

Upside Down Thinking on Efficiency: Do You Have Your Priorities Backwards?

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 noninterest expenses—less amortization of intangible assets—to net interest income and noninterest income. It is, effectively, a measure of what you spend compared to what you make. The very term—*efficiency ratio*—makes us think about how efficient we are with those precious income dollars. If a financial institution has a high efficiency ratio, it is simply spending too much of what it makes. Right?

That is exactly what the name implies, with 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.

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

For many financial institutions, the focus should also 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 percent return on assets and a reasonable efficiency ratio of 60 percent. Its key metrics would look something like chart 1 at right. →

Now let's assume the financial institution can improve its efficiency ratio by 5 percent through revenue increase or expense reduction (see chart 2). →

It shouldn't be surprising that increasing revenues provides better performance, even though this sometimes seems like a counterintuitive approach. Because many financial in-

stitutions need to *increase* investments for growth in order to significantly grow their revenues—thereby increasing the

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.

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expense side of the equation—and because of their excess capacity, this will actually make them more efficient over

they could serve significantly more customers without significantly increasing
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CHART 1	Financial Metric	Before	5% Efficiency Ratio Improvement by Revenue Increase	5% Efficiency Ratio Improvement by Expense Decrease
	Assets	\$500,000,000	\$500,000,000	\$500,000,000
	Efficiency Ratio	60%	55%	55%
	Net Interest/Noninterest Income	\$12,500,000	\$13,636,364	\$12,500,000
	Noninterest Expense	\$7,500,000	\$7,500,000	\$6,875,000
	Net Income	\$5,000,000	\$6,136,364	\$5,625,000
	Return on Assets	1%	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.

CHART 2	Financial Metric	5% Efficiency Ratio Improvement by Revenue Increase	5% Efficiency Ratio Improvement by Expense Decrease
	Assets	\$500,000,000	\$500,000,000
	Efficiency Ratio	55%	55%
	Revenues (Net Interest and Noninterest Income)	\$13,636,364	\$12,500,000
	Noninterest Expense	\$7,500,000	\$6,875,000
	Net Income	\$6,136,364	\$5,625,000
	Return on Assets	1.23%	1.13%
	Net Income Impact	\$1,136,364	\$625,000

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



INDUSTRY INSIGHTS

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POSITIONS AVAILABLE**SENIOR LENDER/BUSINESS DEVELOPMENT OFFICER.**

A \$185-million North Texas community bank seeks experienced commercial and real estate lender with a heavy emphasis on business development to assist in bank growth. The ideal candidate will have an established customer network that can

produce \$7 million to \$10 million new loans annually. Must have four or more years of direct lending experience. A formal degree in finance or accounting is preferred. Competitive base salary augmented by a lucrative incentive bonus and benefits package. Send résumé in confidence to HR Officer, P.O. Box 338, Bridgeport, TX 76426; or email to judi@fsbwise.com. EOE

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expenses. The answer to improving the efficiency ratio is to fill excess capacity with new profitable customers.

How do other businesses look at the issue of excess capacity—for example, a manufacturing company?

- ▶ The facility is running at 50 percent of the capacity it was built to produce;
- ▶ The factory has done everything it can to be as efficient as possible—evaluating staffing levels, implementing 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 banks. They have branches currently attracting 30 percent to 50 percent of the new customers they were built to serve each year, and it 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 enhancements.

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

When comparing clients that have embraced this strategy to the overall industry over a three-year period (2014–17), their improvement in efficiency ratio was 63 percent 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, embracing technology to reduce process costs 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 banks have tremendous excess capacity in their existing branches today. The solution is to start filling them up. ■

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CONSUMER/MID-MARKET COMMERCIAL LENDER.

Ready to get out of the big city? A \$185-million North Texas locally owned community bank currently has an opening for a full-time loan officer specializing in consumer and mid-market commercial loans. Duties include management of an existing portfolio, as well as the ongoing development of new credit relationships. Excellent customer skills and a team player are needed. Competitive benefits and salary. Send résumé in confidence to HR Officer, P.O. Box 338, Bridgeport, TX 76426; or email to judi@fsbwise.com. EOE

FIRST NATIONAL BANK, ALAMOGORDO, NEW MEXICO. A \$350-million banking institution with a 40 percent loan-to-deposit ratio looking to purchase participations. For more information, please contact the bank's president, Greg Garrett, at greg.garrett@fnb4u.com or 575/443-5262.

SEASONED LENDER—COMMERCIAL AND REAL ESTATE LOANS.

A locally owned community bank in Dallas, Texas, currently has an opening for a seasoned lender specializing in commercial and real estate loans. Responsibilities would include underwriting and management of an existing portfolio, as well as the ongoing development of new credit relationships. Ideally willing to grow into a credit position and manage a team. Competitive benefits and salary. Please send résumés to advertising@bankersdigest.com with AUG-1 in the subject line.

CHIEF FINANCIAL OFFICER, TEXAS FINANCIAL BANK, SAN ANGELO DATA CENTER.

Texas Financial Bank seeking chief financial officer for its San Angelo data center. The ideal candidate will have five-plus years of experience in bank operations, proficient in regulatory financial reporting, BSA and accounting. Preferably an accounting degree and experience with Fiserv Precision is a plus. The bank is a stable and home-owned community bank. Please send résumés to Tom Burress at tburress@texasfinancialbank.com.