DREAM METRICS AND PERFORMANCE

by Steve Brown

Times are tough right now, which is why so many banks are trying to dream up ways to reduce costs and increase revenues. One way bankers try to cut costs is by focusing on improving their efficiency ratio. We all know this ratio is designed to help bankers manage costs; however, it also has some deficiencies worthy of a second look that reduce its value as a "dream metric."

In short, many bankers have a hard time cutting costs. After all, branches have already been built and they are brimming with people and equipment. This alone makes cutting costs at least difficult and at the most, nearly impossible. What about the calculation of the efficiency ratio itself? Does this tried and true ratio really still work or has it lost some of its luster?

To find out, recall that while calculation of the efficiency ratio between banking organizations can vary (e.g. some banks use non-interest expense divided by total revenue less interest expense; others use non-interest expense divided by NII before provision for loan losses; still others use non-interest expense divided into revenue; and a final group takes operating expenses divided by fee income plus tax equivalent NII), it is nonetheless critical to know, understand, monitor and manage. No matter how your bank calculates it, an increasing number means the bank is losing a larger percentage of its income to expenses.

Banking, as with any industry has top performing companies, and those companies keep a wary eye on their overhead costs. For banks in particular, the efficiency ratio provides a specific measure of how effectively a bank is operating. Over the years, studies have found top performing banks will have about 25% better efficiency ratios than average performers.

As a place marker, the average commercial bank in the country has an efficiency ratio of 57%. As we all know, larger banks usually have greater economies of scale, so the efficiency ratio is inversely correlated to asset size. This can be even more easily seen by using standard regulatory data categories for commercial banks. By using this analysis as of the end of the 1Q of 2008, we find the average bank with assets below $100mm has a 77% efficiency ratio; those with assets between $100mm to $1B drop to 69%; the group with assets from $1B to $10B are at 57%; and those with assets above $10B are at 55%. It is also interesting to note that virtually all top performing financial institutions will have an efficiency ratio below 60%.

Bankers like to use the efficiency ratio, but believe it or not, most do not build it into their planning process. In addition, few even set targets for it when looking at organizational performance. Maybe bankers realize the efficiency ratio (as with all simplistic ratios) is not a dream metric. For instance, bankers that provide a high touch customer experience will naturally have a higher efficiency ratio. If, however, this results in lower deposit costs, stronger customer retention and more cross-sell, it may be worth it. Conversely, if a bank considers itself a low cost provider, then focusing on controlling expenses will result in a lower efficiency ratio. Depending on the model, the efficiency ratio can be quite different, so in and of itself it is only one data point.

No matter what your efficiency ratio is today, focusing efforts on ensuring costs are contained (within your business model) is more important than ever. Try creating "dream teams" to work on new ways to save money, generate more income and improve performance.

To get the biggest impact, ask employees to dream about those lines of business that have the greatest impact on performance. Some lines of business, no matter how efficient, have little impact on profits. Focus your dream time and you may find yourself waking up more refreshed, with a little extra money under the pillow.

BANK NEWS

M&A Rest

As of July end, 94 bank and thrift deals worth $7.1B were announced for 2008, leading to what looks like the weakest figures in over 15Y. In 1998, there were 474 deals totaling a whopping $206B.

Exam Troubles

As current concerns over bank failures continue, examiners are becoming stricter in pointing out potential trouble spots in banks. Last week, Imperial Capital Bank ($4.1B, CA) entered into a memorandum of understanding with the FDIC to reduce exposure to unspecified loans and improve procedures for determining loan loss reserves, along with other requirements. The bank's delinquent loans and property foreclosures jumped up $137.7mm in 2Q, largely from developer's construction loans and land development loans.

Mortgage Fraud

6 have pleaded guilty in a $17mm mortgage fraud scheme involving 2 title companies in Florida. The title agents fraudulently marked up sales prices in HUD-1 statements provided to lenders, collecting profits into a third party bank account.

Underbanked

Approximately 1/3 of low-to-moderate income Americans (annual household income below $55K) either have no bank accounts or have a basic account but still rely on check-cashing for daily transactions. Less than 60% save on a regular basis. 39% pay bills with cash and 30% through money orders. The only type of investment with significant numbers is in home ownership, at 42%.