MAKING BANK BUDGETING BETTER

by Steve Brown

There are things that we collectively perpetuate as a society that we know don't work, but we support because it feels like it gives us an element of control. The "Close Door" button on elevators, the cross-walk buttons and some say, even Congress, are examples of this. Unfortunately, many bank budgets also fall into this category. While few admit it, many have their finance staff spend a large amount of time creating, tracking, modifying, approving and distributing a budget; only to relegate the document to a perfunctory status akin to last year's weather comparisons. You might be under or over, but little affirmative action is taken to ensure budgetary goals are met. This year, with increased financial volatility, we are afraid that budgets may prove to be even more worthless for some banks. To better understand the value of budgets in banking, we recap some best practice points.

For starters, a budget's primary power is the allocation of resources. As such, good budgeters will be under budget as many times as over. Systems that penalize managers for missing budget inherently create a structure that rewards being conservative. Line managers are conservative, department heads are conservative and thus the aggregate budget wildly underestimates the outcome. As a result, business opportunities are missed and resources are misallocated. Unfortunately, everyone is rewarded. A better way to structure bank compensation around the budget process is to reward for earnings growth (or operating profit for departments) with a higher percentage for budget accuracy.

Part of any budget's power is the process that is an exercise in consensus building. While important in itself, management teams that apply the same process to coming up with alternative scenarios will be ahead of the game. Banks that identify a handful of events (such as another FDIC special assessment, bankruptcy of a major customer or lower deposit insurance) with predefined triggers (such as a drop in net income), can then implement a predetermined contingency plan (such as cutting costs, increasing marketing, etc.). This will speed adaptation and reaction time, thereby increasing the probability of success.

Deciding the budgetary process is also important. Given the need to cut expenses, many successful banks are turning to zero-based budgeting for the first time in a while. Zero-based budgeting breaks away from the problem of anchoring's 2010's budget based on 2009's. Starting each business line from scratch and asking the question - "what resources (including capital) are needed to produce the required level of income?", will force management teams to decide if they really should be in certain business lines or markets. If you are looking to cut costs and improve performance, zero-based budgeting is the best way to accomplish this goal.

Another important part of budgeting is the extrapolation of key metrics. In order for the budget to be met, finance should highlight volume, new account opening levels, cost of funds and other shorter-term items that need to be accomplished. Breaking these key metrics down into quarterly goals will not only keep everyone focused, but will serve to make an abstract budget more concrete for line managers.

Finally, top performing banks often get feedback from line personal early in the process. Starting the budgetary process by asking each manager what they are capable of next year may serve to speed the process instead of starting with a top-down budgetary draft. In periods of uncertainty, getting everyone's buy-in and feedback is critical in the construction of a usable budget.

Budgets are one of the most valuable tools that bank managers have and can have a much more positive impact on performance than elevator buttons or Congress. This year, make sure the 2010 budget is taken to the next level.

BANK NEWS

Bank Equity

In an effort to jumpstart equity investment into banks, the FDIC is expected to ease rules around private equity investments by possibly cutting required Tier 1 capital ratios for banks from 15% to 10%.

Prestigious Bankers

A new survey by Harris finds 16% of people (up from 15% last year and 10% in 2007) ranked "banker" as an occupation of "very great prestige," 21% said bankers had "considerable prestige" and 43% said "some prestige." By comparison, occupations with the most prestige - firefighter (62%), scientist (57%), doctor (56%) and nurse (54%). Those considered the least prestigious - real estate agent (5%), accountant (11%) and stockbroker (13%).

Deposits

According to research by Aite Group, banks can rake in $700mm in revenue by focusing on small business remote deposit capture. Nearly 50% of small businesses don't even know what RDC is and only 1% actually use it. The research indicated that if only 10% of small businesses started using RDC, the banking industry could garner $720mm in revenue a year.

Projected Failure Rate

About 246 banks had a Texas Ratio in excess of 100% as of 1Q, compared to 175 as of 4Q. We'll update this data when the 2Q numbers are final, but banks with ratios above 100% are categorized under extreme stress.