FMS Update

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Perspectives on Profitability

Getting the most out of profitability analysis in community institutions

PROFITABILITY analysis is a paradox.

On the one hand, the prevalence of stagnant net interest margins across the industry suggests that community institutions would be desperate to get an accurate picture of exactly where the potential profits lie within their product lines and customer bases, and to work to capitalize on those opportunities. However, what passes for profitability analysis in many institutions today probably isn't going to reveal those answers. Whether their efforts have been stymied by flawed methodologies, a lack of resources or insufficient buy-in across the organization, many community institutions simply aren't realizing the true value of solid profitability analysis.

What are the challenges and how can institutions overcome them? What are the keys to making profitability analysis work? FMS took these questions to a trio of experts in the field to get their take on what community institutions should be doing if they truly do care about profitability.

What should community institutions be doing to better measure profitability and analyze the performance of various products and delivery methodologies?

Jeffrey Marsico: One thing our industry has not done well is realizing economies of scale. At the granular level, if you are growing, organically or through acquisition, the cost from back-office centers supporting profit centers should decline on a relative basis. For products, the operating expense per account should decline as an institution grows. We've seen little of that at the profit center and product level in our profitability outsourcing service. In other words, 'economies of scale' is a phrase in banking, but not yet a reality. If institutions were doing profitability right, they would manage to ensure that the operating cost per account would decline as they grew, not increase.

Why aren't more institutions doing these things or putting a formal program in place? Culture. Bankers are steeped in responsibility reports – straight out of their general ledger – and budget variance reports. Most institutions are comfortable with, and have a history in, managing at the whole-institution level. Support centers are managed by budget and budget variances. Profit centers are measured by volumes, balances and number of widgets. This was perfectly acceptable when institutions were smaller and margins were commonly above 4%. Now, bankers must be more precise in profitability measurement in order to make better decisions.

Kenneth Levey: It's incredibly important for community institutions to understand why their margins are narrowing, and how profitability can help them not necessarily solve the problems, but at least understand what's going on in terms of customers, products and the organization as a whole. Even though more institutions are starting to do profitability analysis, many are coming up with results that are descriptive rather than diagnostic. So the key is to really understand the hows and whys of that analysis, not only from a standpoint of overall margin but from the standpoint of determining who's contributing the most to the institution. Who are my top 10% clients and what is the makeup of their portfolio? Do they have more loans or deposits or accounts?

Community institutions have really focused on service in the past. But now it's time to start understanding value, and where the profits come from. Institutions have to make the decision to embrace profitability management from the top down. You can't just say 'we're going to implement a profitability system and hope it's successful.' It has to be a whole cultural change within the organization. If institutions have learned anything since the crisis, it's that they have to grow thoughtfully, and one of the ways to do that is through profitability analysis and then to take that all the way through to a risk-adjusted return on capital.

The Profitability Panel

Jeffrey Marsico
Executive Vice President
The Kafafian Group

Kenneth Levey
Vice President – Financial Institutions
Kaufman Hall / Axiom Software

Jeffrey Morris
Managing Director and Principal
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Jeffrey Morris: In my experience, relatively few community institutions (those under $3 billion in assets), have active profitability programs in place, and some that do are still relatively dissatisfied with their results. However, those select few that make it into the realm of profitability systems 'best practices' obtain significant rewards in exchange for their efforts.

What are some of the key things for an institution to keep in mind when trying to develop a profitability system?

Marsico: Don't let the perfect be the enemy of very good. Once the methodology of your profitability system is agreed upon and is consistently applied, executives must demonstrate leadership to ensure the results will be directionally correct to make better decisions. Profit laggards in the bank will always object. Be a leader.

Levey: It has to come from the top down – this is far and away the most important factor. Management has to be clear about what it intends to do and how it's going to do it.

Another key is the data. How can I ensure that my data is of good quality? Do I have the tools to help me analyze that? It's also important to establish and understand methodologies for getting to FTP, allocating expenses and determining standard costs. Those are big questions that have to be answered.

One more aspect of this is education. We're seeing more and more clients going into full-fledged profitability analysis, and they're asking us to come in to educate their boards, their C-levels and their users. They want to make sure they're making the right decisions and that everybody throughout the organization understands why they're doing what they're doing. The idea is to make sure everyone is on the same playing field and everybody understands the methodologies. This should flow throw to incentive payouts as well and if you change how you're paying people, they have to understand and be on board with how profitability is going to affect them. So education is a big part of it as well.

Morris: Some of the higher-level considerations that a community institution should consider when implementing a profitability system include commitment by senior leaders (CEO, COO, CFO, CLO, etc.) to the concept of having valid profitability reporting systems in place, and for using the results to make key strategic decisions. In addition, institutions should focus on procuring an experienced internal or external expert who will be responsible for the development of the system, including facilitating the involvement of all end-users in both the development and use of the system's results. Implementations that are based on the expectation that existing staff can adequately develop and manage the system 'in their spare time,' or as a secondary area of responsibility are prone to failure. Implementations that rely too heavily on software vendor training and support are also less likely to succeed in the long run.

When it comes to the nuts and bolts of designing and implementing a profitability system, it's important to consider multi-dimensionality and full integration, meaning a system that provides all available views of profitability (customer, product, branch, officer, etc.) through a single, fully integrated system. The modular systems of yesteryear (some of which are still in operation today) were built for vendor benefit and revenue enhancement, and were not based on institutions' needs for simplicity and a 'single version of the truth.' The system should also be fully reconciling in every dimension, meaning that all views on profitability reconcile directly to the institution's consolidated financial statements, and all views reconcile to each other.

Finally, the cost accounting system is a crucial aspect of any profitability system. The cost accounting or cost allocation process is time-consuming and requires the experience of a trained analyst, skillful in facilitating this process. The cost analyst will make inquires of the operating managers of the institution who have the best insight on what activities drive costs. The analyst will then turn this information into business rules that allocate costs as the volumes of these activities change over time. Best practices for cost accounting include defining and tracing expenses to product as both variable and fixed costs, as well as direct versus indirect costs (as these concepts relate to products). Taking these extra steps provides the helpful alternative measure of profitability known as the contribution margin, useful for estimating the incremental profitability on the next one account sold.

> *When you talk about measuring profitability and the importance of it, it's certainly about how an institution can improve its margin, but it goes beyond that. It's the whole concept of descriptive versus diagnostic analysis – to really understand not just the what, but the how and the why as well.*
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> *Ken Levey, Vice President – Financial Institutions, Axiom EPM*

What do you see as some of the main challenges of putting an effective profitability system in place at a community institution?

Marsico: Cost, staff resources and a lack of management support all figure in. Too many financial institutions assign profitability reporting as a moonlighting gig to somebody in the finance department. So what happens? It gets put on the back burner and the reporting becomes less timely.

But the number one challenge is treating profitability information as 'nice to know.' Executive management might spend hours in a meeting talking about a capital budget variance, but very little time determining why they are marginally profitable in home equity lending, creating an action plan to improve it and monitoring the progress.

Levey: Twenty-five years ago, people were buying profitability systems and leaving them on the shelf. Why? Because the software wasn't strong enough or fast enough, the hardware was too expensive. On top of that, the quality of data in the core systems was always a problem. These days, the software and hardware issues don't really exist anymore. Data can still be an issue, but it's gotten much better.

So cost is becoming less of an issue for institutions. If they really see the value and really see the potential ROI, they'll find a way to get it done.

Morris: The constraints keeping community institutions from a higher level of achievement do not usually relate to the lack of adequate data resources or powerful enough information systems – certainly those elements are in ample supply in most organizations today. The chief barrier is a lack of sufficient knowledge, understanding and experience in how these systems should be designed and managed, and a lack of commitment of sufficient organizational resources (mostly personnel time and training) to developing systems appropriately tailored to the needs of the institution.

An additional set of barriers relates to inadequate involvement upfront in the systems development by the management team that will be the end-users of the system, and a lack of visibility into the internal workings of the system and its inherent profitability methods. Failure to involve end-users in the system's development causes a 'not invented here' syndrome, and a lack of transparency leads to distrust for the systems results. Without this key ingredient, buy-in and acceptance of the system cannot be achieved.

How widespread is the use of funds transfer pricing (FTP) in profitability analysis at community institutions? How important is it to the establishment of a robust, meaningful profitability measurement system?

Marsico: FTP is a scorecard. In football, you wouldn't credit special teams for the team's superior defensive performance. Why would you credit deposit-gatherers with the bank's yield on loans or earning assets?

My firm recently did a process improvement engagement at a financial institution. As part of that work, we reviewed the profit potential of their branch network. This bank did not employ a profitability system. We probably went back and forth determining the 'credit for funds' for branch deposits four or five times. First we assigned loans to branches and awarded the yield on those loans plus the yield on investments for excess funds. Then we removed loans and used the yield on the bank's investment portfolio. It could go on and on.

With FTP, the argument would be moot. Longer-term deposits would get longer duration credits, and therefore greater spread, rewarding branches with superior funding mixes.

Levey: The answer here is very simple – you cannot do profitability analysis without FTP. Period. For example, let's talk about allocating expenses, which is a big part of customer and product profitability analysis. This is really important. But the allocation of the net interest margin piece is even more important. Why? Because net interest margin typically represents 50% to 85% of an institution's bottom line income. So why would I spend all the time allocating my below-the-margin expenses and not do the same thing for my above-the-margin piece?

If you're not doing FTP methodically or not doing it in a manner that makes intrinsic sense, then you're leaving the biggest piece of the puzzle out. Now I'm measuring all the different pieces of all the different components in an accurate way, which makes it easier to compare one product to another and one organization to another and one customer to another just by allocating all of those elements correctly. And it all starts with FTP.

If a client told me they wanted to do profitability just by assigning a cost of funds, I'd tell them they're making a mistake, because they're not really calculating profitability correctly. I'm pretty adamant about that.

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Morris: Core profitability elements, such as the funds transfer pricing process, properly take into account the cash flows of each product and should be well understood by all users. FTP is the most critical element of any profitability system, as it is used to determine the net interest margin of each product, and this measure is by far the largest contributor to overall profitability. This educational / informational process is not difficult, but needs to happen early in the process (many institutions skip this step) and be revisited periodically over time. ■

What is your institution doing in terms of profitability analysis? What challenges are you running into? Share your experiences today on FMS Connect or email us at markl@fmsinc.org.