose of maximizing shareholder value. In 1997, so-called shareholder primacy was endorsed as a principle of corporate governance by the Business Roundtable, a non-profit association whose members are chief executive officers of major U.S. companies. But as governments retreat from their traditional duty to police undesirable economic externalities like pollution and inequality, corporations are increasingly being urged to fill the void. These trends prompted the Business Roundtable, in August 2019, to abandon its endorsement of shareholder primacy in favor of stakeholder capitalism, a system in which corporations optimize the outcome for all their stakeholders instead of solely maximizing it for shareholders.

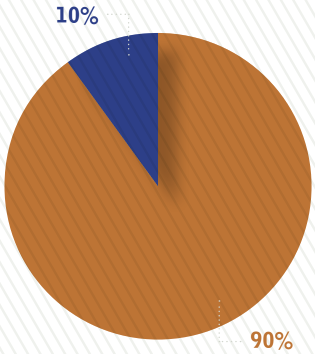
The philosophy of stakeholder capitalism is not new to banking. "As a mutually owned bank, we've taken a multi-stakeholder approach to business for 120 years," says Clay Adams, CEO of Mascoma Bank, a $1.9 billion bank based in Lebanon, New Hampshire. In 2018, Mascoma reinforced this by becoming a Certified B Corporation, obligating it to consider the impact of its strategies and business model on its employees, customers, community and the environment. The benefit of a mutual bank, of course, is that it doesn't face the same pressures to generate returns. "A nice luxury a mutual has is that we can take a longer-term perspective because we don't have the quarterly pressure that exists with publicly traded companies," Adams says.

> ***"There are a lot of really good companies and banks that don't have strong cultures but drive better returns than we do. But I believe in balance. That's a central part of our culture. I believe that we have a commitment to one another, to our customers and to our shareholders."***
>
> **Cort O'Haver,**
> CEO of Umpqua Holdings Corp.

A number of publicly traded banks have also predicated their business models on the idea of serving a broader base of stakeholders. "Our first core value is people first, and, embedded within that, is the concept of being client first," says Frank Sorrentino, chairman and CEO of ConnectOne Bancorp, a $6.2 billion bank based in Englewood Cliffs, New Jersey. "If you look at our logo, it was designed to demonstrate that there's always a seat for the client in every single thing we do. The reason for that is because I was once the client. I was the person who was mistreated in the last relationship I had with my bank. So my answer to fixing that was to start a bank."

"We have to do a great job for our shareholders, our customers and our teammates. If we don't produce for all of them, our business model will be in trouble, our customers will leave us and there'll be different people running the company. And we have to produce for society because, frankly, that's what capitalism can do is solve problems — big problems."

Brian Moynihan,
chairman and CEO of Bank of America Corp.



INVESTORS COULD HAVE AVOIDED 90% OF CORPORATE BANKRUPTCIES OVER THE PAST FIVE YEARS BY FOCUSING ON COMPANIES THAT PRIORITIZED ESG FACTORS.

Source: Bank of America

The biggest bank in the Pacific Northwest, Umpqua Holdings Corp., a $28.9 billion bank headquartered in Portland, Oregon, adopts a similar approach. "There are a lot of really good companies and banks that don't have strong cultures but drive better returns than we do," says Umpqua CEO Cort O'Haver. "But I believe in balance. That's a central part of our culture. I believe that we have a commitment to one another, to our customers and to our shareholders."

Yet, while adopting the principles of stakeholder capitalism was once voluntary, today it's increasingly mandatory — especially for publicly traded companies on stock indices like the S&P 500. It's no longer enough to simply say that you embrace these ideals, there must be quantifiable evidence to bear it out. In recent years, large institutional investors have started engaging with companies on issues spanning the environmental, social and governance spectrum. "Society is demanding that companies, both public and private, serve a social purpose," wrote BlackRock CEO Larry Fink in his 2018 letter to CEOs. "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

Other institutional investors are following suit. Many large banks will no longer fund the private prison industry. Goldman Sachs Group won't take a company public if its board consists only of white males. And State Street Corp. has created a new scoring system to measure companies based on environmental, social and governance issues. "We believe a company's ESG score will soon effectively be as important as its credit rating," wrote State Street Global Advisors CEO Cyrus Taraporevala in his 2020 letter to directors of corporate boards. Taraporevala went on to say that State Street, a leading shareholder in virtually all major publicly traded U.S. companies, is "prepared to use our proxy voting power to ensure that companies are identifying material ESG issues and incorporating the implications into their long-term strategy."

Institutional investors are not saying these things to advance social agendas; instead, they believe sustainable business practices drive long-term value. "The evidence on climate risk is compelling investors to reassess core assumptions about modern finance," wrote Fink. "Will cities, for example, be able to afford their infrastructure needs as climate risk reshapes the market for municipal bonds? What will happen to the 30-year mortgage — a key building block of finance — if lenders can't estimate the impact of climate risk over such a long timeline, and if there is no viable market for flood or fire insurance in impacted areas? What happens to inflation, and in turn interest rates, if the cost of food climbs from drought and flooding?"

It's still too early to say whether the embrace of stakeholder capitalism over shareholder primacy represents an enduring new paradigm. But that misses the point. A growing number of sophisticated investors and top-performing bank CEOs argue that these paradigms aren't mutually exclusive.

"We call it the 'Genius of the AND,'" says Moynihan, adopting a concept from Jim Collin's book, *Built to Last: Successful Habits of Visionary Companies*. "We have to do a great job for our shareholders, our customers *and* our teammates. If we don't produce for all of them, our business model will be in trouble, our customers will leave us and there'll be different people running the company. And we have to produce for society because, frankly, what capitalism can do is solve problems — big problems."

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS

Capital Allocation

VI

In 1980, a man by the name of Robert Wilmers was on the hunt for investment opportunities. He had spent much of the past 18 years working for two of the most prestigious banks on Wall Street — Bankers Trust Co. and J.P. Morgan & Co. — so it was only natural that he was drawn to banking. He wanted a bank with between $1 billion and $3 billion in assets. He wanted to pay a reasonable price. And the bank had to be based in a city that could be accessed by direct flight from Wilmers' home in New York City. After winnowing the list down to two banks, Wilmers and his partners settled on First Empire State Corp., the parent company of M&T Bank, the fourth biggest depository institution based in Buffalo, New York, at the time.

After suffering for more than a decade and a half from placeholder managers and an imprudent international expansion, M&T's shares by 1980 were trading for a third of book value. It was exactly what Wilmers was looking for. He and his partners bought a quarter of its outstanding stock, and three years later named Wilmers chairman and CEO. He brought in new talent, jettisoned M&T's international operations, cleaned up its loan book and refocused the bank on lending to consumers and businesses in its core Western New York markets. By 1987, the turnaround was complete, and Wilmers was ready to grow. That year, M&T acquired East New York Savings Bank, a $1.9 billion thrift based in New York City. The deal cost M&T next to nothing, as East New York's conversion from a mutually owned thrift to a stock-based bank took place during the 1987 stock market crash.

Over the next thirty years, M&T made acquisitions in every crisis, ultimately completing 23 bank and branch deals and growing to $119 billion in assets by the time Wilmers passed away in 2017. Throughout this period, Wilmers generated a higher total shareholder return than any other bank CEO in the modern era.

The secret to M&T's success isn't that it operated the most profitable bank in the industry every year. Its performance was always good, but it was rarely extraordinary. Rather, the thing that most separated M&T from the pack has been its capital allocation decisions, especially the disciplined price and opportunistic timing of its acquisitions. "All excess rents, all excess returns, come from capital allocation decisions," says Rene Jones, current chairman and CEO of M&T.

It was once axiomatic that the ideal corporate CEO was a master operator — a management and marketing guru. But this is no longer accepted wisdom. The turning point came in 2012, when William Thorndike published his book, *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*. With the help of Harvard MBA students, Thorndike showed that the CEOs of U.S. companies who had created the most shareholder value over their tenures were first and foremost masters of capital allocation.

The process of allocating capital is central to the success of a bank. This flows from the nature of both banks and banking. A bank is nothing more than a highly leveraged fund perched atop a slim sliver of capital. The industry is acutely competitive and commoditized. And the internal operations of most banks tend to converge around common standards driven by regulatory prerogatives and high consultant reuse. It accordingly follows that capital allocation is one of the few ways a bank can differentiate itself from its peers.

> ***"This whole approach of what's good business versus what's bad business, tying it all back to capital usage, was maybe the most important thing I learned in my career."***
>
> **Michael O'Neill,**
> former chairman of Citigroup (2012-2019)

It's no coincidence that the most successful bank CEOs have all excelled at capital allocation. The only one who rivals Wilmers' record is Michael "Mick" Blodnick, the CEO of Glacier Bancorp from 1998 to 2016. During Blodnick's time at the bank, starting in 1978, Glacier grew from a $72 million savings and loan with a handful of locations throughout the Flathead Valley of Northwestern Montana into a $9.5 billion commercial bank spanning the Rocky Mountain region. It did so through a series of two dozen acquisitions. Its strategy was to pay reasonable prices for banks and then fold them into a decentralized manage-

> *"Understanding the credit cycle and making all kinds of decisions, whether it be hiring people during a recession or being able to be there for your customers during a difficult time, those are all capital allocation decisions to me. And they are the differentiator."*
>
> **Rene Jones**,
> chairman and CEO of M&T Bank Corp.

M&T BANK'S VALUE CREATION

Total shareholder return since 1980

Source: YCharts

ment structure that allowed the acquired institutions to increase revenue and remove excess costs. The net result is that, since going public, Glacier has generated a total shareholder return of approximately 40,000%.

Allocating capital is a mindset, not a mechanical process. "Understanding the credit cycle and making all kinds of decisions, whether it be hiring people during a recession or being able to be there for your customers during a difficult time, those are all capital allocation decisions," says M&T's Jones. "And they are the differentiator."

It starts with the decision of whether to reinvest excess capital within a bank or to distribute it to be invested by shareholders elsewhere, much like an industry agnostic investor would approach the decision. "If you approach banking from an investor mindset like we do, one primary difference is that, although we're in a great business and there are a lot of opportunities in banking, maybe more now than ever for a bank our size, we're not culturally committed to banking," says Patrick Gaughen, president and chief operating officer of Hingham Institution for Savings, which has produced superior returns since his family gained control of the Boston area bank in 1993. "Which is to say, if the chocolate industry were interesting and seemed to have features that allowed for sustainable long-term returns on capital, then I'd be happy to be a chocolatier."

There are three ways to distribute capital: pay it out as dividends, repurchase stock or make an acquisition. None is superior to any other; what matters is a coherent strategy. Glacier and M&T demonstrate the virtues of disciplined acquisition strategies. Under the father/son team of Bill and Joe Turner, Great Southern Bancorp has generated superior returns in large part by repurchasing 42% of its outstanding stock over the past three decades. And for years, New York Community Bancorp generated industry-leading returns despite distributing more than 90% of its annual earnings as dividends.

A similar process informs how retained capital is deployed within a bank. Michael O'Neill spent his career turning around marquee institutions in the industry — as CFO of Continental Bank Corp. in the early 1990s, CFO of BankAmerica Corp. in the mid-1990s, CEO of Bank of Hawaii Corp. in the early 2000s, and finally as chairman of Citigroup from 2012 to 2019. O'Neill attributes much of his success as a turnaround artist to an approach he learned early in his career about making sure that each division within a bank earned its cost of capital. "This whole approach of what's good business versus what's bad business, and tying it all back to capital usage, was maybe the most important thing I learned in my career," he says.

A coherent approach to capital allocation is especially critical for banks right now, given the growing importance of internal investments in technology. In light of this, the biggest banks, as well as superregionals like Fifth Third Bancorp, U.S. Bancorp and others, are adopting new, agile decision-making processes to facilitate better and faster investment decisions. The point being, if you want to compete with the best banks in the industry, it isn't enough to run an efficient and consistently profitable institution. You also have to catalyze your performance through disciplined capital allocation. It is the key to not just banking, but any business that strives to create value.

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SIX TIMELESS TENETS OF EXTRAORDINARY BANKS