FIVE PROVEN APPROACHES TO IMPROVING BANK EFFICIENCY

An eBook that examines the keys
ECONOMISTS PREDICT CONTINUED SLOW GROWTH THROUGH 2013, WHICH PLACES ONGOING STRAIN ON THE NATIONAL ECONOMY.

In the face of challenging economic conditions, U.S. financial institutions need to pare down costs even further in order to survive in this environment. Executives must create new operating models, as a few key banking industry statistics paint a grim picture of the challenges banks and credit unions face.

According to a Mercator Group report, overall financial institution operating income has dropped from a historical high point in 2007 and continued in a downward trend through 2011. Obviously organizations will not be able to grow to improve profitability. The profitability answer lies in cutting expenses. And the growth of the industry’s overall efficiency ratio – up to 60 percent through September 2012 – indicates the magnitude of that challenge.
OPERATING INCOME AND INTEREST AND FEES OF LOANS
(In $ Billions)

Sources: Federal Financial Institutions Examination Council Annual Reports, Federal Deposit Insurance Corporation, National Credit Union Association
EFFICIENCY RATIO – INDUSTRY AVERAGE

Efficiency Ratio
Source: FDIC 9/30/12

- 1999: 58.5%
- 2000: 58.4%
- 2001: 57.8%
- 2002: 56.2%
- 2003: 56.6%
- 2004: 58.0%
- 2005: 57.3%
- 2006: 56.8%
- 2007: 59.5%
- 2008: 59.4%
- 2009: 55.6%
- 2010: 57.2%
- 2011: 60.6%
- 2011: 61.4%
- 2012: 58.5%

* Annualized Q3 Data
FIVE PROVEN APPROACHES TO INCREASING BANK EFFICIENCY

Bank executives need a comprehensive viewpoint as they seek to rigorously cut costs in order to improve efficiency and ultimately profitability. For financial institutions planning to survive and even thrive in today’s no-growth world, action needs to be taken. Here are five proven approaches financial services executives can leverage to ensure their efficiency ratios are well under 60 percent and their organizations are in the top quartile of high-performing institutions.

1. Rationalize branches and optimize delivery channels
2. Initiate business process improvements aligned with enabling technologies
3. Align sales resources with market opportunities
4. Evaluate strategic sourcing opportunities
5. Evaluate selective outsourcing alternatives
The industry seems, for the first time, to be offsetting increased spending on alternative delivery channels with hard reductions in legacy branch costs. Research justifies this cost reduction, as illustrated by the following data from Financial Management Solutions, Inc. (FMSI). The average number of teller transactions has declined by 40 percent in the past 12 years as seen in the following chart, with the biggest single year decline occurring during the most recent annual period.

Given this decline in branch volumes, matched with the desire to maintain service levels, how do bank executives embark upon a sensible branch rationalization plan?
THE STEPS IN A BRANCH RATIONALIZATION EVALUATION

The key to any branch rationalization analysis is to understand current performance and the potential to improve results given existing market realities. The following graphic illustrates the key drivers of branch network performance and highlights the critical steps in evaluating options for improving overall branch effectiveness.
STEP 1: DETERMINE IF THE BRANCH OR BRANCHES IN QUESTION ARE SATISFYING PROFIT CONTRIBUTION OBJECTIVES

STEP 2: EVALUATE THE POTENTIAL OF THE MARKET SERVED BY THE BRANCH TO SUPPORT A PROFITABLE OPERATION

STEP 3: PERFORM A COMPETITIVE PRODUCT EVALUATION

STEP 4: RE-EVALUATE PERSONNEL PRACTICES
Achieving marginal profitability is not the same as enhancing shareholder value (or generating a reasonable dividend/interest payment to mutual depositor owners). The scope of financial modeling and analysis is critical to branch evaluations and should include at least the following key elements:

- Determine if credit for services is provided to accountholders who are not domiciled in the target office. While many banks reassign deposits to the locations where the customer is most often serviced, many do not. At least on a pro forma basis, credit for this interbranch servicing needs to be made in order to understand the actual financial contribution of a location.

- Ensure the interest income earned from branch-based loans is adjusted for loan loss provision expense rather than simply reflecting gross yields.

- Determine a normalized transfer pricing credit rate for excess deposit balances generated in the branch.

- Consider unallocated expenses, particularly variable overhead costs for administration. Regional and district personnel are the largest category of such expenses. This staff exists in some relationship to the number of branches in total in most organizations. If the running rate contribution of the office is inadequate to satisfy the bank’s financial goals, a secondary analysis of the cost to close the facility will be required.

- This analysis, as with any investment decision, should be viewed as a longer-term decision. Otherwise one-time costs (while a cash flow reality) will distort the understanding of the full benefit of exiting the location. Consider a five-year net-present value analysis when evaluating a closing decision.
What if a branch is falling short of required profit contribution levels? Then the next step is to pose several key questions to gain a clear understanding of upside market potential. These steps include:

- What business does the bank service in each census tract that is supported by a branch today?
- How does that compare to the estimate of available business, assuming that the branch captures a fair share of the potential?
- Will a fair share of the available market produce a profitable contribution from the office?
Sufficient insight is available from competitive market surveys to move forward in adjusting products and services. This evaluation can be conducted to the extent that market trends show your institution is lagging with regard to the array of products in demand by the segments evaluated in Step 2.

There are a number of quality market research organizations focused on updating and maintaining current competitive data for banks, thrifts and credit unions, including one particularly cost-effective organization: Financial Shop Solutions.
FIST™ client engagements across the country have found the following to be all-too-common personnel impediments to improving branch effectiveness:

- Inadequate criteria for identifying the characteristics of an effective sales staff and recruiting qualified staff
- An emphasis on one-shot sales training seminars as the solution to creating a sales environment
- Failure to assign sales staff with appropriate skills and knowledge to those territories with the maximum quantifiable market potential
- Misalignment of sales goals and incentive programs as part of a larger salary administration program that fails to consider market potential, or plans that reward gross account opening rather than net business growth
- Inadequate management reporting resulting in a lack of visibility to aid sales management
- Inadequate performance evaluations, coaching and remedial action to address shortcomings

Each of these can be addressed with proven techniques, and in virtually every case we have observed, the changes have improved overall individual sales effectiveness in markets that have upside potential.
Substituting technology for manual processes has always been a key to improving productivity. The application of emerging technologies and the expansion and adaption of even older IT platforms, such as a document imaging solution, remain crucial to improving productivity and further reducing overall costs. In fact, imaging technology coupled with business process improvements can yield significant rewards.

Working with a Midwestern regional bank, FIS Consulting identified more than $6 million in potential savings with 160 unique projects. The timeline and savings identified are shown in the following table.
### INTEGRATED RECOMMENDATIONS AND IMPROVEMENTS

<table>
<thead>
<tr>
<th>Wave</th>
<th>No. of Items and Business Cases</th>
<th>No. of Items</th>
<th>Valuation</th>
<th>Completed By</th>
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<tbody>
<tr>
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<td>11</td>
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<td>Implemented</td>
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<td>Quick Hits (QH)</td>
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<td>$405,499</td>
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<tr>
<td>Intermediate and Long-term Results</td>
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<td>180</td>
<td>$4,577,320</td>
<td>9/30/2012</td>
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<td><strong>Subtotal</strong></td>
<td><strong>160</strong></td>
<td><strong>218</strong></td>
<td><strong>$5,116,660</strong></td>
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</tr>
<tr>
<td>Additions</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Courier – Salary and Benefits</td>
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<td></td>
<td>$518,700</td>
<td>3/31/2012</td>
</tr>
<tr>
<td>Courier – Vehicles and Gas</td>
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<td></td>
<td>$438,400</td>
<td>3/31/2012</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td></td>
<td></td>
<td><strong>$957,100</strong></td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td>160</td>
<td>No. of Items</td>
<td>$6,073,760</td>
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</tbody>
</table>
Critical elements for encouraging positive performance and gaining improved business processes include:

- Eliminating unnecessary work that consumes time without adding perceived value in the eyes of the customer
- Simplifying tasks that must be completed to produce quality service, achieve sales objectives and manage risk effectively
- Utilizing available technologies more effectively and implementing new systems to improve processing throughput and ensure quality outcomes
- Streamlining organizational structures to support both revised and enhanced workflows and achieve reasonable management spans of control across the company
- Realigning responsibilities and tasks to ensure that personnel with appropriate skills are assigned to complete required work
- Restructuring employee compensation, including variable incentives, to more closely align with all sales and service objectives in all units of the bank

HOW TO INITIATE BUSINESS PROCESS IMPROVEMENT EFFORTS

In order to transform a bank’s entire operations, including all business processes, we recommend the following strategies: start from the top down, create an ongoing sense of urgency, break the silos between functional areas and communicate plans often and through different channels.
However, today’s circumstances demand it. Survival must not be taken for granted. Banks that survive will have shifted their focus from maintaining the status quo to driving substantive change.

**Break the Silos between Functional Areas**

With clear deadlines established, employees must often work in cross-functional teams in order to complete transformational tasks. These teams must transcend traditional bank boundaries. Managers must empower individuals to make recommendations and changes for the greater good of the institution as a whole. Facilitated planning sessions will go a long way toward breaking down departmental barriers.

**Communicate Changes Often and through Different Channels**

Beyond breaking down silos, effective communication also drives the transformation effort. In almost every study, communication-related issues are the most frequent problems a bank transformation team experiences. The change manager or program manager spends almost 90 percent of their time communicating. For a significant change, a formal Communications Management Plan should be developed that goes beyond status reports. The Communications Management Plan includes the following processes:

- Identify stakeholders
- Plan communications
- Distribute information
- Manage stakeholder expectations
- Report performance
In order to achieve increased efficiency and satisfy strategic objectives, it is critical to systematically and consistently allocate human resources with the support of staffing and scheduling tools. Key points of staff capacity forecasting include:

- Establishing targets and supporting staffing levels to achieve them, driven by market business development potential (as opposed to using “business as usual” as the sole determinant of new sales goals)
- Staffing both branch and support functions using criteria driven by service expectations consistent with the bank’s desired image in the marketplace and commitment to the communities it serves
- Allocating time in a manner that is consistent with prudent, compliant controls and statistically justified assessments of actual risk
- Allocating staff to incorporate sufficient time for training and education, coaching and counseling, and general oversight of all front-line and back-office units

- Utilizing a well-conceived and consistently applied approach to determining capacity over time. This is essential to realize long-term benefits from more effective staff allocation and avoid single, quick-fix staff cuts that never produce lasting results.

One of the best illustrations of aligning sales resources with market potential is from a project Chemical Bank undertook with FIS Consulting. Teams from the bank and FIS consultants worked together to ensure sales resources in the bank’s branch network were matched to the greatest market opportunities. The follow graphic highlights that effort.
HIGHLIGHTS

CHEMICAL BANK:
Chemical Bank in Midland, Mich., has grown to more than $3.7 billion in assets, with 129 offices throughout the state’s Lower Peninsula.

Business Objectives:
A long-time client, Chemical Bank wanted to enhance value by fully leveraging its FIS partnership. Ultimately it wanted to:
• Improve branch sales effectiveness
• Improve branch efficiency
• Increase channel flexibility
• Enhance financial performance

FIS Solution:
FIS performed a Deposit Growth and Branch Effectiveness engagement that focused on market potential rather than past performance.

Benefits Achieved:
The consulting engagement uncovered growth opportunities and focused sales and incentives accordingly. This led to:
• $7 million annual financial benefit
• $47 million increase in consumer loan originations compared to the previous year
• 8 percent increase in the lending portfolio
• 25 percent increase in application volume
• 3,000 new deposit accounts
• More effective resource deployment
• Realistic incentives and rewards
The purchasing operations of many mid-tier financial institutions provide fertile ground for cost saving procedures. It may come as a surprise to executive management that the purchase of goods and services comprises 50 to 60 percent of non-interest expense (NIE), with staff expenses comprising almost all of the rest. The diagram below shows this distribution at a midsize Midwestern bank. Inevitably, some of this expense will not lend itself to immediate sourcing, usually due to the existence of long-term contracts. Nevertheless, more than 40 percent of NIE can be reduced with concentrated effort.

**NON-INTEREST EXPENSE (MILLIONS) OF MIDSIZE MIDWESTERN BANK (SOURCE: FIS RESEARCH)**

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sourceable</td>
<td>18.9%</td>
<td>$53 MILLION</td>
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<tr>
<td>$113 MILLION</td>
<td>40.2%</td>
<td>$113 MILLION</td>
</tr>
<tr>
<td>Sourceable</td>
<td>40.9%</td>
<td>$115 MILLION</td>
</tr>
<tr>
<td>$281 MILLION</td>
<td>100%</td>
<td>$281 MILLION</td>
</tr>
</tbody>
</table>

**TOTAL**

19
BY NATURE, BANKERS KNOW A GREAT DEAL ABOUT THE BUSINESS OF BANKING.

What bankers do not generally know, however, is how to procure goods and services with rigor and supply market knowledge. This deficiency can result in a lack of knowledge, skills, methodologies, tools and creativity – all of which are the hallmarks of best-in-class procurement practices.

In order to appreciate the transformative power of strategic procurement, it is important to distinguish it from traditional approaches to acquiring goods and services. The approaches can be categorized as purchasing, procurement and strategic procurement, with each category demonstrating increasing levels of strategic awareness and operational sophistication, as shown in the following diagram.
LEVELS OF PROCUREMENT SOPHISTICATION

Using the discipline and rigor of strategic procurement, two mid-tier banks were able to realize an average of 17 percent annual savings – savings that flowed directly to the bottom line. Moreover, with proper monitoring of procurement processes and vendors, these particular institutions can reasonably expect these savings to recur for the next several years.
One obvious solution to achieving a greater degree of productivity is the outsourcing of functions that can be performed by another entity more cost-effectively due to the outsourcer’s economies of scale and utilization efficiencies. Financial institutions can now leverage a new outsourcing alternative – selective outsourcing. Selective outsourcing combines the banking expertise, banking technology and highly skilled work force offered by outside providers. As a result, financial institutions can source specific tasks to highly qualified providers.

The following definitions contrast general outsourcing and today’s selective outsourcing alternatives.

- Outsourcing – The hiring of subcontractors to perform specific jobs or functions based on their superior economies of scale and expertise with certain business functions and services.
- Selective Outsourcing – This form of sourcing is aimed at building trust and establishing compatibility between the provider and the outsourcing partner before any long-term agreement is reached.
## EVOLUTION OF BANK OUTSOURCING

<table>
<thead>
<tr>
<th>Outsourcing Administrative Functions</th>
<th>Outsourcing Information Technology</th>
<th>Outsourcing Business Processes</th>
<th>Business Transformation</th>
<th>Selective Sourcing</th>
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</thead>
<tbody>
<tr>
<td>Payroll</td>
<td>Deposits</td>
<td>Call center operations</td>
<td>Create differentiation</td>
<td>Laser focus on specific challenge</td>
</tr>
<tr>
<td>Finance</td>
<td>Lending</td>
<td>Focus on labor arbitrage</td>
<td>Create competitive advantages</td>
<td>Dependent on banking and technology integration</td>
</tr>
<tr>
<td>HR</td>
<td>Internet</td>
<td></td>
<td>Improve speed-to-market</td>
<td>Can address regulatory requirements</td>
</tr>
<tr>
<td>Security</td>
<td>CRM</td>
<td></td>
<td>Create value</td>
<td></td>
</tr>
<tr>
<td>Etc.</td>
<td>Etc.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**CREATING BUSINESS VALUE BEYOND COST SAVINGS – THE KEY CHALLENGE**
A wide array of services is available to banks on a sliding scale tied to volumes. Perhaps the best example of such services for bankers today is check processing. As overall check volumes decline, individual banks find it makes more economic sense to outsource this back-office function. This can reduce expenses as volumes decline rather than burden the bank with high, fixed, internal costs.

Selecting a strategic partner for a full range of business processes and IT outsourcing is critical. Key considerations when selecting a partner include:

- The partner’s reputation for regulatory compliance, service quality and financial soundness (which can be determined with the proper due diligence)
- The partner’s willingness to enter volume-sensitive/scalable pricing arrangements that reflect decreases as well as increases in volume (for example, generate reduced unit pricing as volumes increase)

- Clear, unambiguous service-level agreements for all key business outcomes, as well as clearly defined processes for escalating problems for prompt remediation
- The partner’s willingness to periodically meet to review contract performance and operational issues

When an outside provider serves as an extension of a bank’s organization, they have an inherent responsibility to act in bank’s best interests. It is incumbent on the bank’s management to continually monitor the provider to ensure they are up to the above tasks.
SUMMARY

Executing these five approaches offers today’s financial institutions a chance to make steady efficiency improvements. But the bank’s culture should also be addressed, which is a topic for another eBook. Here are a few last thoughts on the common characteristics of highly efficient banks. From FIS’ experience working with highly productive, high-performing financial institutions, we found these select banks:

1. Rely on exceptionally focused senior management
2. Deliver a clear, consistent message of purpose throughout the organization
3. Embrace change and support a culture of quick adaptation
4. Understand their market and the competition
5. Maintain a customer-centric focus
6. Leverage meaningful metrics that work
7. Maintain openness to new technologies