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Measure for measure

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Which profitability measurement tools are best for your bank?

The financial crisis has been difficult for all businesses, but it's been particularly hard on community banks. With some banks failing and many struggling, it's vital to monitor your performance closely.

Measuring profitability serves two important purposes: First, it lets you know how your bank stacks up against the competition. Second, it helps you to compare results to budgeted expectations and spot negative trends early.

Gauging profitability

"Profitability" is generally defined as the ability of a business to generate net income. But your income statement tells only part of the story. A bank with a seemingly healthy bottom line, for example, may be generating a low return on equity (ROE). And focusing on overall bank profitability may conceal underperforming branches or product lines, causing the institution to miss profit-boosting opportunities.

Finally, as recent experience demonstrates, net income as a measure of bank performance can be deceiving unless it's adjusted for risk. Before the real estate bubble burst, many financial institutions were thriving, but profitability derived from high-risk activities turned out to be illusory.

Knowing your purpose

Banks typically use one or more financial ratios to measure profitability. Historically, return on assets (ROA) has been the most popular. ROA remains a useful tool, but its value is limited. For one thing, ROA essentially ignores the cost of equity capital. A highly capitalized institution with a strong ROA may actually disappoint its owners if they're seeing a meager return on their investment. For this reason, banks are now placing greater emphasis on ROE.

Also, by focusing on the balance sheet, ROA fails to measure the profitability of banking activities that

generate noninterest income. Other metrics — such as an overhead efficiency ratio [for example, noninterest expense/(total income – interest expense)], operating earnings per full-time employee, and net income growth rates — may provide a more accurate picture.

It's important to recognize the limitations inherent in any single profitability ratio. A bank's efficiency ratio may improve, for example, if revenues increase, but this may conceal rising costs. Operating earnings per full-time employee favors banks involved in less labor-intensive activities (such as wholesale banking), so it may not be the most appropriate measure for a traditional community bank.

Net income growth is a valuable measure, but it can vary dramatically depending on base-period income. Suppose, for example, that Bank A has $100,000 in net income in Year 1 and $200,000 in Year 2: a 100% growth rate. During the same period, Bank B increases its earnings from $400,000 to $600,000 — twice as much growth as Bank A, but only a 50% growth rate. Did Bank A really outperform Bank B?

To develop a complete and accurate picture of your bank's performance, the best approach is to use several profitability measures that allow you to look at performance from a variety of perspectives.

Branching out

Overall bank profitability is important, but focusing on it exclusively may deprive you of opportunities to evaluate — and improve — branch performance. Measuring branch profitability is a challenge, however, because funds gathered by one branch are often used by other branches.

Suppose Branch X attracts a substantial deposit and Branch Y uses the funds to make a loan. Branch Y enjoys the interest income while Branch X is stuck with the interest expense. Comparing the branches based on net income alone ignores Branch X's contribution to profits.

To overcome this problem, many banks use funds transfer pricing (FTP). Using one of several methods, FTP assigns a value or "price" to various sources of funds and uses it to allocate net interest margin among users and providers of funds throughout the bank.

FTP can provide you with a more accurate comparison of branch profitability, but, as with other measures, it's important to avoid placing too much emphasis on the results. First, FTP isn't an exact science. The methodologies for calculating transfer prices are complex and highly dependent on the underlying assumptions.

Second, and more important, a branch's performance should be evaluated in the context of its market. Net income data may indicate that a branch is highly profitable, but if it's located in a wealthy suburban community, it may in fact be underperforming because it could be doing even better.

To evaluate branch performance, therefore, you should also look at whether the branch is meeting its budgeted goals for revenue growth, deposit growth, fee income, and so on. This sort of analysis allows you to develop strategies for improving a branch's profitability in areas where it's languishing.

Accounting for risk

Regardless of how you measure profitability, it's important to consider the impact of risk. If the financial crisis taught us anything, it's that profitability is meaningless if it can evaporate overnight.

There are several methods for calculating risk-adjusted profits, such as shareholder value added (SVA) and risk-adjusted return on capital (RAROC). While the economics may differ, all of the methods recognize that revenues generated by highly risky activities are worth less than those generated by "safer" activities.

Looking beyond the numbers

Measuring bank profitability is as much art as science. Net income, financial ratios and other numbers are a good place to start. But to gain a true understanding of your bank's performance, you must view these results in light of your institution's particular circumstances. ▲

Profitability in practice

The Financial Managers Society's most recent *Profitability Measurement Survey* shows how banks are measuring profitability and using the results. Here are a few highlights:

- Although 54% of respondents have developed a profitability measurement process, only 27% have fully implemented it.
- The biggest obstacles to implementation are staffing resources (43%) and management/board buy-in (38%).
- The most common use of the data is "comparing results to budget" (56%), followed by "evaluate and budget costs" (49%) and "basis of incentive-based compensation" (43%).
- When asked the single greatest value received from profitability measurement, the largest number of respondents (28%) said "branch improvement."

Outsourcing: Another cost-saving strategy

In times when cost-cutting is king, outsourcing some functions can be more appealing than ever to community banks. First and foremost, it can be more feasible than hiring full-time staff. But that's not all.

Outsourcing also can shift the burden of keeping up with technological changes or compliance requirements to a responsible party outside of your institution.

And it can allow your bank to offer products and services you normally might be unable to afford — with outsourcing, the costs will be incremental rather than upfront. Additionally, it can give banks in small communities more access to a qualified workforce. The key to success is finding the areas of your bank's operation that are right for outsourcing and carefully selecting and monitoring the service provider.

Should you outsource auditing?

A bank should have an internal audit function appropriate for its size and scope of activities. But some banks may have the same firm handle internal and external auditing functions when splitting audit activities poses a significant cost or burden. It also may be appropriate when people with the appropriate specialized knowledge and skills are difficult to locate and hire, the bank is closely held, or outsourced internal audit services are limited in scope or frequency.

The key to success is finding the areas of your bank's operation that are right for outsourcing and carefully selecting and monitoring the service provider.

If your bank uses the same firm for internal *and* external auditing, the audit committee should document its consideration of independence issues and preapprove the outsourced services to satisfy AICPA and regulatory guidance, which requires independence.

Keep in mind that, while the FDIC encourages nonpublic institutions with less than $500 million in assets to refrain

from outsourcing, internal audit activities may be outsourced to an external auditor.

What about human resources?

It can be difficult to outsource HR because of the high interpersonal contact required, but many banks have determined that outsourcing specific aspects of HR will save them money and resources in the long run.

For instance, it can be costly to keep up with payroll process software upgrades. By outsourcing payroll, you can reduce the administrative costs and benefit from an improved process.

Benefits management also is commonly outsourced. This can provide workers with quick and easy access to information about their medical plans, flexible spending accounts, 401(k)s and more. Just be sure that you can guide your staff through the self-service process and respond to questions in a timely manner — it's frustrating for employees if they have to ask multiple people to obtain information.

Keep in mind that your HR needs will change as your community bank grows. So you'll want a provider with the capability to meet new objectives, which may include recruitment, performance management, strategic growth and employment related compliance.

Over there

A growing number of Day 2 processing functions — capturing data, handling checks, and processing documents for loans and new account openings — are now being handled via offshore outsourcing. But how much of a risk is this for community banks that pride themselves on knowing their customers better than their larger counterparts do?

Offshore outsourcing has challenges that you might not encounter with domestic outsourcing. You must become familiar with the political, cultural and regulatory environments into which your bank is entering to avoid possible interruptions in business due to unstable environments.

Your bank should also anticipate public relations repercussions — especially in a downturned economy. So be prepared to assure customers that their information will be kept private and secure, and explain to your community why some products and services are being outsourced.

Any other functions?

Some community banks are farming out basic processes that underlie consumer products such as first and second mortgages, home equity lines of credit, auto loans and credit cards. This allows your employees to focus more on underwriting risk with customers and prospects than on handling mortgage fulfillment.

Another outsourced service is proof of deposit, especially by banks that use an external data processor. This means no more proof machines and proof operators in-house. All of that work is handled by individuals who focus only on that function.

Where to start?

Before you sign a contract for an outsourcing arrangement, make sure you lay the groundwork. First, determine your objectives for outsourcing. Then develop an implementation plan, and be sure to include details on how you'll evaluate the service provider's performance.

Also, consider launching the outsourcing as a pilot program related to one product or service and then slowly expand to other areas as your bank's comfort level increases. With proper planning and monitoring, outsourcing can improve efficiency and save your bank money. ▲

Reduce costs without losing control

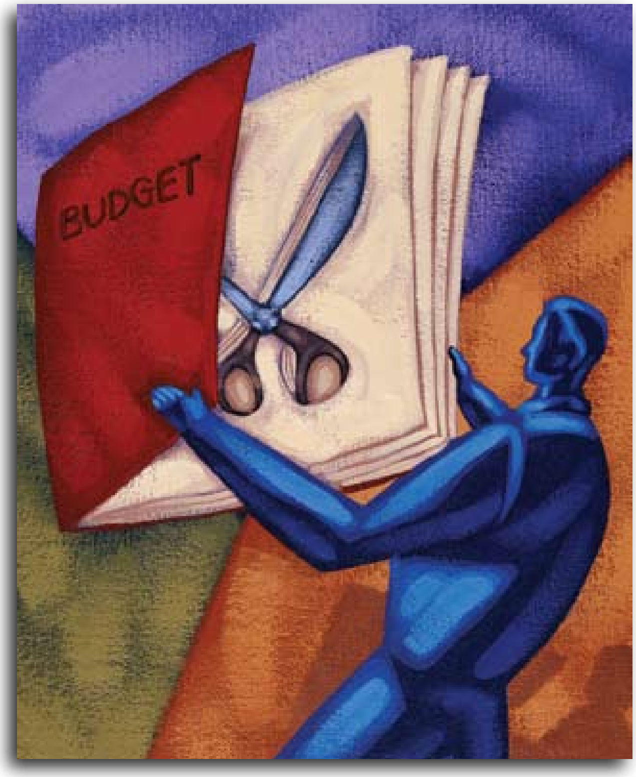
Many community banks are under enormous pressure to improve their earnings. And in a weak economy, like it or not, cost-cutting is an integral part of their strategy.

There's no one right way to cut costs, but as you review your options, consider their potential impact on internal controls. For banks, like many companies, salaries represent a major fixed expense and are an obvious target for cost-reduction. But eliminating jobs can heighten a bank's risk if affected employees are integral to internal control processes.

Why internal controls matter

Internal controls form the foundation of a bank's risk management system. Weak or ineffective controls can lead to operational losses and often contribute to bank failures as well as create a higher risk of fraud.

The Association of Certified Fraud Examiners' *2008 Report to the Nation on Occupational Fraud & Abuse* demonstrates the importance of internal controls in preventing and detecting fraud. Survey participants said that the three most important factors that allowed fraud to occur were: lack of internal controls (35.2%), lack of management review (17.4%) and override of existing controls (17.4%).



Internal controls are even more important now. The same economic forces that are causing banks to tighten their belts also are putting pressure on employees' personal finances.

The survey also showed that median fraud losses were significantly lower in organizations that had implemented antifraud controls, such as surprise audits and job rotation.

How layoffs affect controls

Segregation of duties, for example, is a key control, especially for banks. Assigning different people responsibility for authorizing transactions, recording them and maintaining custody of assets makes it more unlikely that any one employee could both perpetrate a fraud or error and conceal it. To the extent that job elimination reduces the segregation of duties, it can significantly weaken a bank's internal controls.

Another important concern is the internal audit function. Reducing IA staff — or cutting spending on an outsourced or co-sourced IA function — can severely diminish a bank's ability to uncover accounting irregularities and fraud.

How to protect yourself

Ironically, internal controls are even more important now than they were when the economy was flourishing.

The same economic forces that are causing banks to tighten their belts also are putting pressure on employees' personal finances, so sacrificing internal controls may be an invitation for fraud. So it's critical to protect yourself.

The first step is to review your internal control policies and procedures so you can anticipate the impact of contemplated cost-cutting measures. If a staff reduction is unavoidable, try to eliminate jobs that have little or no impact on internal controls.

If you must eliminate employees who perform internal control procedures, a risk assessment can help you identify the areas within the bank where job elimination will present the least amount of risk. Finally, consider whether beefing up other types of controls — such as surprise audits, management or director oversight, job rotation, mandatory vacations, employee support programs or fraud training — can help compensate for weaknesses caused by cost-cutting.

Think long-term

In today's economy, cost-cutting may be unavoidable. But as you take out your red pen, be sure to consider the risk management implications. Don't sacrifice your bank's long-term strength and stability for the sake of short-term gains. ▲

Buying a troubled bank — a good strategy if you do it right

One byproduct of the financial crisis is an unprecedented number of failed or failing banks for sale. In recent months, troubled banks have been sold for substantial discounts, with little or no premium on core deposits.

For a healthy community bank, acquiring a failed or failing institution can provide a valuable strategic opportunity: Such a move can be a cost-effective way to enter new geographical or demographic markets, build core deposits and take advantage of net operating losses and other tax benefits.

Keep in mind, however, that just because the price is low doesn't mean you're getting a bargain. Here are some tips for buying a troubled bank the right way:

Develop a strategy first. Rather than waiting for an opportunity to present itself, start thinking now about whether an acquisition could make sense for your bank. Is acquiring a troubled bank compatible with your institution's strategic plan? Outline the benefits you hope to achieve and create a profile of the ideal acquisition target. Having a strategy in place will help you make the right decisions under the time constraints of a distressed sale.

Don't skimp on due diligence. The only way to determine whether you're getting a good deal is to find out how the target got into trouble and what you'll need to do to correct it. Is the problem declining asset quality? Lack of capital? Securities losses? Fraud? Are there pending lawsuits or other contingent liabilities? Whatever the problem, will you be able to fix it?

Focus on valuation issues. In the current economic environment, valuing financial assets is extremely challenging. Taking the time to price the transaction appropriately can make the difference between a good deal and a disaster.

Determine the right structure. Work with your advisors to structure the deal in a way that will maximize your benefits and minimize your risks. For example, you might consider an asset-only deal or some sort of contingent pricing mechanism. ▲

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