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COMMUNITY BANKING

Measuring Your Profitability, Piece by Piece

BY STEVE GARMHAUSEN

When a car rolls off an assembly line at Ford or General Motors, executives know just how much of its cost is attributable to parts, labor, and marketing.

It is a different story at community banks, where many executives often have only a vague idea of what their loans, deposit accounts, and other products truly cost.

Detroit-style performance measurement seemed poised to take off at community banks a few years ago, as it had long before at larger ones. Increasing competition and the growing array of bank products appeared likely to make investment in performance-measurement software a high priority after Y2K worries passed.

The reality, though, is that "50% to 60% of community banks are still not thinking about it," said Robert Kafafian, a profitability measurement expert who runs The Kafafian Group Inc., a community bank consulting firm in Parsippany, N.J.

In a survey last year conducted by the American Bankers Association and *ABA Banking Journal*, 62.3% of respondents said they do not analyze the profitability of their consumer banking relationships; 22.1% said they do, and 15.6% said they analyze everything but kids' accounts and other "starter" relationships.

Why haven't banks taken to performance measurement? The reasons range from uneasiness about what it will reveal to concerns about the cost and time involved, bankers and others say.

"A lot of community banks have historically been run by local people who have been there for 25 years," Mr. Kafafian said. "I think there is a bit of a fear factor in finding out what's really going on."

Poor stock performance, shareholder pressure, or new board members can nudge a bank toward performance measurement, he said, but a new perspective most often arrives with a new chief executive.

Executives at community banks that have implemented performance measurement say it has been worthwhile.


David Lubarsky

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"It certainly requires work," said Anthony Labozzetta, the chief operating officer at the $1.4 billion-asset Interchange Bank in Saddle Brook, N.J. "But I don't see how you can improve your performance if you don't know how you're performing."

Bank managers often work by intuition, without statistical validation, Mr. Labozzetta said. Performance measurement, which Interchange began in 1999, has confirmed some such intuitions and knocked down others.

For example, he said, Interchange was concerned that peers were doing better in collecting deposit fee income, but it learned that its own transaction accounts averaged nearly twice their peer average balance. Though Interchange did worse in low-balance and overdraft penalty fees, the bigger balances meant cheap loan capital.

Without performance measurement, Mr. Labozzetta said, "we might have tried to overcharge people, thinking we needed to get the fee income to higher levels."

On the other hand, careful study convinced Interchange that its consumer and mortgage lending units were filling similar roles. As a result, the operations were combined and their employees cross-trained.

So Interchange has found performance measurement "extraordinarily useful," Mr. Labozzetta said.

Most large banks had brought in technology to measure the profitability of products, lines of business, and branches by the early 1990s.

Performance-measurement software slices an organization by products, branches, customers, cost and capital assignment, and so on and measures and analyzes the performance of each category. To get an accurate picture, a bank will typically download all accounting and customer data into these profitability systems every month or quarter.

At Interchange, back-office operations were analyzed as well. How much time did the accounting department spend on loans? How much on investments or deposits? Management and human resources came under the same microscope.

The resulting metrics helped the bank determine where to concentrate spending and where to cut back, Mr. Labozzetta said.

Microscopes make some people nervous, of course, and that may help explain why many banks have shied away from performance measurement, said Walter Reese, the treasurer for Ridgewood Savings Bank in New Jersey.

"Maybe people are afraid to find out that things are not working so well," said Mr. Reese, whose $3.3 billion-asset mutual thrift initiated performance measurement three years ago.

For instance, he said, the head of a bank may have to confront the fact that his pet projects are money losers.

Skeptics say performance measurement takes too much money and effort.

At the start Mr. Reese said, a bank must invest hundreds of hours a quarter to gather information, analyze it, and explain its relevance to employees.

And the software — sold by such companies as IPS-Sendero of Norcross, Ga., Harte-Hanks Inc. of San Antonio, and Orlando's Harland Financial Solutions Inc. — can cost tens of thousands of dollars.

The practice also has limitations. One blind spot has to do with funds-transfer pricing, which can make it difficult to distinguish how much profit comes from efficiency and how much from interest rate changes.

But Mr. Reese said that though profitability is a gray area, what counts is the trend.

Many line managers resist the idea of focusing on profitability and are afraid to do so.

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"If I'm the head of commercial lending, I'm focused on loan volume, so profitability can threaten my way of measuring success," said Steve Williams, a principal at Cornerstone Advisors of Scottsdale, Ariz. "We've all grown up just loving volume."

Indeed, Mr. Labozzetta spent a year educating Interchange's employees about profitability before beginning to implement performance measurement. "You have to have a culture shift," he said. "Then you can roll it out. For some people, candidly, it makes them nervous."

Fidelity Bank in Pittsburgh began measuring performance about nine months ago.

"We have a marketing budget, and we wanted to spend those dollars wisely," said Lisa Griffith, its chief financial officer. "From an organizational and product profitability standpoint, we wanted to see what was really making money for us."

The $650 million-asset bank had never had enough data to determine much more than whether a unit was profitable. Now, Mr. Kafafian's firm sends the management team detailed quarterly profitability reports, and comparisons with peers.

Once trends are clear, Fidelity can use the information to direct resources to more profitable products and locations, and may even expand successful branches, Ms. Griffith said.

But the analysis will also become a pillar of the bank's 6-month-old market segmentation effort, she said. Within a year Fidelity hopes to be promoting its most lucrative products to the most profitable customers, she said.

What can we do to make them more profitable?' "

At Ridgewood Savings, performance measurement has led to a range of initiatives, including incentives for customers to keep higher savings account balances and draw more from their equity lines of credit, Mr. Reese said.

The thrift thinks it got its money's worth, he said.

Many banks buy the software and try to run it and analyze the data themselves. Fidelity did just that at first but eventually decided to hire a consultant.

"It's a very, very time-intensive project, and we didn't have the technical tools either," Ms. Griffith said. At a community bank "you are wearing more than one hat, so time is hard to come by."

Whether a bank outsources or analyzes the data in-house, performance measurement requires a strong commitment from management, Mr. Labozzetta said. "The executives at the very top have to believe in it and support it."

And they have to be willing to follow through, said Mr. Williams at Cornerstone Advisors.

"Until people realize that there are teeth in the measurement, nothing really happens," he said.

Mr. Labozzetta said it is easy for information to dead-end on a shelf. "The hardest thing I see in this business is that all that work becomes nothing more than another report."

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