# Tying Management Information to the Front Line

By Jeffrey P. Marsico

*How profitability information can simplify loan pricing and align incentives with strategy.*

Abraham Lincoln once said, "If I had eight hours to chop down a tree, I'd spend six sharpening my ax." The most important function of senior management is the development of strategy. Execution of strategy is a very close second. Management information should give you the necessary data to measure progress in executing strategy and to make course corrections to ensure you achieve your bank's strategic objectives.

Exhibit 1 identifies management information in community banks. The top three types—asset/liability management, budgets and strategic planning and board reporting—are required by regulators or part of good corporate governance. Responsibility reporting, breaking down financial reports by management responsibilities and ad hoc reporting are not necessary but are frequently used within the industry. Profitability reporting (identified in items 6 through 11) is not required and is used less frequently due to time and resource constraints within community bank finance departments.



## Why Do You Need Profitability Reporting?

Wal-Mart Bank. The very thought of this potential creates fear among community banks. The clamor over Wal-Mart's industrial loan company charter application was conspicuously absent when Target and Toyota received their charters. Home Depot is in the process of acquiring such a charter, and it doesn't appear as though comments are pouring into regulators on that one, either. Bankers' objections to Wal-Mart's application are partly, if not predominantly, based on what the retailer has done to competitors with its low-cost strategy.

Successful or not, Wal-Mart Bank should serve as an industrywide rallying cry that managing the profitability of your institution at the whole-bank level is no longer good enough. Wal-Mart executives claim they are only interested in the charter to process customer transactions. However, Wal-Mart's net profit margin is less than five percent, while bank net profit margins are typically greater than 30 percent. If you were Wal-Mart, would you be interested in banking? This stark reality highlights the need to manage your bank with greater precision, using profitability reporting that ties performance to compensation to achieve results.

Providing responsibility reports to business-line managers is no longer enough. At its basic level, a branch that contains predominantly deposits and very few loans ends up with negative net-interest income. Having recognized this as an issue, many community banks have created some form of funds-transfer pricing ("FTP") scheme to credit deposit gatherers with a credit for funds ("CFF") and charge lenders a cost of funds ("COF").

The simplest form of FTP is single-rate, or pool, pricing. The key benefit of pool pricing is its simplicity. Many community banks use their own COF to charge lenders and their yield on earning assets to credit deposit gatherers. The principal limitation of this method is that it penalizes efficient deposit gatherers if the lenders are not successful at generating loan volume or price their loans aggressively.

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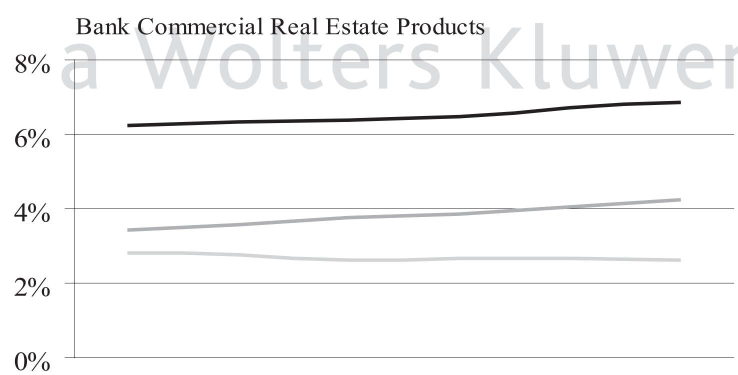
Conversely, lenders that demonstrate discipline in loan pricing could be penalized because the branch network fails to generate lower-cost deposits. This method also ignores the balance-sheet mismatch, thus crediting (or penalizing) business-line managers for the bank's willingness to take interest rate risk.

Another form of FTP, specific matching, when lenders are charged the bank's COF for a similar-duration liability, mitigates the impact of interest rate risk. But this method still puts part of the burden of efficient deposit gathering on lenders and part of the burden of well-priced loans on deposit gatherers. It is also difficult to track.

*Exhibit 1. Types of Management Information*

1. Asset/liability management
2. Budget and planning reporting
3. Board reporting
4. Responsibility reporting
5. Ad hoc reporting
5. Organizational/line-of-business profitability reporting
7. Branch profitability reporting
8. Product profitability reporting
9. Customer/relationship profitability reporting
10. Officer profitability reporting
11. Market segment profitability reporting

*Exhibit 2. Coterminous FTP Spread Shows Importance of Loan Pricing*




| | 4Q04 | 1Q05 | 2Q05 | 3Q05 | 4Q05 | 1Q06 |
|---|---|---|---|---|---|---|
| Interest income | 6.22% | 6.31% | 6.39% | 6.50% | 6.73% | 6.86% |
| Cost of funds (FTP) | 3.42% | 3.57% | 3.77% | 3.85% | 4.04% | 4.23% |
| Coterminous FTP spread | 2.80% | 2.74% | 2.62% | 2.65% | 2.69% | 2.63% |

*Source:* The Kafafian Group, Inc.

Multiple-pool FTP is an extension of pool pricing. Essentially, each side of the balance sheet is split into pools of assets and liabilities related by maturity characteristics and other factors. Then each pool is matched to a similar maturity pool on the other side of the balance sheet to establish a COF or CFF, whichever the case. Multiple-pool FTP relates better to reality but still has its challenges as lenders expect the cheapest COF and deposit gatherers expect the highest credit for funds.

The preferred FTP method is matched maturity, or coterminous, FTP. This method assigns a market rate for a term loan or deposit for a market instrument of similar duration. For example, a one-year certificate of deposit opened on a certain date will receive a CFF rate of a market instrument, such as a Federal Home Loan Bank (FHLB) borrowing, on the same date for the same term. For amortizing loans, a coterminous FTP system can use the cash flow method or duration for determining the appropriate term of the market rate. The benefit of coterminous FTP is that a well-priced loan maintains its healthy spread throughout its life, regardless of what interest rates do subsequent to the booking of the loan.

Imagine the powerful information generated by coterminous FTP and the influence it would have on bank decision makers. We have been hearing much in recent months about the flat and inverted yield curve and how it is adversely affecting bank net-interest margins. One would think that the yield curve was the primary culprit in margin compression. However, the chart in Exhibit 2, generated from The Kafafian Group ("TKG") peer database containing dozens of community banks, demonstrates that using coterminous FTP highlights something more actionable than the macroeconomic yield curve.

A flat yield curve relates to a bank's inability to generate spread income by taking interest rate risk, that is, borrowing short and lending long. Coterminous FTP removes interest rate risk. If coterminous spread is declining, as it is in the above commercial real estate example, it is more related to the pricing of new loans and the spreads of loans coming off of the books than it is related to the interest rate environment. Armed with this knowledge, bankers are more prepared to address a declining net-interest margin issue rather than writing it off as a yield curve issue where nothing can be done.

Management information can dig even deeper into an issue. Exhibit 2 shows the results of coterminous FTP for every loan account where the loan type is mapped to a rollup product termed commercial real estate. If the FTP system transfer-prices every account, why can't it show a coterminous spread at the account and officer level? The answer is that it should. Exhibit 3 is a sample of an officer spread report generated from the FTP process.

Exhibit 3 shows a sample of accounts opened or booked by one particular officer. Imagine the behavioral changes that would occur if the loan officer were held accountable for generating coterminous spread instead of volume. Desperate pleas from lenders to make price concessions in order to get the loan deal done would tend to decline as the lender focused on well-priced loans to generate spread instead of any-priced loans to generate volume.

Imagine a senior management meeting. Armed with the above information, the CEO singles out a lender to congratulate him or her for booking loans with the best coterminous spreads instead of exhorting the lenders to do something about the margin and the others either shaking their heads or invoking the yield curve. After the meeting, the senior lender can meet with the lender with the thinnest coterminous spreads to discuss an action plan to improve performance. That's accountability that leads to action, and that is what FTP can do for you.

FTP is not the only discipline that benefits from profitability information. An analysis of hundreds of branches in the TKG database revealed that, on average, 51 percent of total branch expenses are indirect expenses. This means that if your branch managers believe they have achieved profitability when only direct expenses are included, they are half right. That won't be precise enough if you are competing with Wal-Mart (or Capital One or Countrywide). Exhibit 4 shows what departments provide support, on average, to branches.

*Exhibit 3. Individual Officer Spread Report Generated from the FTP Process*

| Average Balance | Date Opened | Next Reprice/ Maturity | Actual Rate | FTP Rate | Spread Rate | Actual Interest | FTP Amount | Spread | Product |
|---|---|---|---|---|---|---|---|---|---|
| $127,248 | 05/07/01 | 05/10/09 | 6.91% | 5.35% | 1.56% | $2,211.50 | $1,709.72 | $501.78 | Residential Mortgage-Hybrid |
| $44,341 | 08/07/02 | 08/07/07 | 4.11% | 4.08% | -0.03% | $458.62 | $454.21 | ($4.41) | Certificate of Deposit |
| $103,043 | 09/05/02 | NA | 1.47% | 5.30% | 3.83% | $381.74 | $1,373.92 | $992.18 | Money Market Account |

*Source:* The Kafafian Group, Inc.

*Exhibit 4. Departments That Support Branches*

| | |
|---|---|
| Network/IT | 9.02% |
| Branch Administration | 10.57% |
| Collections | 1.78% |
| Loan Operations/Administration | 9.28% |
| Deposit Operations | 5.98% |
| Audit | 1.51% |
| HR/Training | 4.29% |
| Marketing | 2.02% |
| Misc Operations | 6.79% |
| Accounting | 1.08% |
| Miscellaneous | 1.90% |
| General Overhead | 45.79% |
| | 100.00% |

Note that Exhibit 4 represents allocations to an average branch, and these allocations represent 51 percent of total branch noninterest expenses. Experience has shown that banks with lower indirect allocations to branches tend to be more profitable. It is one indication of efficient back-office support. For a business-line manager to understand his or her actual profitability, it is important to allocate all costs associated with running that line of business. Profitability reporting can give you a full understanding of all the costs associated with a line of business, product and customer. If you rely on center-level responsibility reports alone, you are probably not fully addressing true profitability.

Holding business-line managers accountable for true profitability may have a significant effect on budget meetings. No longer will the profit center manager be passive when the support center manager requests additional personnel or some nifty but expensive software package. Knowing that these costs will be allocated to the profit center, these managers may actively participate in a discussion on how other costs may be reduced or how to maintain accountability for increased efficiencies that should result from the new software. In this manner, profitability will become everyone's responsibility.

For example, in a performance review meeting I attended, business-line managers were debating why certain marketing expenses were allocated to them. Since nobody claimed ownership of the expense, the controller suggested eliminating it. Suddenly, the topic of the meeting changed from passing the buck to how to make those expenditures more effective. Efficient and effective support expenditures became everybody's responsibility.

## Profitability Prerequisites

If you believe that developing management information and tying results to the front line is critical to your success, what should you do next? Scores of financial institution finance departments have been on the long journey to build sophisticated profitability models, only to fail in the end for one reason or another. To improve your chances of success, ensure the following prerequisites are covered.

- **Secure senior management's support.** There is no quicker way to kill profitability reporting than to put on your green eyeshade, go into your office, lock the door, and—six months to a year later—plunk volumes of profitability reports on the CEO's desk. You may be proud of the accomplishment because of the challenges in getting to that point, but all that you have accomplished is to kill several trees. The very first step in implementing profitability reporting is to make a case for it, not dissimilar to the case made above, and to get everyone in the room shaking their heads that they want it, they need it, and they will use it.
- **Create a performance culture.** Banking has changed significantly over the past three decades. It is no longer enough to serve customers well once they walk through the door. Now you must give them a reason to come through the door. There is very little difference between the products and services offered in this industry. To succeed, everyone must take ownership of his or her contribution to the bank's profitability. Once that attitude is adopted by senior management and communicated through the organization, you must take the next step to measure and maintain accountability for performance and truly reward the top performers.
- **Reflect management's operating philosophy by whom and what you measure.** Bring your organization chart to the next senior managers' meeting and make sure that it reflects what you want your organizational profitability system to measure. Don't let the challenges within your general ledger or the perceived inflexibility of the profitability software dictate the content of your reporting. This is critical if you are to succeed in measuring performance and maintaining accountability.

  If you are measuring products, don't be constrained by asset or liability accounts within the general ledger. For example, if your general ledger has two accounts for mortgages, fixed and variable, but you want to measure more product types, use statistics generated from your application system to accurately slice and dice those accounts to the necessary level to measure products you want measured.
- **Tie managers' performance incentives to profitability.** Jack Welch, former CEO of GE, would probably find it humorous that this needs mentioning. But, in my experience, few banks are actually linking performance incentives to profitability.

Instead, banks continue to reward employees for generating volume or for profitability at the whole-bank level. This dilutes accountability and motivates employees to price aggressively. I recall attending a strategy session where a chief operating officer of a bank told a senior lender that the bank didn't need high-priced lenders to be the best price in town. He could hire clerks to do that. If you want business-line and support managers to focus on profitability, hold them accountable for it and make profitability affect their paychecks.

- **Make profitability reporting understandable to the end user.** There are very smart people in bank finance departments who are capable of building very sophisticated profitability models. However, the profitability model need not be built by a mad scientist to be effective. Don't let perfect be the enemy of the very good. The easier it is to educate users on various model assumptions and methods, the more effective the information will be in enabling managers to improve profitability of business lines, products and customers. That is, after all, the desired result.

  Another hazard associated with building an overly complex profitability model is the time that it takes from project inception to information delivery. If you are successful in the above prerequisites and senior management is chomping at the bit to receive and use profitability reports, don't let managers lose enthusiasm by taking too long to deliver. Once you deliver, make certain the information is understandable to the end user.

- **Consistently apply model assumptions.** This is not to suggest that once the model has been built that all model assumptions remain the same forever. On the contrary, a profitability model evolves over time and gets better as inputs come in from senior management and all managers that use the information.

  However, once managers agree on methods, which are part of the buy-in process, they should be consistently applied. This is particularly important when business-line or product managers put pressure on you to change things because their area of responsibility is not looking particularly profitable. Doing so only dilutes accountability and postpones the need to take positive action.

- **Use as a diagnostic tool.** Reading profitability reports is like reading a novel. There is a story being told in the numbers arrayed in front of you. When educating bank managers about using profitability data, inform them they should use it much as a medical doctor uses a thermometer and stethoscope, to confirm a clean bill of health in some areas and to identify potential problems in others.

  A single period's profitability results should not be used as the only input in determining if there is an actionable issue. Rather, use trend information to see if things are getting better or worse and to compare the business unit, product or customers to others in your institution to see where it ranks. If there appears to be an actionable issue, dig deeper to get closer to the actual reason there is an issue and develop a solution from there.

*Imagine the behavioral changes that would occur if the loan officer were held accountable for generating coterminous spread instead of volume.*

- **Secure senior management's support.** This is not a typo. It is mentioned twice to highlight how important it is to the success of your profitability project and the importance of maintaining senior management's support throughout implementation. Without it, you may be wasting your time and resources. Being receptive to profitability reporting means being ready to take action and to make changes. Are you and your management team ready?

## The Future

Bank products are becoming more homogenous, but the entirety of managing finances for both businesses and individuals is increasingly complex. In the midst of industry change, banks must find their pockets of opportunity to profitably serve the needs of their customers.

According to TKG's peer database, 81 percent of community banks' revenue comes from the spread, and the remaining 19 percent is derived from fee-based products and services. Without going too much out on a limb, I believe fee income will be an increasingly important part of bank revenue streams. But can banks deliver these services profitably?

One reason for the prediction is the increased competition and commoditization of bank spread products. Exhibit 5 shows various nontraditional banking companies and their respective net-interest margins.

The net-interest margin column may be disturbing to some. But with bank net profit margins exceeding those of other commercial enterprises, the operation of expensive branch networks and limited entry imposed by law and regulation, it should be no surprise that competitive forces would eventually drive down margins.

If you are resigned to do nothing, then you must believe that ING Direct will discontinue pricing aggressively or that your customers will simply not bank there. ING Direct has grown to $47 billion in deposits since the latter half of 2000. The competitive squeeze on bank net-interest margins and net profit margins is likely to continue as customers continue to become more comfortable with nontraditional delivery channels and Capital One, Countrywide, possibly Wal-Mart and others enter the fray.

How do bankers respond to these challenges, if at all? Consider the typical spring home equity campaign where the goal is to generate $40 million in new loans or lines. In our collective experience in measuring profitability for hundreds of banks, home equity loans are currently break-even products on a fully absorbed cost basis. Had the bank that implemented the traditional home equity campaign known this about its products, it may have linked a relationship component to the promotion to generate additional, more profitable business from the new customers they attracted through the campaign. By using profitability information, the purpose for the campaign may change from one of generating and rewarding volume to one that generates and rewards relationship building.

Don Shula, the legendary former football coach, said, "If you don't seek perfection, you can never reach excellence." How can the head of commercial loans seek perfection in loan pricing if the only measure he or she has available is the yield on all loans in the commercial portfolio or the bank's net-interest margin? To seek perfection, that manager must know the coterminous spread trends of every product and lender and develop action plans to improve performance of some and reward the performance of others. Seek perfection to achieve excellence.

Profitability information is no longer optional for those wishing to survive and thrive in our industry's new world. From the boardroom to the mail room, everybody should be held accountable for profitability. Tying management information to individual performance can be an effective method to increase profitable relationships, reward top-performing employees and improve your bank's bottom line.



*Exhibit 5. Nontraditional Banking Companies and Their Respective Net-Interest Margins*

| | At or for last 12 months ended March 31, 2006 | | | | | | |
|---|---|---|---|---|---|---|---|
| *(dollars in thousands)* | Date Established | Total Assets | Total Deposits | Gross Loans | Net Interest Margin | ROAA | ROAE |
| Countrywide Bank, NA | 08/30/90 | 79,879,571 | 45,464,799 | 71,235,319 | 2.17% | 1.28% | 19.08% |
| ING Bank, FSB | 08/04/00 | 59,410,941 | 47,024,140 | 13,115,570 | 1.27% | 0.48% | 5.71% |
| Metlife Bank, NA | 02/23/99 | 7,222,991 | 4,551,909 | 2,631,789 | 1.35% | 0.16% | 2.58% |
| State Farm Bank, FSB | 03/12/99 | 12,675,414 | 9,113,978 | 7,647,655 | 2.30% | 0.21% | 2.58% |
| TD Waterhouse Bank, NA | 10/13/94 | 9,644,154 | 8,551,081 | 26,837 | 2.40% | 0.79% | 12.86% |

*Source:* Federal Deposit Insurance Corporation