BACK TO PROFITABILITY FOR COMMUNITY BANKS

It was a pleasure to host the ***Back to Profitability for Community Banks*** webinar on May 27.
Your feedback regarding this important topic was very positive. We received a number of good questions from our discussion. We would like to share those questions and our answers with you.
We appreciate your interest and we are sincere in our effort to help you achieve success through excellence in customer service and profitability. Please contact me with questions, or to learn more about our services.

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1) How do you define a profitable customer? Deposit and loan balances, products and services, fees generated?

Several different customer profiles lead to profitability, and the factors you mention figure in, although sometimes in different ways. In the past, retail customers with low average balance checking accounts that frequently bounced checks were among the highest profit and ROE producing customers in the bank. Now, that trend is shifting to retail checking customers with generally higher balances who are heavy users of debit cards; rely on e-statements, electronic and mobile banking; and who are less likely to visit branches. Interchange income and account service fees are replacing NSF and overdraft protection fees . A profitability system is designed to help you differentiate unprofitable from profitable customers. Generalized rules are no longer reliable. Consider the large depositor with high balances in money market and CD products; these high balances do not lead to profitability. This is also true of commercial customers, where credit grades, loan parameters (both rate and term), and the placement of deposit balances by product type will affect profitability more than account size.

2) How applicable are these profitability strategies for real estate lending?

Profitability and ROE measurements for commercial real estate or residential mortgages are applicable. Measurement methods such as funds transfer pricing, and determining levels of product profitability can make a difference in many areas of banking.

3) Is cost accounting worth the headache to obtain more specifics/accuracy with profitability?

In general, yes, however, be careful how much time and effort you put into your cost accounting exercise. The majority of a bank's profitability comes from the net interest margin, and knowing which products have the highest incremental profit is essential to ***improving*** bank-wide profitability. In the big picture, an accurate and sound funds transfer pricing methodology is more valuable than cost accounting. Additionally, do not spend too much of your cost accounting effort focusing on fixed cost allocations, which can be arbitrary and will not affect incremental profitability. Make reasonable assumptions in this area, and move on. Your best investment in cost accounting is to identify your direct costs which vary based on volume, and understand how these costs are driven by increased customer activity. This exercise helps to create a picture of the incremental profitability of each product or service. Outside of these areas, additional time spent on cost accounting is less valuable.

4) Can a small organization (under $100 M) be profitable in a highly regulated environment? In the future do you see fewer small banks? If so, what asset size do you feel a bank needs to be to be profitable in the future?

Financial institutions of all sizes have been negatively impacted by increased regulatory scrutiny and the burden of compliance as a result of the 2008 financial crisis. Associated costs hit small institutions hard. However, many smaller organizations continue to perform well in the current regulatory environment. The regulatory environment has clearly increased bank mergers over the past two years. Regulation will continue to drive industry consolidation for institutions of all sizes.

5) What strategies are effective for improving income in the current economy?

A few strategies that universally apply are:

- Identify individual products that are producing the majority of your marginal and incremental profitability today. Understand which of these products are growing and declining based on current market demand and the rate environment.
- Use a disciplined loan pricing method that will help you to keep current business at rates of return above your current portfolio and bank-wide actuals. Know when to walk away from pricing that is too low.
- Reward customers who fit highly-profitable customer profiles in commercial and retail lines of business. This will strengthen relationships with customers that are most valuable to the bank.

6) Can you give best practices for efficient, timely and accurate measurement of sources for profitability?

In our webinar, we identified six best practices for profitability measurement:

1) Utilize a single system that provides multiple views, so that all internal users can be served by the same system and all users are seeing consistent results. These include branch, product and customer profitability viewpoints, among others.
2) Include team members from all areas of the institution in the process to increase buy-in.
3) The system should reflect current, up-to-date results that are reconciled to your financial statements.
4) We encourage highly-visible rules and assumptions. Include documentation of your system’s assumptions, and display the results in graphic formats whenever possible.
5) Make sure that all users receive the appropriate information for their areas of responsibility by providing comprehensive reporting.
6) Integrate your profitability system with your operating systems including marketing, operations and lending.

7) **Currently, we are using an internal profitability model but it is bulky and not easy to use. We are looking at using an outside model for value and greater operating efficiencies and strategies to compete for loans in ways other than price.**

Hiring a specialist with expertise in designing and maintaining your profitability system can add value to your organization. You will find that you can get your system up and running more quickly and at a lower total cost. You can also benefit from the specialist's breadth of experience that includes knowing what other banks are doing to grow product lines, improve branch profitability, and build stronger bonds with customers.

8) **I am interested in product pricing and evaluating branch efficiency.**

Many community financial institutions are validating their branch networks using branch profitability analytics designed specifically for this purpose. In some cases, branches are being consolidated and the mode of operation is being significantly reconfigured. Understanding the multiple levels of product profitability, including the net interest margin, operating margin, and the bottom line, helps to validate pricing adjustments needed in the current interest rate environment.

9) **I am interested in the pricing of credit today in the current interest rate environment.**

Product profitability and loan pricing are two systems that work extremely well together. Add in the ability to credit risk adjust each and every loan / customer in your portfolio and you can be assured that your institution will be compensated for each incremental risk it takes. In some cases, it may be a few additional basis points, or you may need significantly larger adjustments to protect your institution. With these two systems working together, you can accurately target the real requirements for your bank.

10) **What is your approach to profitability?**

The Austin Profitability System is a comprehensive solution that was designed specifically for community-based financial institutions that want sound profitability metrics, but don't have the depth of resources required to develop an in-house system. Our approach includes all of the best practices discussed above (single system, multiple views, continuously reconciling, etc.). We provide system integration, including funds transfer pricing and cost accounting; comprehensive reporting; and analysis in both hard copy and internet delivered formats. Access to the data is an important first step, but the payback comes from linking the information to operational systems including lending, marketing, and operations. The Austin Profitability System is available separately, or in tandem with **LoanPricingPRO™,** Austin Associates' loan pricing system.

11) **What are ways to reduce expenses?**

The main purpose of a profitability system is not to reduce expenses, but rather to measure profitability and to enable profitability improvements. Occasionally, opportunities to reduce expenses do become apparent in either the cost allocation process, or when reviewing profitability reports. For example, branch profitability reports are often used to analyze low or unprofitable branches to determine if restructuring is needed. This may also occur when reviewing products with higher than average (or expected) costs per account. A part of our standard cost allocation process is to review assigned responsibilities of each major job category by department, reviewing the list of products supported by each, and determining the method for allocating these costs to product. Sometimes excessively high and / or duplicative costs can be identified in this process and an operational improvement study can be performed.

To balance between the goals of growth and profitability, the measures used must be focused on more than just short-term monthly or quarterly profit targets. You must also include long- term return, such as what occurs when calculating the ROE of a five-year fixed rate CRE loan for a customer. The profitability system must take into account the profit to be earned across the entire period of the relationship, or at least the five-year life of the loan. By having your profitability system incorporate these longer-term measures of customer profitability, the probability of making risky short-term choices that have unfavorable long-term effects is minimized.

12) We are looking for some key performance indicators and ways to increase the bottom line.

One excellent KPI is the operating margin of each product compared with the operating margin of the bank as a whole. This measure incorporates the net interest margin, fee income, credit cost, and direct variable cost to produce and service each product in the institution and excludes fixed overhead costs. The best method of improvement is to focus on the growth of products with above average operating margins. Additional valuable measurements include the ROE of each product as compared to the bank-wide average. This measure correlates the dollars of profit produced with the capital necessary to support each product, an extremely important measure as capital becomes more scarce and valuable due to competition and regulation.

13) We would like to learn more about the profitability of mobile banking.

Mobile banking has the potential to improve profitability in a number of ways. First, once mobile transactions reach critical mass, their costs are likely to be substantially lower than those processed in a bank. Secondly, the mobile option helps attract and retain younger customers who tend to be higher profit customers based on their usage patterns with e-banking and debit cards. They are an important target audience for the future of any financial institution.

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