Point of View Paper

Five Simple Steps to Improving Profitability

Navigating the Journey in Warp Speed Digital Space

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Does your financial institution consistently exceed stakeholder expectations? Do you have a well-defined process that continually challenges you to improve the outcomes? Let's explore the common characteristics of high-performing financial institutions and the simple five-step process to drive continuous improvement in your organization.

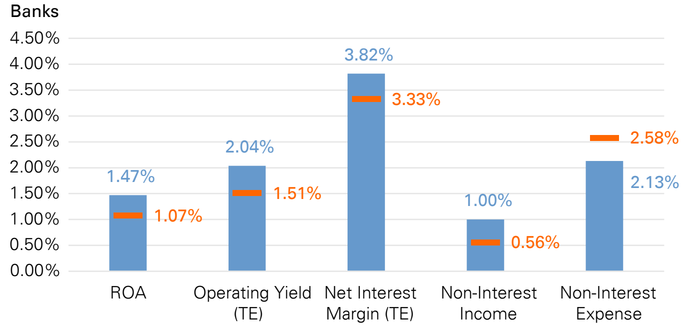
Top-Quartile Performance

A common method of measuring results is to benchmark against a group of local peers, regardless of strategic orientation or performance level. For most financial institutions, this approach tends to give a false sense of security and set average expectations.

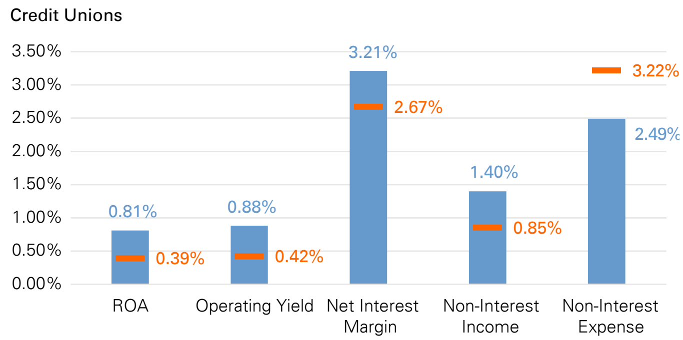
Your stakeholders (That is, customers, members, shareholders, employees and communities) will benefit more over the long term when you set aspirational benchmarks, have a process to define and document performance improvement strategies, and have a mechanism to track and communicate the results.

Let's compare the results at the 50th national percentile (NP) – median – and the 75th NP – top quartile – to illustrate the difference between average performance and high performance.

The accompanying charts highlight the differences between median and top-quartile performance for banks and credit unions across five metrics: return on assets (ROA), operating yield, net interest margin (NIM), non-interest income and non-interest expense.



Source: BankAnalyst® 1Q2021



Source: CUAnalyst℠ 1Q2021

Without going into the details behind each of these metrics, it's important to understand how to calculate the opportunity gap between average and high performance.

The top-quartile breakpoint for ROA during the first quarter was 1.47% for banks, while the median was only 1.07%. This 40-basis-point (bps) difference amounts to $400,000 in net income for every $100 million of assets. Note the top-quartile ROA for credit unions was 42 bps better than median ROA during the first quarter.

(1.47% – 1.07%) × $100 million = $400,000

The same formula could be applied to the other metrics in the charts to calculate the opportunity gap for each.

Likewise, you could substitute your financial institution's results for the median (50th percentile) results to calculate your institution-specific opportunity gap.

(Top Quartile Value – Institution Value) × Institution Assets = Institution Opportunity

Why This Is Important

Earnings are fuel for sustained growth, and high-performing institutions have more options than average performers when evaluating strategically alternative uses of capital, such as acquisition opportunities, shareholder or member dividends, technology investments, delivery channel expansion or even staffing needs.

In the illustration below, a $100 million financial institution producing ROA of 1.47% (75th NP) rewards its shareholders with a $3.23 higher book value per share (BVPS) and $32.3 million more in asset growth over a five-year period than an institution producing ROA of only 1.07% (50th NP). To estimate the impact on your institution's share value and/or potential asset growth, substitute your institution's values to compare the differences between multiple ROA scenarios.

Key Assumptions

- Assets: $100 million
- Liabilities: $90 million
- Equity: $10 million
- Shares Outstanding: 1 million
- Investment Horizon: 5 years (n)
- ROA Scenario 1: 1.07% (50th NP)
- ROA Scenario 2: 1.47% (75th NP)
- Other: Retain all earnings and hold the equity multiplier and shares outstanding constant over the investment horizon

$$\text{Equity Multiplier} = \frac{\text{Assets}}{\text{Equity}} = \frac{\$100 \text{ million}}{\$10 \text{ million}} = 10.0$$

Return on Equity = Return on Assets × Equity Multiplier
Scenario 1: 1.07% × 10.0 = 10.70%
Scenario 2: 1.47% × 10.0 = 14.70%

$$\text{BVPS} = \frac{\text{Equity}}{\text{Shares Outstanding:}} = \frac{\$10 \text{ million}}{1 \text{ million}} = \$10.00$$

Projected BVPS = Current BVPS × (1 + Return on Equity)^n
Scenario 1: $10.00 × (1 + .1070)5 = $16.62
Scenario 2: $10.00 × (1 + .1470)5 = $19.85

Projected Assets = (Projected BVPS x Shares Outstanding) × Equity Multiplier
Scenario 1: ($16.62 × 1,000,000) × 10.0 = $166,200,000
Scenario 2: ($19.85 × 1,000,000) × 10.0 = $198,500,000

Are you encouraged and excited about the opportunity to lead your institution to higher performance, but don't know where to start? Now that you have a better understanding of how a shift in just a few basis points can have a significant impact on profitability and growth, let's discuss what you can do to make a difference for your financial institution. The following five steps will have you on the right path in no time. In fact, there are things you can do today to start the process.

Five Simple Steps to Improving Profitability

1 Benchmark

2 Develop

3 Implement

4 Measure

5 Repeat

Step 1:

Benchmark

The first step in the process is to benchmark your current performance against a meaningful set of peers. This involves first selecting high-performing institutions of similar size and strategic orientation, and identifying gaps in financial performance. The charts above identify some of the most common metrics to consider first, and can help identify where further analysis is required.

At this stage of the process, it is important to communicate the results of the analysis to your leadership team and align expectations with new performance targets.

Step 2:

Develop

The next step is to develop new strategies for growth and efficiency. The goal of these strategies should be to grow revenue faster than expenses. With strategies in place to create positive operating leverage, your institution will quickly improve its operating yield and efficiency ratio.

Your competitors are not afraid to try new things. You shouldn't be, either. Consider which new ideas align best with your strategic objectives and prioritize those ideas based on their growth potential.

Step 3:

Implement

Implementing your new growth and efficiency strategies may involve new processes, procedures or products, and may also include new promotion and pricing strategies and/or upgrades to your distribution channel strategies. At this point, it is critically important to communicate the "why" behind each of the changes. To keep your associates invested in the process, maintain regular status updates and provide specific training where necessary.

It is also important to have strong leadership at this stage, and there are times when having outside assistance can keep things moving along.

Step 4:

Measure

Set reasonable goals and measure results against these internally defined targets. This is different from the previously discussed benchmarking process, where results are measured against external peers. This step involves using your financial institution's internal data to measure progress toward the strategies implemented in the previous step. This data may come directly from your core account processing system, or may reside in a data warehouse or other application.

An example of this is debit card utilization. Consider metrics such as the percentage of accounts actively using a debit card, the number of debit card transactions per account or the average dollar amount spent per transaction.

Another example is related to account growth. Consider metrics such as number of accounts opened and number of voluntary and involuntary account closures (charge-offs). High-performing institutions further track these metrics by branch, client segment and product.

The type and number of new metrics will be unique to your institution, but once the new standards are established, communicate the standards to all associates. Internal reporting should be robust and frequent. Remain committed to the measurement and reporting process.

Step 5:

Repeat

Congratulations! You have created the framework necessary to become a top-quartile performer. But to ensure your success, you must remain invested in the process by regularly benchmarking your results against other high-performing peers and against your own internal targets. As momentum builds, develop and implement new strategies frequently. You can plug them into this process at any time. Just remember that this is a continual process and will take some time to materialize. If top-quartile performance seems out of reach right now, just set smaller incremental goals and work toward them each time you cycle through the process.

Stay on the Path

Your financial institution can improve profitability and achieve top-quartile performance by benchmarking your progress against high-performing peers, by developing and implementing new strategies to improve performance, and measuring results against internal targets. Continue on the path to improved profitability by repeating the process. A suite of automated decision tools, such as Bank Intelligence Solutions® from Fiserv, can help you identify the right strategies for your financial institution.

About the Author

Eric Stables brings 30 years of experience in financial services to his role as a senior strategist at Fiserv. He is a trusted leader with a proven ability to solve complex business problems and generate tangible results. Prior to joining Fiserv, Stables held senior leadership positions in financial and product management at multiple banks ranging in size from $100 million to $350 billion. His broad expertise in asset-liability management, financial analysis, revenue enhancement, process improvement, risk management and strategic planning helps Fiserv clients develop actionable strategies to improve profitability and efficiency.

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