THE KAFAFIAN GROUP INC.
...helping banks perform better™

Performance Measurement
Strategic Management
Profit & Process Improvement
Board & Management Advisory Services
Financial Advisory

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TKG Perspective

Teaching & Speaking Engagements

Pennsylvania Bankers Association
Advanced School of Banking
The Penn Stater Conference Center
State College, PA **July 14**
How Do Banks Generate/Measure Revenue & Performance

SNL Financial
Analyst Training in the Banking Sector
University of Virginia Darden School of Business
Charlottesville, VA **July 27**
Fundamentals of Bank Financial Statement Analysis

Maryland Bankers Association
The Maryland Banking School
University of Maryland Inn & Conference Center
College Park, MD **August 3**
Bank Financial Principles

Kansas Bankers Association
CEO Forum/Annual Meeting
The Broadmoor
Colorado Springs, CO **August 7**
Things Community Bankers Should Know and Be Aware of in 2015 and Beyond

More Teaching and Speaking Engagements

Conferences, Conventions & Other Events

TKG would like to announce the opening of our Bethlehem, PA office as of this past April, 2015. In addition, our suite number in Parsippany, NJ has changed. All of our phone numbers, and email addresses are the same. Please make a note of these changes. We can now be reached as follows:

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Do Banks Really Care About Their Financial Performance?

By: Robert E. Kafafian, President and CEO

I'm sure that most of you would say that the answer to the above question is, "sure they do," and often this starts and stops with "top of the house" financial statements. But perhaps the real question is, are banks willing to do anything about performance? Or, do banks really want to take the time and effort to measure their performance with any granularity, and if they do, do they then want to hold their management team accountable for improving results?

Financial accounting is the foundation of balancing the books, collecting receivables, paying invoices, keeping track of revenue and expense, and reporting top level and overall financial performance. Doing this well is a given and keeps investors, regulators, and auditors happy.

But it's not enough. The strategic use of management information can separate successful banks from those that give up and sell, or even fail. Very few banks identify accountability culture as a critical strategic objective. In fact, in all the strategic planning work facilitated by TKG, we can only recall one of our clients that listed management information, or an accountability culture, as one of their top strategic objectives. This client happens to be a high performing bank. Coincidence?

If used properly, this information can assist senior management in breaking down and understanding a bank's financial performance across lines of business and products. It also allows line and staff to better manage areas of responsibility, customer relationships and their impact on profitability.

The following is a list of the various types of management information being utilized by financial institutions:

Bank Management Information

1. Asset/Liability Management
2. Budgeting
3. Strategic Planning
4. Responsibility Reporting
5. Organizational Profitability
6. Line-of-Business Profitability
7. Product Profitability
8. Branch Profitability
9. Officer Profitability
10. Customer/Relationship Profitability
11. Market Segment Profitability

In addition, the following functions are used to support the above listed categories:

1. Funds Transfer Pricing
2. Cost Assignment
3. Capital Assignment
4. Data Warehousing/Mining/Mapping/MCIF/CRM

TKG estimates that at least fifty percent of the financial industry doesn't use any MIS data beyond the top four Bank Management Information items listed above. The other fifty percent might utilize some form of items five through eleven, but often not in any meaningful way.

Imagine a manufacturing firm not understanding its cost of goods sold, or unit profitability of the products it sells and the lines-of-business it operates. Management accounting has been at the fabric and core of successful performance and management of these types of companies and industries for the entirety of their existence.

I somewhat understand the historical insignificance of bank management accounting given the regulated products and pricing that we operated under before deregulation. Those days ended around 1980. Today, thirty five years later, a typical bank sells well in excess of one hundred (100) products and services and competes against numerous traditional and non-traditional financial institutions. Managing today's strategic issues using only top of the house financial statements in this complex and dynamic market and rate environment can only lead to trouble.

Many banks who start the process give up because developing, maintaining, reviewing and acting upon reporting outputs takes time and effort. But TKG is concerned that the other reason for not pursuing such analysis is an unwillingness to manage a business, and hold line and staff accountable. ***It puzzles me that so many banks can be so disinterested in understanding and managing their business and its future success.***

In addition, there is often disbelief and push back over profitability concepts and results. For example:

- Many banks don't understand the breakeven points for branch profitability and how they have been pushed higher by the sustained low interest rate environment. The ABA recently did a study that showed 54% of all bank branches today are unprofitable, which means that only 46% are profitable and the typical bank is losing money in its branch network. TKG's own statistics mirror the ABA's results. This does not mean banks should close unprofitable branches, but does mean they should understand why interest rates have caused these losses, and secondly, utilize management information to improve overall branch profitability and relativity.
- Scale is required to successfully operate various fee based lines-of-business.
- A bank that had an ROA below 20bps couldn't understand why most of its lines-of-business were losing money and everyone complained they were being charged with too much overhead.
- Another bank had engineered its system so every line-of-business was making money, but the overall bank was showing a loss. Imagine that!
- Some banks that develop management information don't share the results beyond a small group of senior managers, and for some reason shield this data from line and staff that could greatly benefit from having access, and help improve the banks performance significantly.
- ***Many banks give up when performance declines, or disinterest occurs, instead of doubling down and trying to understand why***.

These examples highlight an additional important factor, the ability to compare management accounting to the performance of peers. Remember, meaningful management information should focus on relativity and the comparable nature of the results, not the absolute nature of the results. Also monitoring trends is critical. Some examples of missteps include:

- A bank was concerned about a five quarter decline in the margin of its Commercial Real Estate Loan trends. Upon further analysis it was found that they had previously held a competitive advantage to the peers, and the competition had brought them back to market pricing.
- A bank had a line of business that so outperformed meaningful norms that questions should have been asked, but denial set in which resulted in the bank being sold when fraud was detected.
- A bank's lending officers were in denial when their loan yields were consistently below peers, only to find out that there was a problem in their core system which wasn't adjusting loan pricing to prime in a rising rate environment. Funds transfer pricing indicated there was a problem, but nobody wanted to believe it. Remember, rising rate environments may be back soon.

At TKG, we take managing our business seriously. Along with our annual budgeting and strategic planning process, we understand monthly performance of all of our lines-of-business, as well as the profitability of each of our client relationships. We wouldn't be able to operate our business without this discipline.

I encourage all bankers to follow the lead of bankers that have built an accountability culture and manage their banks by utilizing management information at a more granular level. It will not only help improve performance if utilized properly, but give banks a leg up on competitors, some of whom continue to run their banks by the "seat of their pants." ***The goal is to provide meaningful management information to make informed decisions on an ongoing basis.*** And, if banks don't continue to improve and use the results of the process, they won't reap the rewards or benefits of the process.

Remember, if you don't measure it, you can't manage it, and, if you don't manage it, your business may be in peril.