

Walk Before You Run

A Phased Implementation Approach to Profitability

By Dale Kovar

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Are you struggling with the installation of a profitability initiative due to its perceived complexity? The challenge of profitability reporting can be overwhelming particularly when a full absorption methodology is assumed. We get hung up on allocation issues for accounts that may be insignificant in the big picture. This task may not be as grueling if we would only learn to walk before we run. The financial industry is continuing to experience increased competition from both traditional and non-traditional institutions such as insurance companies and brokerage firms. This increase in competition has resulted in narrower spreads and higher servicing costs as consumers demand additional delivery channels. To meet the challenge of increased competition, financial institutions need to measure the profit contribution of each dimension of organization, product, and customer to support pricing decisions and strategic alignment.

The “Walk Before You Run” philosophy is nothing new. It is simply a means of focusing our efforts on that which will provide the greatest return. The low hanging fruit for most financial institutions is best summed up in what I would refer to as the “Big Five”. For any financial institution, there are a few big ticket items that account for a majority of the profits. They are:

1. Net Interest Margin
2. Loan Loss Provision
3. Fee Income
4. Branch Compensation
5. Data Processing Expense

You may notice that a couple of these items represent a rather broad section of the income statement. Although this is certainly true, you will see that the allocation of their respective income/expense accounts is rather straight forward. In the remainder of this article I will focus on the product dimension of profitability as this tends to be the area, where many that embark on this journey, struggle. I will explain why it is important to focus your efforts on the “Big Five” and how you may begin to measure profitability even before the process is complete.

1) For a given financial institution, Net Interest Income will typically represent well over 80% of the institution’s revenues. After all, it is why we are in the business. We gather deposits for the later sale of these funds in the form of loans. In so doing, we assume (and are subsequently rewarded for) mismatched risk. We also gather funds at rates below market and sell these funds at above market rates resulting in spread. Depositors are traditionally viewed as a source of expense paid in the form of interest expense. Borrowers are traditionally viewed as a source of revenue paid in the form of interest income. We intuitively know value exists for funds providers while the users of funds return something less than the stated note rate. Funds Transfer Pricing (FTP) is the methodology used to provide a credit for the source of funds and a charge for the use of funds.

There are several methodologies available to funds transfer pricing. The most meaningful methodology, in my opinion, is matched-funded. This methodology is the most sophisticated and accurate FTP methodology available. It gives credence to the unique characteristics of each individual instrument, taking into account the funding curve in effect at the instrument's origination/re-pricing date. The funding credit/charge applied to each instrument is then "locked-in" until the next re-pricing date or maturity. This "locked-in" rate is what separates the mismatch from the instrument and is typically isolated in a central funding unit *(There have been numerous articles written on this subject of matched funded FTP that will provide adequate explanation for those seeking additional information. A detailed explanation of matched funded FTP is outside the scope of this article.)*

There are many software vendors that provide solutions for matched funded FTP. Technology has made it possible to efficiently and painlessly allocate the net interest income attributable to each product. Once the setup has been completed, the monthly process to update and calculate this contribution requires little effort with a significant return. Knowing the spread for each product goes a long way towards identifying which products you want to focus your strategic efforts on. Given the low cost for these software systems, there is no sensible reason to delay implementation of a matched funded FTP system. You get a big bang for your buck.

2) Before you begin to compare the margin contribution of each product, an adjustment for credit risk is warranted. For this reason and given the amount of this expense, the allocation of loan loss provisions is listed as one of the "Big Five". I advocate allocations based on a *sustainable* loss provision rather than allocating the *expensed* loss provision. The loan loss provision expensed in any given period may or may not reflect the *expected* loss. For example, the expensed loss provision in the current year may be a make up for lower accrual in the prior year. This method recognizes the credit risk inherent in each product offered. The sustainable loss rate for a given product is based on an analysis of historical net losses and expected net losses. This sustainable loss rate is then applied to the entire balance. In this way, a residual is created that can be managed by a credit administrator to evaluate whether the current provision is adequate.

3) Fee Income represents the largest portion of Non-Interest Income for most financial institutions. Concentrate your efforts on those income accounts that are most significant. These will typically be NSF Fees, Service Charges, Check Card Interchange Income, Loan Late Fees, and Loan Origination Fees. Fee Income is also typically product specific. Assuming that the GL structure has sufficient detail, the allocation of fee income to products is fairly straight forward. "Late Charges on Agriculture Loans" would be allocated to the "Agriculture Loans" product. For fee income that may not have sufficient detail such as Check Card Interchange Income, this revenue source can be allocated to the various Checking products based on number of accounts. Ideally, a query that captures product transactional data by purchase amount should be used since this revenue is based on the dollar amount of purchases. One would have to weigh the trade-off of additional effort for better information.

Now that a majority of the institution's revenues have been allocated to the products with consideration for credit risk, a comparison can be made among the products. Assuming that you continue to actively manage expenses, you could begin to measure your branches and products based on adjusted revenue. If the profitability of a product is in the red at this allocation phase, do you need to allocate expenses? You can now begin to report on profitability and educate branch personnel on the revenue allocations thus far before continuing with expense allocations.

4) The largest Non-Interest Expense for financial institutions is compensation and benefits. The costs associated with support areas such as Human Resources and Accounting are usually allocated as indirect expenses. These functional costs are usually cascaded to other cost centers since they support other functions within the organization rather than products directly. Branch compensation should be allocated as a direct expense because of the direct relationship between costs and products. For most financial institutions, branch personnel make up a significant portion of compensation expense. Since this is a direct expense, the information attained is worth the effort to cost out this area. Traditional cost accounting used a single stage allocation whereby compensation expense was allocated directly to the product based on statistical data. Activity Based Costing or ABC is a two- stage allocation methodology that was developed due to the need for a better method than what the traditional single- stage provided. ABC not only focuses on the activities that are performed but provides insight into why these activities occur. The two stage methodology first allocates costs to activities performed based upon a resource driver such as "% of Time Spent". This resource driver as it relates to compensation is typically developed using surveys. A "survey" is a measurement of how employees spend their time performing various activities. It can be a simple interview process or as complex as time studies. I personally believe a simple approach is preferred for initial implementation of a profitability initiative. The old 80/20 rule can be applied here where accuracy is important but precision is not. It is more important to be directionally correct than precisely wrong.

Once Branch compensation has been allocated to activities, the second stage of ABC allocates these activity costs to products that benefit from the activity performed. An activity driver is used to allocate these costs to the products. Activities can share such drivers but it is important to use a driver that has a causal relationship to the activity being performed. For example: The activity "Process Deposits" should use *number of deposits processed* for each product as the activity driver. If this statistic is not available, a percentage breakout might be more meaningful than *number of accounts*. As you may have noticed, this process is a little more complicated than traditional single-stage allocations but much more accurate and meaningful. There is tremendous value in identifying the activities performed and the cost of these activities. One could also develop *unit cost* information that can be used for operational trending analysis or input into customer profitability systems. A *unit cost* is nothing more than the activity cost divided by the activity driver.

5) The fifth and final item in the "Big Five" is Data Processing Expense. This expense is typically the second largest Non-Interest Expense for financial institutions and warrants

attention during initial allocations setup. The allocation of this expense is fairly straight forward as it is a direct expense. Depending on how this expense is posted to the general ledger, you may want to split this cost into various accounts that will make allocations simpler. Similar to the ABC methodology, you may need to first allocate the expense to *Loan Systems*, *Deposit Systems* or *Item Processing* for example. Depending on the causal relationship, this expense can be allocated to the products that benefit from these systems or services. Here, the drivers commonly used are *transactional data* or *number of accounts*.

At this phase you would have allocated most of the financial institution's revenue and expense using well established methodologies. It is crucial to begin reporting and sharing this information. I cannot stress enough how important it is to produce reports in a timely manner. You do not want the process to stall. The reports will spawn questions that will drive the learning process. Ensure channels of communication exist to answer questions and encourage feedback. Allocations should be well documented to help explain the reasoning behind the methodology used. Now that you have learned to walk, you can begin to run by completing the task of allocating the remaining revenue and expense accounts once you feel your organization is ready. It is my opinion that a fully allocated income statement should be achieved. You may not use these indirect allocations in your decision making but it is important to see how these support areas impact the bottom line. The process does not stop here. It is ever evolving as you continue to enhance the model. The return on your investment is well worth the effort. You will be up and running in no time.



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Deb Verdecchia, Council Administration

Phone: (800) 356-9655, ext. 4357

FAX: (608) 231-4061

E-mail: dverdecchia@cuna.coop