

The Way Forward...

Accelerating bank earnings and capital accumulation without increasing your risk profile

By

Nicholas Ceto, Jr. and Noel Busch

The recent Winter Olympics in Vancouver, British Columbia, brought to mind a remarkable occurrence at the winter games thirty years earlier at the other end of the continent. The lesson learned from the U.S. – Soviet Olympic hockey game at Lake Placid in 1980 is an instructive metaphor for bankers today.

The Soviet team, considered the best in the world, played with precision, like a machine, but without imagination or leadership. So, when they were behind, they were described by a spectator as playing with poise yet confused. They needed someone to take the lead, to invent something to go ahead, but could not transcend their condition—a reflection of their way of life at home.

On the other hand, Team USA invented a way to catch up and go ahead. The players transcended the circumstances and forged a way forward to victory. In large part due to Coach Herb Brook's training that taught the players how to seize every advantage, they prevailed with a 4-3 victory over the USSR in a match that is still remembered as the "Miracle on Ice."

Transcending banking conditions today will also require that bankers seize every possible advantage. Miracles are a bit much to expect, but inventing the way forward is a critical necessity for bank management.

Today's challenges require that bankers devise strategies and solutions to forge the way ahead despite the many obstacles and uncertainties. Bankers are accustomed to pricing risk, but how does one price uncertainty? And how does one transcend the current impediments to growth and profitability?

Among the uncertainties and potential challenges is the posture of the Federal Reserve. Fed Chairman Bernanke's statements notwithstanding, the Federal Reserve will have to unwind its accommodative stance, and probably sooner rather than later. The inevitable need to sell off \$1.5 trillion of assets and the necessity for monetary tightening poses a double-barreled, inflationary threat of some magnitude. Long bond yields have already signaled the potential for escalating rates.

When the Federal Reserve ratchets down its role as the liquidity provider of last resort it is likely to exacerbate inflationary tendencies while also creating a game-changing impact on banks. The Fed's tools to dampen emerging inflation are limited and do not lend themselves well to incremental throttling.

Although the Fed's strategy is not an immediate concern, it is already exploring "innovative" ways to restrain monetary expansion, such as imposing higher capital requirements and larger reserve levels on banks. Another variation on this theme is term deposits, a way of reducing the money supply by moving it over to the Fed's balance sheet and out of circulation. But, at what cost to the banks? The tightening moves under consideration would limit bank growth and profitability. Even if the Fed were successful at preventing punishing levels of inflation, the banks will still encounter considerable headwinds from the monetary controls most likely to be employed.

Banks need a way forward that seizes every advantage available within current regulatory and market parameters. Unless one's strategy is to sell or merge—a less than sanguine prospect just now—the times and conditions demand that we become possibility thinkers and agile strategists. It is to no avail to forge ahead with poise and confidence if we are not quite sure of our direction or objective, or how to measure our progress. Now is the time to embark on the planning effort that will be crucial to assure a sound and profitable future.

There are several considerations that should be factored into every bank's strategic planning.

Three key planning considerations

First, at a Brookings Institution speech March 19, former Federal Reserve Chairman, Alan Greenspan, argued that a chief element in preventing future banking crises would be "higher capital buffers," explaining that "Adequate capital eliminates the need for an unachievable specificity in regulatory fine-tuning." There goes the little leverage that banks have!

A second consideration is the secular decline in Net Interest Margin. Some years ago, one could humorously remark that "A banker cannot live on spread alone," a comment that has become all too true. With the exception of one or two years, margin compression has continually worsened for nearly twenty years. Unless your bank is located in an exceptional market, expecting a replay of the halcyon days of 5 % is a highly speculative strategy.

Thirdly, competition for all customers, especially those that are the most profitable, will become more fierce as de novos, unburdened by troubled assets, and multi-regionals emboldened by their survival of the worst banking crisis in recent history strive for growth and profits in a languid, jobless recovery.

To the extent these above scenarios play out over the next several years, your bank will require strategies and solutions that accelerate earnings and capital accumulation with less credit, interest rate and market risks.

Some suggested action steps

Allow us to suggest a prudent, incremental process that will accomplish those very objectives with minimal to no customer sensitivity and without impairment to your bank's competitive vigor. Here are our suggestions:

Non-earning asset (non-loan) reductions

Identifying non-earning assets (non-loan) should be the very first matter for scrutiny. Regrettably, even such scrutiny and analytical exercises often miss the potential that lies hidden on the balance sheet. Redeploying non-earning assets is a relatively simple and effective means of increasing funds for loans and investments, and boosting earnings on existing assets, yet many banks have not yet done so.

As one important example, Regulation D balances maintained at the Federal Reserve Bank are a major non-earning asset. (We believe that the current amount paid on reserve balances of zero to 25 basis points can be classified as "non-earning".) Since 1994, bankers have been allowed to recapture this sterile asset by internally reclassifying a significant portion of interest-bearing and non-interest bearing transaction accounts to a non-reservable savings status. A typical \$500 million-asset bank will recapture about \$2 million of these assets for new loans and/or investments. Billions of dollars of reserve funds have already been redeployed by this means.

Although some banks use their core processor's software to perform this re-classification function, most have opted for software that resides on a stand-alone desk-top computer. Not only does this desk-top option provide greater flexibility, the cost is substantially less and one-time, and does not require third-party support. If your bank has not already taken advantage of this initiative, you will find that desk-top implementation can be accomplished with ease in a very short period.

Cash level minimization

Once deposit reclassification is accomplished, another opportunity for converting a non-earning asset presents itself. After reserves are reduced to a minimal amount, vault cash needs and levels require scrutiny. Vault cash levels are virtually always found to be higher than actual usage would call for, due to many factors—some historical, others psychological, and others that are the product of varying degrees of calculated guessing. In addition to the opportunity cost of excessive cash surpluses, cash shipping costs are seldom measured relative to the cost of carrying cash. Plotting cash usage and fluctuations related to day of the week, holidays, community festivals and payday enable the bank to define optimum levels, and to identify optimum order quantities, deliveries and shipments.

Implementing a vault cash management tool empowers branch personnel and management to collaborate in optimizing cash levels and cash ordering decisions. In most cases cash levels are reduced by 15-25% and cash delivery costs are pared by about 15%. The 'best in class' solutions are those that are web-based and provide real-time information access, dynamically aligning competing cash needs, usage,

denomination mix, carry cost and delivery cost, while freeing up another non-earning asset for more productive purposes. However, in most cases this solution is more beneficial if deposit reclassification is accomplished first.

Non-interest income maximization

The next most opportune initiative is a thorough assessment of non-interest income. There was a time not so long ago when one could stipulate with confidence that a bank should generate a target return per transaction account per year of total service charge income. Owing to the new Regulation E rules and the uncertainties that accompany the changes, bankers are now factoring a revenue loss of some \$15 billion that will have to be replaced. That equates to about a third of the typical bank's overdraft fee income. In a period of continued net interest margin compression and a sluggish economy, that is a tall order.

As significant as this impact might become, the great majority of banks will have little difficulty off-setting the loss, and, indeed, even augmenting non-interest income to an impressive degree. Prior to the so-called meltdown, we conducted a statistical analysis with a revealing and instructive outcome. The project entailed a distribution of banks by earnings results, from lowest to highest. Virtually two-thirds of the banks fell below the average. The most revealing finding was that the primary difference between the one-third above the average and the two thirds below the average was the level of non-interest income. Almost all of the banks with the best earnings performance exhibited the same trait—non-interest income that exceeded one-percent of average assets.

On close scrutiny, every bank reveals undetected and untapped opportunities to increase revenue from existing products and services to achieve higher earnings performance levels. A comprehensive assessment of all product offerings and associated transactional functions will typically yield additional, pre-tax earnings on the order of \$1,000 to \$2,000 per million of assets. For a \$500-million-asset bank, that amounts to a return of up to \$1 million.

You might well question how this is possible, but it is in the very nature of banking today that it has become extremely difficult to allocate the necessary time and talent to discover those “hidden” opportunities. And when an internal profit improvement team is assembled, many of the potential initiatives remain “hidden” because they are either unknown or continue to be overlooked. An impartial, objective assessment is difficult to achieve without a new set of eyes, so to speak. Moreover, the verdict by personnel most closely involved will all too often follow the line. “But we have always done it that way,” failing to see the benefit of change.

Whether your scrutiny is directed toward service charge routines, waiver and exemption practices, balance requirements, account analysis methodology, loan processing and cost recapture fees, transactional timing differences or interest and service charge computation techniques, there are quite literally hundreds of areas that

are amenable to recalibration or restructuring to yield added earnings on a recurring basis.

Additional sources of revenue

There are, of course, other initiatives that will increase revenue. Not to be overlooked are non-traditional functions, such as trust services, third-party brokerage, insurance products and mortgage loan processing. In addition, there is potential for increasing interest income while also improving the bank's competitive ability to obtain greater loan volume. Smaller banks may consider fractional loan pricing (in quarters, eighths, etc) and larger banks will do well to implement basis point pricing. A ten basis point increase on a \$500 million loan portfolio is an additional \$500,000 of interest income per year. Pricing software models will be of particular assistance to effectively employ these strategies.

Cost Savings on Third Party Contracts

Cost containment and reduction is a parallel opportunity that will often yield comparable results. For example, banks contract with a number of third-party providers for certain, vital, operational, support functions. Hidden among a host of price points and sundry contract provisions are thousands of dollars of expense that can be negotiated downward. The key to achieving the reductions is an intimate knowledge of each provider's billing parameters and a comprehensive knowledge of the 'best in class' deals in today's market. The contracts that are most amenable to this appraisal and negotiation process are: core data processing; item processing; ATM/Debit card processing; internet banking and electronic bill payment; and check printing. This cluster of contracts will regularly yield cost savings on the order of \$500 per million of assets, without resorting to tactics that might undermine the bank's relationship or alter the quality of service. These are substantial cost savings that do not in the slightest affect bank personnel, bank customers or the bank's competitive standing.

Other Cost Savings Opportunities

On the other hand, one ought not overlook or avoid the potential for process improvement. There are numerous methods from Total Quality Management (TQM) to Six Sigma, but the most prominent methods were developed in a manufacturing context and are not readily applicable or adaptable to banking. Bank management is as much concerned with achieving zero defections as with zero defects, a standard more useful in manufacturing. Operational effectiveness initiatives for banks will be focused on both productivity and customer satisfaction.

Analyzing systems integration, evaluating organizational structure, increasing channel utilization, enhancing span of control, scrutinizing opportunities for process re-engineering and developing appropriate metrics for performance measurement will contribute incremental improvements to revenue optimization and expense containment. Creating the staffing model that assures efficient operations, based on real-time job analysis metrics, along with these process improvement initiatives, may lead to staff reductions or re-assignments, but will also yield added earnings gains.

Summary

To illustrate the impact of a thorough assessment, it is instructive to compare its benefits to that of making new loans. Suppose that the example of the \$500-million-asset bank mentioned earlier achieves a combined earnings benefit of, say, \$2,500 per million of assets as a direct result of implementing many of the proposed initiatives outlined herein. That would total \$1,250,000 of additional, annual pre-tax income.

On the other hand, if that \$500 million bank has a net interest margin of 3.5%, it would need to originate \$35.7 million of new loans to obtain an equivalent impact on annual earnings. Considering the personnel resources and attendant costs of originating and maintaining this higher volume of loans and, most importantly, the associated credit and interest rate risks, this comparison rather convincingly favors the approach outlined in this paper. Which option would your bank prefer, especially knowing that the approach outlined has a significantly lower risk profile and an immediate, sustainable impact on earnings?

One cannot emphasize strongly enough that all banks should scrutinize the areas discussed here thoroughly and take immediate and appropriate action on those that are warranted. Given the pace and complexity of banking today, especially with its current challenges, few banks are able to allocate the required internal resources to accomplish an in-house, comprehensive review. Bankers today are required to perform in their unique capacity almost like a super athlete, but often without the benefit of an impartial, objective viewpoint that can help take the bank to the next level.

Whether tapped internally or externally, like Team USA at the Lake Placid Winter Olympics, inventing “the way forward” is more readily attainable by accessing the best possible resources and intelligence available so that your bank can “accelerate earnings and capital accumulation without increasing your risk profile”.

About the authors

Nicholas Ceto, Jr. is the chairman and chief executive officer of Ceto and Associates which he founded after his retirement from KPMG where he served as the firm’s national partner in charge of their revenue enhancement consulting services. His professional career has included a wide variety of management consulting engagements for over 1,000 clients in the U.S., Europe, Canada, Australia, and many other countries.

Noel Busch has been actively engaged in the banking industry for more than 38 years. He was the principal consultant in the formation of eight Bankers’ Banks, including the nation’s first in Minnesota where he served as the first chief executive officer, and Florida where he also served as the first chief executive officer. During the past fifteen years he has been engaged in bank consulting. He currently serves as senior vice president and national account manager for Ceto and Associates in Atlanta, Georgia.

Company profile

Ceto and Associates, an Atlanta based financial consulting firm, specializes in providing revenue enhancement, operational efficiency and other profit improvement services to banks, thrifts and credit unions. *Visit Ceto and Associates on the web at www.ceto.com.*