


THE KAFAFIAN GROUP INC.

...helping banks perform better™


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TKG Perspective

Watch for Us

Teaching/Speaking Engagements

Northern New Jersey Community Bankers
Stony Hill Inn
Hackensack, NJ **January 20**
Corporate Governance & Risk Management

Southeastern Conference of Community Banks
Hyatt
Key West, FL **January 26-28**
Keys to Bottom Line Profitability

Financial Managers Society
Philadelphia Chapter
Philadelphia, PA **February 9**
CEO Roundtable

American Bankers Association
School of Bank Marketing and Management
Southern Methodist University
Dallas, TX **May 17-24**
Product and Customer Profitability
Profitability and Strategic Issues

Pennsylvania Bankers Association
PBA School of Banking
Penn State University
State College, PA **June 5-10**
Strategic Decision Making & Organizational Structure

Pennsylvania Bankers Association
PBA Advance School of Banking
Penn State University
State College, PA **July 24-29**
How Do Banks Make Money?

Maryland Bankers Association
The Maryland Bankers School
University of Maryland
College Park, MD **July 24-29**
Bank Financial Principles

2011 Conferences and Conventions

New Jersey Bankers Association
Annual Convention
Fairmount
Adventura, FL **May 11-15**

Pennsylvania Bankers Association
Annual Convention
Boca Raton Resort
Boca Raton, FL **May 12-15**

Maryland Bankers Association
Annual Convention
The Greenbriar
White Sulphur Spring, WV **June 5-8**

New York Bankers Association
Senior Management Conference
The Otesaga
Cooperstown, NY **June 8-10**

North Carolina Bankers Association
Annual Convention
The Homestead
Hot Springs, VA **June 11-14**

A Practical Approach to Reducing Operating Expenses

By Robert J. Sanders, Managing Director

In the present economic environment, revenue growth is becoming much more difficult to attain, net interest margins are under pressure, and compliance costs are on the rise. In these challenging times, it is imperative that community financial institutions control operating expenses without sacrificing service levels. Reducing costs can have an immediate impact on the bottom-line, and often requires less of a strategic investment than trying to expand the customer base and associated revenue.

There are various metrics available to determine if your institution needs to review operating expenses including return on assets and equity (ROA and ROE), the efficiency and non-interest expense to average assets ratios, various peer analyses, trends, and benchmarking. The typical challenges to success in these types of studies are personnel entrenchment, internal politics, and finger pointing to other areas of the institution. Some of the comments frequently heard from bank staff include: “we have always done it that way,” “the system can’t do that,” and” we are already efficient.”

Dodd-Frank is motivating community bank executives to re-think how efficient their institutions really are. There is no consensus on how much the new law will impact profitability, but certainty that it will. In a recent TKG speech to Maryland bank CFO’s, we offered what those costs might be and how they would impact profitability as shown in the table on the following page. The table demonstrates the potential impact on a hypothetical bank’s income statement, including costs associated with additional compliance personnel, systems, and consultants. It also shows the profitability impact, and the potential stock price decline. To eliminate earnings dilution, this bank would have to reduce operating expenses by 2.32%. For a hypothetical $236 million asset community bank to break even, we estimated 5.12% of expense savings.

Prior to undertaking the profit and process improvement route, Senior Management should determine their objectives. These could include financial (i.e., save $500,000 in annual operating expense), relative performance (i.e., reduce efficiency ratio to the peer median), or target particular ratios such as non-interest expense/average assets below 3.00%. Generally, personnel expense constitutes more than 60% of a banks total operating expense. Senior Management should discuss and agree upon whether personnel reductions are to be considered as part of the process. However, if the strategy calls for growth, then the purpose may be to increase capacity without adding personnel. The keys to success include obtaining buy-in from Senior Management, next level managers, and front-line supervisors.

The review can be conducted by internal teams from all areas of the institution, outside management consultants, or a combination of both. In conducting the review, the objective is to achieve early recommendations that in-house personnel agree with. The most common “easy wins” often found include, for example, reducing outside expense such as cell phones, maintenance, office supplies, equipment and armored car service. This demonstrates to personnel that the recommendations are actually being implemented and provides incentive for them to contribute additional ideas.

Impact of Frank-Dodd	$1B Bank		Adjustments		Proforma	
	(dollars in thousands, except per share data)					
Total Assets:	$	964,757			$	964,757
Income Statement:						
Net Income Available to Common	$	7,290	$	(375)	$	6,915
Net Interest Income		24,839		(20)		24,819
Non-interest Income		9,669		(335)		9,334
Operating Expense		24,627		221		24,848
Performance Ratios:						
Return on Average Assets		0.76%				0.72%
Efficiency Ratio		71.48%				72.76%
Market Pricing:						
Diluted Earnings Per Share	$	1.22			$	1.15
Assumed P/E multiple (x)		14.0				14.0
Estimated Market Price	$	17.08			$	16.16
Estimated Stock Price Decline						5.38%
Cost savings for no dilution (% of Op. Exp.)						**2.32%**

Recommendations for personnel reduction should be delayed until the completion of the study to avoid any potential conflicts. The entire institution should be reviewed so that no one can say that there was a hidden agenda. The typical areas where the majority of process improvement opportunities are uncovered include personnel savings, retail branches, deposit operations, and loan administration.

Some proven process review techniques include: developing transaction volumes and the amount of time required for daily activities by clerical staff compared to peek and low volume levels; identifying manual processes and determining if they can be improved or eliminated; and evaluating systems utilization or additional automation that can be developed or implemented.

When interviewing personnel, be sure to ask the same questions to the supervisor and the clerks. It is surprising how often the answers and perceptions differ. Determine if the same data is entered multiple times into various computer applications and also evaluate centralized versus decentralized clerical activities to obtain the most efficient organizational structure with adequate internal controls.

There are also common checklists that can be utilized. These lists cover the entire banking operation and contain specific questions unique to each area. Some typical findings include streamlining the account opening process, standardizing branch and operations forms, reducing overdraft and critical file maintenance reports, analyzing and reducing the number of waived fee accounts as well as transactions, reviewing all outsourcing alternatives and reducing cash requirements for ATM's and branch vaults.

Prior to finalizing a recommendation, appropriate costs and benefits must be estimated. The costs may include such items as new software, and the resources required to complete an implementation, or contract termination fees. The benefits usually involve reducing personnel, reducing expense or outsourcing specific tasks. These costs and benefits should then be annualized and utilized to prioritize their implementation.

The next step after analyzing and obtaining Senior Management approval and prioritization is to develop implementation timeframes and individual responsibility for each recommendation. Then, get to work on implementation. Appoint a project manager to track progress, and monitor the plan monthly with Senior Management.

TKG has completed these studies in banks ranging in size from $100 million in assets to those over $10 billion. Whether you tackle this project on your own or enlist a consultant, annual savings (or revenue enhancements) should at a minimum be greater than the cost of the endeavor. In our experience, the average financial institution has improved annual earnings by several multiples of their investment in the engagement or process.

It is virtually certain that increased regulation and regulatory scrutiny will increase the operating cost of financial institutions. This provides three choices: absorb the cost, increase revenue, or decrease expenses. If doing nothing is not an option for you, and your budget next year may not permit the investment required to grow and expand customers and the balance sheet, then perhaps conducting a profit or process improvement review is in order. The cost associated may be minimal and the benefit may be significant as compared to the alternatives.

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