

Upside Down Thinking on Efficiency

Do you Have your Priorities Backwards?

By David Carlson

Many financial institution executives spend considerable time thinking about strategies to improve efficiency in order to improve overall profitability. The efficiency ratio is the ratio of non-interest expenses (less amortization of intangible assets) to net interest income and non-interest income, so it is effectively a measure of what you spend compared to what you make. The very name – “efficiency ratio” – makes us think about how efficient we are with those precious income dollars. If a financial institution has a high efficiency ratio, they are simply spending too much of what they make...right? That is exactly what the name implies (emphasis on the spending side of the equation). But this is just a ratio of two numbers, and as we all know, there are two ways to bring the ratio down – reduce costs or increase revenues.

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The focus across industry press and conference best practices is generally aimed at strategies to cut expenses – using technology, looking at staffing levels, increasing productivity, etc. Although this advice is sound, what happens when a financial institution has already cut what can be cut and improved what can be improved, AND still struggles with efficiency? It is sometimes difficult to save your way to prosperity.

For many financial institutions the focus should be on the bottom portion of the equation – increasing revenues. Let’s look at an institution that has \$500 million in assets, a good return at 1% ROA, and a reasonable efficiency ratio of 60%. Their key metrics would look something like this:

Financial Metric	Before	5% Efficiency Ratio Improvement by	
		Revenue Increase	Expense Decrease
Assets	\$500,000,000	\$500,000,000	\$500,000,000
Efficiency Ratio	60%	55%	55%
Net-Interest and Non-Interest Income	\$12,500,000	\$13,636,364	\$12,500,000
Non-Interest Expense	\$7,500,000	\$7,500,000	\$6,875,000
Net Income	\$5,000,000	\$6,136,364	\$5,625,000
ROA	1.00%	1.23%	1.13%
Change in Net Income		\$1,136,364	\$625,000

\$500,000 less if the better efficiency ratio is achieved by reducing expenses!

Now let’s assume the FI can improve its efficiency ratio by 5% through revenue increase or expense reduction.

Financial Metric	5% Efficiency Ratio Improvement by	
	Revenue Increase	Expense Decrease
Assets	\$500,000,000	\$500,000,000
Efficiency Ratio	55%	55%
Revenues (Net-Interest and Non-Interest Income)	\$13,636,364	\$12,500,000
Non-Interest Expense	\$7,500,000	\$6,875,000
Net Income	\$6,136,364	\$5,625,000
ROA	1.23%	1.13%
Net Income Impact	\$1,136,364	\$625,000

\$500,000 more if the improvement is achieved by adding revenue!

Most community financial institutions still have tremendous excess capacity, meaning they could serve significantly more customers. The answer to improving the efficiency ratio is to fill excess capacity with brand NEW profitable customers. This is a counterintuitive approach because in my view many financial institutions need to increase investments for growth, thereby increasing the expense side of the equation, in order to significantly grow their revenues, and because of their



excess capacity, this will actually make them more efficient over time. Many financial institutions have cut expenses almost to the bone and can't materially improve their efficiency ratio by further reducing costs. They need to take a step back and realize some fundamental business dynamics that are often ignored in our industry.

The answer to improving the efficiency ratio is to fill excess capacity with brand NEW profitable customers

One of the biggest ignored financial dynamics is excess capacity. How do other businesses look at the issue of excess capacity – for example a manufacturing company:

- The facility is running at 50% of the capacity it was built to produce;
- The factory has done everything it can to be as efficient as possible—evaluate staffing levels, implement technology solutions, etc.; and
- Management's major goals and objectives are still focused on improving profitability by further evaluating already efficient processes and selling more to current customers.

Given the excess capacity at the manufacturing company, wouldn't it also make sense to evaluate if more widgets can be run through the facility? Would the market support providing more products to more people

in order to increase net income without substantially increasing expenses?

The manufacturing company analogy is very similar to the situation being faced by community financial institutions. They have branches currently attracting 30% - 50% of the new customers they were built to serve each year, and inefficiency is getting worse as transaction volume continues to decline in branches. Most financial institutions have used technology and staff reductions to become more efficient; however, they still spend much of their time, effort and energy focusing on cost reductions and additional efficiency enhancement.

One reason for not actively growing revenues is based on a perceived problem – some significant percentage of potential customers may not be profitable. Numerous studies show the fully allocated cost of a checking customer is \$250 - \$350 per year; if that is truly the case, over 50% of the customers we attract may be losing us money.

This is valuable analysis and we would argue the math is correct; however, the application is incorrect. The cost of a checking customer at \$250 - \$350 per year looks at all fixed costs and divides them by an institution's number of customers.

When a community financial institution starts welcoming twice as many customers per year, fixed costs do not substantially change

When a community financial institution starts welcoming twice as many customers per year, fixed costs do not substantially change – no new branches have been built and no additional employees have been hired. Actual data from hundreds of community financial institutions illustrates the impact on actual expenses is truly just the marginal costs - generally an additional \$30 - \$50 per account per year (even if we must mail a paper statement). Conversely, the same data base shows the average annual contribution of each new account per year is between \$250 - \$350.

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Realistically, will all customers recoup marginal cost? No. Client data shows that approximately 6% of consumer checking accounts opened are single product checking households who produce less than \$30 per year in revenue. It's not a secret; it's something we have always known. 94% of customers contribute to profitability. Once a financial institution embraces the marginal vs. fully allocated model, it can start making different decisions in terms of product, policy, procedure, process, training and marketing – allowing it to attract TWO TIMES the new customers it had been attracting previously. Yes, 6% of new customers lose money at the margin; that's okay because a financial institution with a dedicated strategy also gets twice as many that are adding to overall profitability. It's a simple tradeoff. It's just math.

94% of customers contribute to profitability

When comparing clients that have embraced this strategy to the overall industry over a three-year period of time (2014 to 2017), their efficiency ratio was 63% better. This has been accomplished by significantly increasing the number of new customers coming in the front doors of existing branches.

There is only so much blood in a turnip. Controlling costs by embracing technology and evaluating staffing are all things financial institutions should be doing; however, if they have already become very efficient in these areas, the focus must shift to driving revenue. Most financial institutions have tremendous excess capacity in their **existing** branches today. The solution is to start filling them up.

David Carlson is a Senior Executive Vice President at Haberfeld, a data-driven consulting firm specializing in core relationships and profitability growth for community-based financial institutions.



*David can be reached at **402-323-3600** or **dcarlson@haberfeld.com**.*