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PRACTICAL INSIGHTS FOR TODAY'S MARKET

COMMENTARY

Good Planning Now Means Sorting Data in Detail

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Financial institutions are learning that it is no longer acceptable to plan, report, and manage at the total institution level.

As the industry has gotten more complex, shareholders, analysts, regulators, staff, line, and senior managers are requiring better information to make informed decisions. As a result, more banks are using management accounting and information systems to more closely examine each component of their businesses.

First and foremost, you need a strategic plan.

Strategic planning is usually done once or twice a year and includes a mission and vision statement. It often incorporates multi-year financial projections and a written description of what the company intends to accomplish and be.

Unfortunately this planning often produces nothing more than a nicely bound document placed on a bookshelf. A dynamic process would do various organizational assessments; identify strengths, weaknesses, opportunities, and threats; determine crucial issues and operating assumptions; highlight specific goals and objectives, with timelines for achieving them; and assign responsibility.

The budget process is the annual ritual of developing the coming year's projections, only to have senior management state: "The bottom-line needs to be 'X' dollars — now redo your estimates."

I'm being facetious, of course, but the point is that budgeting, though an important exercise, is often poorly executed. To budget successfully, financial institutions need to move away from dollar budgeting to statistical and volume budgeting. For example, an automaker should probably begin its budget with the number of cars it intends to build and sell. Only then would it know how many steering wheels, brake pads, assembly lines, employees, and factories it will need.

Financial institutions must project how many customers they will serve, with what products and services, and through what delivery channels. They can then develop budgets based upon data such as number of accounts, number of transactions, number of employees, square footage of facilities, and average loan or deposit size. Doing this makes explaining budget variances an exercise in noting the inevitable and unexpected changes in business activity, not in deciding who "screwed up." This is a far more productive learning experience.

Most general ledger systems offer the capability to break down an institution by departments and then use hierarchy tables to roll up individual centers to their reporting areas, and the reporting areas to the total company.

What occurred before the appearance of stand-alone profitability measurement systems was that many institutions overbuilt the responsibility reporting process.

Features like intricate cost and capital allocations and multiple forms of funds-transfer pricing rendered the reports too confusing to be useful.

Profitability reporting systems create an opportunity to clean up the responsibility reporting process and return it to what it was originally intended to be — the identification of assets, liabilities, income, and expense accounts for which the center manager can be held directly accountable.

ASSET-LIABILITY MANAGEMENT

The seeds of asset-liability management were planted in the early 1980s when interest rates were as high as 20%. It was an outgrowth of economic conditions and the deregulation of products and pricing. Though many financial institutions failed because of credit-quality problems, many others failed because of negative spreads caused by balance sheet mismatches.

When used properly, asset-liability management should be the thread that binds all management information. It is a 12-month picture of what the asset-liability management committee believes the institution's balance sheet will look like. Therefore, it should be the front end of budgeting.

Profitability measurement typically includes line of business, organizational, branch, product, customer, relationship, and

market segment profitability. All of these areas have distinct, though connected, roles. In fact profitability measurement is largely responsible for bringing together the finance, systems, and marketing functions of an organization.

Line of business, organizational, and branch profitability analysis each accumulate slices of an institution's internal operations, locations, and reporting lines. The goal is to objectively review the performance of organizational units to evaluate individual and group performance, as well as to strategically assess business-line emphasis. In this type of analysis, it is important to understand the distinction between organizational and/or location performance, on the one hand, and an individual's performance, on the other.

PRODUCT AND CUSTOMER PROFITABILITY

Financial institution products can be separated into fund-providing, fund-using, and fee-based categories.

Fund-providing products are primarily fund sources or liabilities such as deposits

and borrowings. Branches typically generate most deposit products, but borrowed funds and purchased or brokered deposits are also funding sources.

Fund-using products are primarily earning assets consisting of loans and investments typically found in special-purpose revenue centers, the branch network, or both. Fee-based products generally have only incidental balances associated with them, if any. The primary source of revenue from these products is service fees.

The important distinction among these three product categories is that fund-providing and fund-using products are spread-based but nonfund products are fee-based.

Customer profitability can be defined by account level, namely the profitability of an individual customer account record, such as a CD or a loan. Individual customer relationships, extended customer relationships and market segment can also determine profitability.

SUPPORT FUNCTIONS

Support functions include funds transfer pricing; cost and capital assignment; data

warehousing; mining; and customer relationship management.

Funds transfer pricing is used to credit and charge fund providers and users, respectively. Cost assignment spreads operating costs to the various slices of profitability measurement. Capital assignment allocates required levels of capital to various components, based upon defined risk factors.

The data warehouse is the repository for all information from disparate systems. As a result it is the engine that drives all profitability input, calculations, and output.

As community banks chart a course to growth, profitability, and shareholder value, the creation and use of management information will be paramount in achieving success and staying independent. For many community institutions, this use of data is no longer optional.

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