Use Profitability Terms When Talking with Your Executive Team

MARKETERS TEND TO BE MORE CREATIVE than other bank executives and sometimes use terminology that can solicit blank stares. But reporting to your CEO on how you intend to improve the return on equity (ROE) of specific underperforming branches to raise the overall bank ROE would be a different story.

ROE is one of the most common gauges of your bank's financial performance. It is a simple calculation at the whole bank level. But what about at organizational units (i.e. branches, lending, etc.) and products? Here is where profitability measurement is instrumental in making decisions to improve overall performance. Organizational and product profitability has three basic components that you should understand:

- **Cost Allocation.** The operating expense to run a branch goes beyond the direct expense of the branch itself. What about information technology, operations and marketing? Every financial institution requires a rational means to allocate "support center" and "overhead" costs to profit centers and products—to determine the "all in" cost.
- **Funds Transfer Pricing (FTP).** Most of your bank's revenues probably comes from the spread. But how do you calculate the profitability of a branch whose balance sheet is mostly made up of interest-expense generating deposits? The answer is FTP, providing a market-rate funds credit for all deposits within the branch.
- **Capital Assignment.** How would you calculate ROE of a home-equity loan if you don't assign the "E," or equity, to this product? You can't. The best practice for assigning capital to products and organizational units is based on the risk characteristics of the product or the products within the profit center. This method is termed "risk adjusted return on capital" or RAROC.

Knowing those three components will help you communicate to the C-suite in your bank, especially the chief financial officer. So how do you discuss your plans to improve the profitability of struggling branches?

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The fundamental manner to improve profitability is the same in all industries: either grow revenues or reduce expenses or some variation of the two. To improve the ROE of the branch, grow revenues, reduce expenses or reduce the amount of equity needed to support the branch.

One method to reduce the needed equity is in product design. Let's assume the plan to improve the profitability of struggling branches includes increasing the amount of home-equity loans originated in those branches. In the product design discussion, you determine that you can reduce loan-to-values of newly originated loans from 90 percent to 80 percent without significantly reducing volume. This reduces risk, and will reduce the amount of equity needed to support each loan, increasing ROE of the product and the branch.

How about increasing revenues? Focusing on the home-equity example, how do you increase revenue per loan booked? Bank revenues are driven by balances. The spread per loan is calculated off of the loan balance. So by focusing resources on loans that carry higher balances will yield greater revenues.

Lastly, how can marketing impact the cost component? Bank costs are mostly fixed. If a branch has a $15 million loan portfolio, how will operating costs increase if it grows to $20 million? The answer: not much. So, increasing a branch's footings at a reasonable cost will most likely improve that branch's profitability and decrease cost per account of the home-equity loan product. ■

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