High Performance:
Still the Holy Grail in Banking

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EXECUTIVE BRIEFING

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High Performance

Still the Holy Grail in Banking

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Many of us remember the “good years” in banking. Between 2002 and 2004, as any industry we achieved historically high numbers in Return on Assets and Return on Equity. Net Interest Margin was still viable, and Non Interest Income was on the rise. Depending on asset size, high performing banks regularly achieved a 2+ ROA and a 16+ ROE. Those numbers were so solid that they were a beacon for those banks looking to improve. But even if true “High Performance” was not within reach, banks could set themselves incremental goals across performance measures, implement manageable changes to maximize their performance, and attain meaningful improvements. Margins and growth trends favored the banker at that time.

Then everything changed. Economic downturn turned into the Great Recession, and even formerly high performance organizations started to congratulate themselves on another year of keeping the doors open. The goals of high performance were replaced with goals of survival, and as we all know, not everyone made it.

Bankers and economists alike all seem to agree that the worst is over in terms of credit quality. But many banks are still struggling with efficiency, and since the numbers of a decade ago are nearly unachievable in today’s environment, fewer bank Boards and executives are setting goals of high performance. For the past few years, comparing ourselves with “C “players has seemed to be enough. Going forward, though, we need to focus more on comparing ourselves with—and becoming—“A” players. Shareholders will ultimately demand it.

Charting the Numbers

What we all have to remember is that high performance today doesn’t mean what it meant ten years ago. The world is new and different, better in some ways like technology, harder in some ways like compliance. But since the environment itself has changed so drastically, perhaps it’s time that our expectation of high performance does the same.

The key metrics by which banks measure performance remain largely unchanged. Return on Assets, Return on Equity, Efficiency Ratio, Net Interest Margin, Non Interest Income, and Non Interest Expense have long been, and continue to be, the gold standard by which organizations compare themselves to their peers. But what metric level does a bank need to achieve high performance in 2014?

Many organizations achieved Top 25% performance on a single metric, or even a combination of two or three. But across the board, in terms of managing shareholder value, expenses, margin, and efficiency, High Performance does seem to be something of a Holy Grail.

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The New Quest for Performance

While industry-wide ROA numbers are interesting, the more telling statistics come from benchmarking performance against more closely identified peer groups in terms of asset size. A $250 million community bank can't be meaningfully compared to a $4.2 billion regional organization, but examining the performance of peers in more granular asset bands starts to yield telling results.

As banks plan for and move quickly into 2014, we believe that there is a new standard of High Performance, and we also believe that there are realistic, attainable, and measurable ways for banks to get there. Let's discuss the "New High Performance" in greater detail, and then recommend strategies that executives across the country and at organizations of all sizes can implement in order to move themselves closer and closer to that goal.

The RPI Modified Universe

Defining true High Performance can be a herculean task for the average bank, and it's as much art as science. Here is how we arrived at our numbers.

As of September 2013, there were 6900 institutions. To account for de novo organizations, acquisitions, or any of a number of other circumstances that can inordinately skew performance numbers, we first removed all organizations less than $50 million and greater than $10 billion in assets from consideration and divided the banks into four distinct asset bands. We further eliminated the top 3% and the bottom 3% of performers on each ratio from each asset band; so, if a bank had a top 3% or bottom 3% number on any of the six measures, they were eliminated from the RPI Modified Universe. Additionally, if a bank did not report any of the six measures, they were also eliminated from consideration. After this normalization, we were left with 4857 organizations in the following asset size bands:

Asset Size Bank	Number of Banks
$50 million to $300 million	3183
$300 million to $1 billion	1213
$1 billion to $3 billion	343
$3 billion to $10 billion	118
All	4857

The following charts depict three distinct performance levels for each asset size band:

1. The average of the RPI Modified Universe.
2. The Top 20% breakpoint – all banks above this level are in the top 20% on that measure. They are the "B" players, and they represent a level of performance that all banks should be able to reach.
3. The Top 10% breakpoint – all banks above this level are in the top 10% on that measure. They are the true "A" players, and they represent a level of performance that only the most efficient and well-run banks achieve, but to which all banks should aspire.

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Return on Assets

Clearly the days when the average bank regularly achieves a 1.5 to 2.0 ROA are a thing of the past. However, as Figure 1 (below) indicates, the top 10% of banks are still able to achieve an ROA above 1.5. Depending upon asset size, the average number is just under or at 1.0, and if your organization is hitting a 0.75 ROA then it clearly has room to improve.

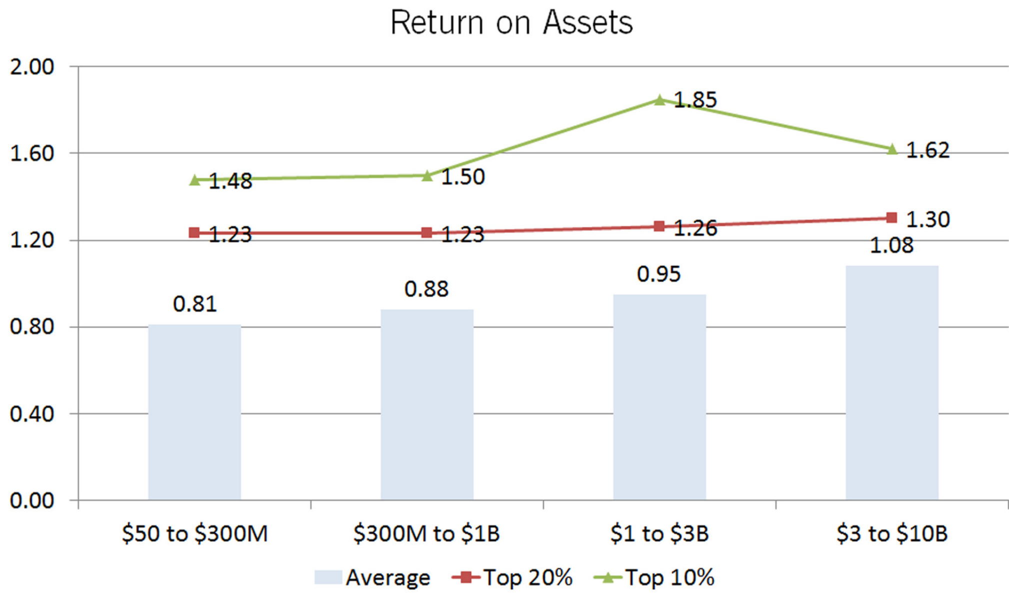

Figure 1: Return on Assets for the RPI Modified Universe, September 2013

Return on Equity

Shareholders expect a solid return on equity, and while average performing banks are still turning in an ROE below 10%, the top 10% of banks is achieving between 14% and 15% ROE, while even the "B" Players are well above 11%. What does this mean for your bank? It may be difficult to satisfy your shareholders with less than 11% ROE in 2014. We understand the regulatory pressure for more capital, but many of the high performers are also well capitalized.

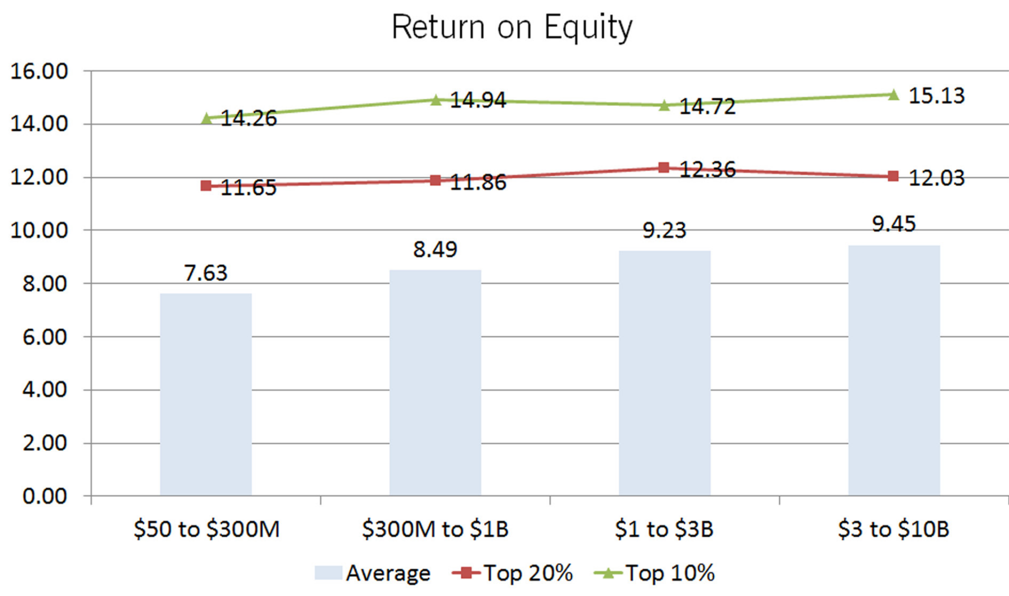

Figure 2: Return on Equity for the RPI Modified Universe, September 2013

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Efficiency Ratio

We are firmly of the belief that efficiency drives performance. The more efficient the bank, the better able it is to attract capital, entice and retain high quality employees, and create real shareholder value. Even in today's environment, there is no reason for any typical commercial banking organization to have an efficiency ratio above 63% to 65% on a sustained basis. The highest performing organizations above $3 billion are able to keep their Efficiency Ratio at or below 50%.

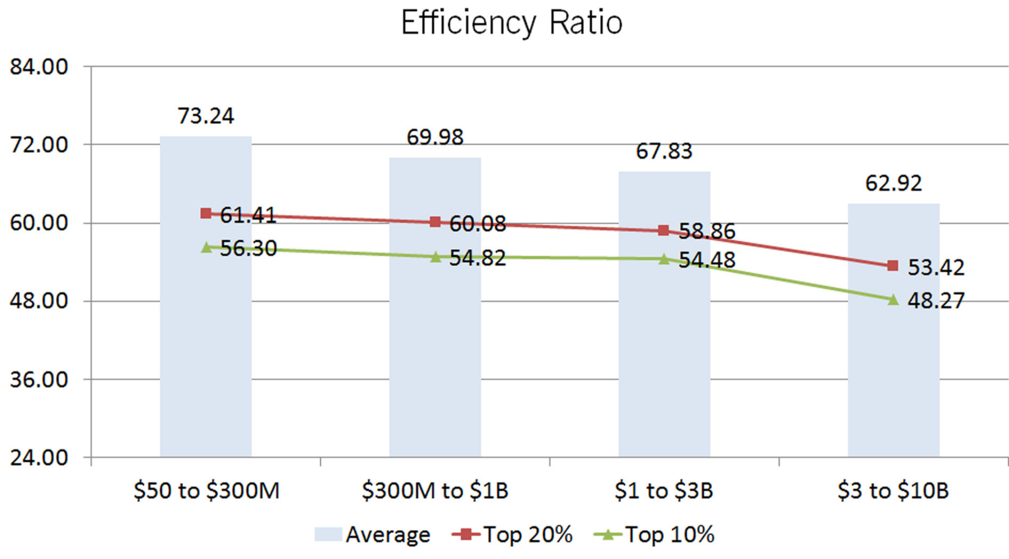

Figure 3: Efficiency Ratio for the RPI Modified Universe, September 2013

Net Interest Margin

Industry margins are currently narrow. There is no question that as our slow economic recovery continues, they will continue to be narrow. Net Interest Margin represents an area that is clearly impacted by a sales culture in the bank. Bankers who believe in their organization and the value that it brings to its clients will be able to bring in loans at higher yields, as well as manage down funding costs.

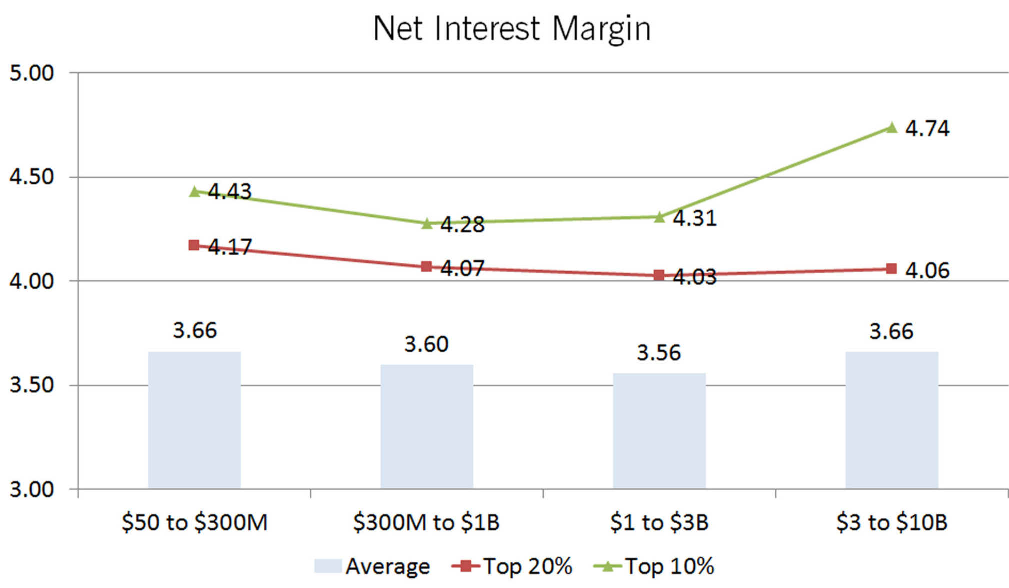

Figure 4: Net Interest Margin for the RPI Modified Universe, September 2013

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Revenue per Employee

Revenue per employee (calculated as Total Interest Income + Total Non Interest Income / Number of Employees) is another number that relates to sales culture in the bank. While the highest Revenue per Employee numbers are clearly driven by asset size, it's also important to note that even in the smallest organizations the average performers are clearly and dramatically separated from the highest performers. The service levels of the highest performers enable them to collect a greater level of non interest income while maximizing their net interest margin too. This may be common sense, but it is not common practice.

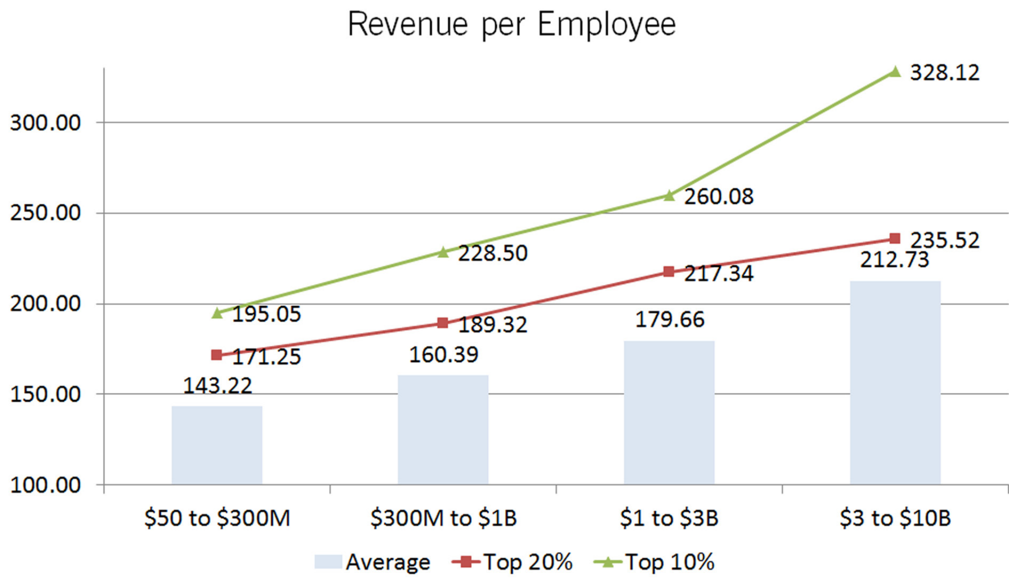

Figure 5: Revenue per Employee for the RPI Modified Universe, September 2013

Non Interest Income

Another revenue performance measure driven by the state of the economy is Non Interest Income / Average Assets. While NII is again driven by the asset size of the organization, it's clear that the highest performers out-earn the average by nearly 80%. Collecting the fees you charge, making someone responsible for NII, delivering services and service quality that enable greater revenues, and expanding into new lines of business will all drive that measure the right direction. We can no longer afford to leave money on the table or miss profitable cross-sell opportunities.

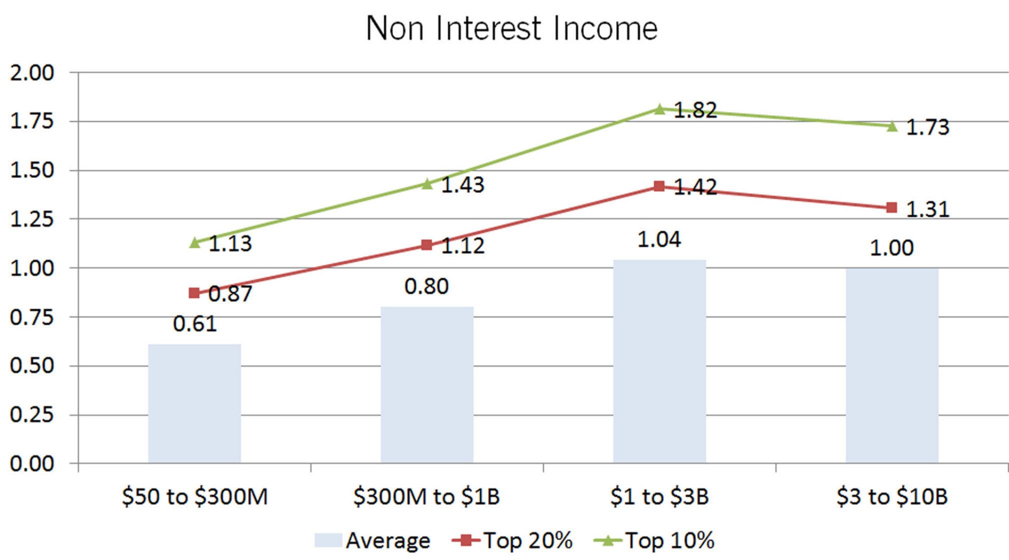

Figure 6: Non Interest Income for the RPI Modified Universe, September 2013

Non Interest Expense

Non Interest Expense is a traditional performance number that deserves new scrutiny in today's environment. We recognize that you must have the right technology to be competitive. You must have quality (sometimes expensive) human resources to be truly competitive. And you must comply with an often complex set of regulations in order to simply remain in business. Technology, human resources, and compliance all are driving costs, but a balance must be achieved between these and generating adequate profitability for your shareholders.

Our ongoing research will explore whether true "high performance" on NIE equates to the lowest spend possible, or whether it means optimizing spending on the right investments. Your own analysis of "The Right Balance" is an on-going activity today as well.

In the meantime, however, it's clear that the lowest spending organizations on the single measure of NIE regularly spend just over 2% of Average Assets. If your bank is well above average, then expense management may be a priority for you in 2014.

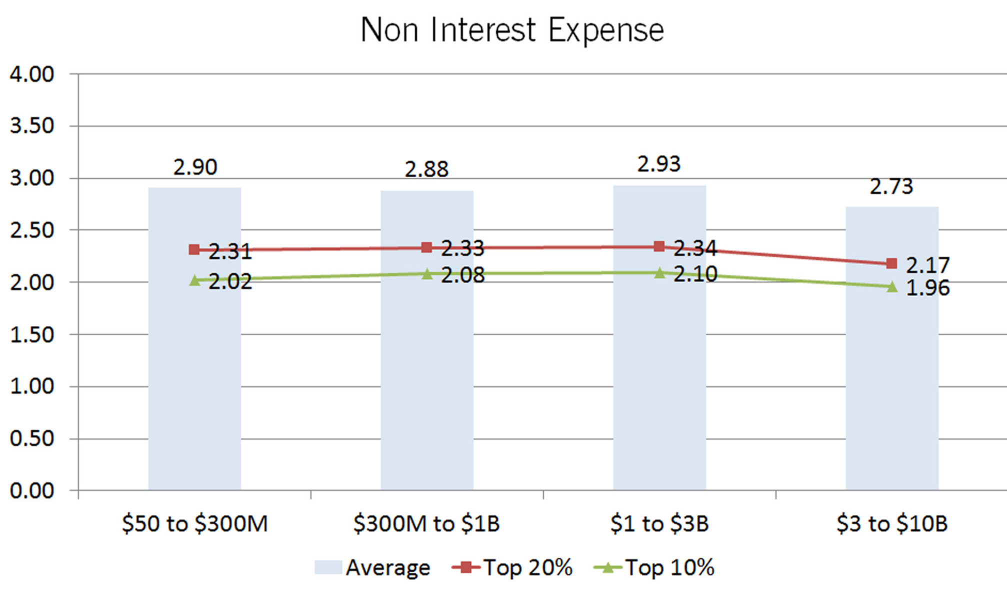

Figure 6: Non Interest Income for the RPI Modified Universe, September 2013

Prescriptions for the Future

It's great to say we need to move toward high performance. But how do banks make those incremental changes?

It's Not the Business of Banking. It's Just Business.

For too many decades, bankers have operated under the mistaken impression that "banking" is somehow a protected class of business. And while it has its distinct challenges, like compliance, it also has more in common with a for-profit, widget-selling business than you might think. It's focusing on those business fundamentals and facing those hard truths that are going to separate the banks who survive—or don't survive—or just continue in mediocrity—from those who achieve high performance.

Hard Truth #1: Banking Is Tied to the Economy, and the Economy is Not Thriving

In a broad statement of the obvious, banking is tied inextricably to the state of the economy. While historical GDP growth rates experienced a steady and relatively steep incline from 1950 through 2007, since then it's been a more turbulent ride. There is every indication we are in for a few more bumps before the trend smoothes back out.

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So what does this mean for banks? The success or failure of banking is largely dependent upon the state of the economy. Today, the magnitude of banking industry impact relative to fluctuation in the GDP can be mitigated to a certain extent through better risk management practices.

Even today, Q3 / 2013 GDP numbers show a significant lift in economic activity, but a sustained, positive trend of significant magnitude has not developed yet and still most banks are better prepared. If the GDP were to decline again, we can further limit our downside and increase our upside through better, deeper operational and risk management, but the bottom line is that every bank is impacted by the larger economic picture – to at least varying degrees.

The reality, as a nation, is that we are looking at the kind of economic growth that Japan has experienced for the past two decades. Albeit slow, there will be growth. In such an environment, those bankers who can maximize their own specific opportunities within the confines of the larger economy are the ones who will achieve high performance.

Hard Truth #2: Net Overhead Has to Come Down, Probably in Human Resources

Most banks believe they have cut overhead about as far as the can cut it, which is more of a visceral, human reaction. Independent, quantitative study for many banks would prove differently. Nonetheless, to decrease net overhead you only have three options. You can grow your revenues, or you can cut more expenses, or preferably you can do both.

Even with increasing bank technology deployment as a given long-term, technology costs are actually coming down for many banks in the current environment on a relative basis, as core systems vendors have continued to consolidate. The next, most logical and most productive area of expense management is in staff costs. No banker wants to have to embrace this reality, but the fact is that we cannot continue to support a large, overstaffed branch network, staff functions, or back room. Productivity enhancement through process improvement would enable more profitable growth.

Hard Truth #3: We Have to Sell Bank Services –Much More Products and Services

While the Recession may be over on paper, third quarter of 2013 was not strong. Banking had its first overall decline in gross revenues in more than 12 years. In a time when we need to reduce overhead by either increasing revenue or cutting expenses, revenues are trending down.

How do we stanch the bleeding? Bankers have to first provide value via their products and services, embrace the fact that they provide customer value, and then become comfortable selling that value. This is not a new story. Pundits have been preaching “sales culture” in banking since the early 1990s. Then, it was a luxury. Now it’s a survival tactic. Find a niche or a void, fill it, and do it profitably.

Hard Truth #4 (And This Might Be the Hardest of All): Somebody Has to Be Accountable

So let’s say we set new goals for selling services and decreasing overhead. And let’s say those goals aren’t met? Is it “Better luck next time, team!” or is it “Let’s find the team who can make it happen.”

Because banking is not just a business, but a tough, brutal, competitive business, its goals have to be set for strategic growth, and its tactics have to be executed to achieve those growth targets, or the business fails. Maybe it just sub-optimizes, but who wants to invest or work in that environment?

If you give your team the right tools to succeed and the goals are still not met, then your options are to keep the team and change the goals, or keep the goals and change the team. In some cases, however, there are training deficits that have to be surmounted before making this evaluation. Nonetheless, as the banking industry continues to consolidate at a faster clip in 2014, sitting still is looking less and less attractive.

Accountability will have to start at the highest levels, and it will have to filter down through every job in the bank. High performers thrive with accountability and high performing individuals, as you know, create HIGH PERFORMING BANKS – Healthy, profitable, growing, change-oriented businesses with loyal customers, deep relationships and employees that are fulfilled, excited, and happy.

The Bottom Line

While every organization operates within a unique market and local economy, there are some unmistakable changes that every bank can make that will start it down the road to high performance.

Small changes that will drive performance numbers:

- Collect the fees that you say you charge. It sounds simple, and it is. Aim for 95% collection on fees, and incent your employees to get there.
- Implement regular, meaningful employee reviews, and release your lowest-performing employees without hesitation. It's painful, but it's necessary.
- Review unnecessary spending. At this point, all expenses should go under the microscope. This isn't a rich margin business anymore.

Strategic shifts that will drive performance numbers:

- Find a key niche that you can serve, and serve well. Whether it's a professional community, a gender or ethnic group, a small business type (industry specialty), an agricultural specialty, or some other unique focus, do one thing and do it well. Niche business lines are typically the most profitable from our experience.
- Become a sales organization. Either hire professionals who are excited about selling, or train your existing employees so that they understand the value that your bank provides, and can communicate that value to your customers and your market.
- Embrace a culture of accountability. Whose job is it to move the bank into high performance levels? Everyone! Yes, everyone at the organization has a role to play, and it's the job of the Board and the Executive Team to assign measurable, meaningful goals to each officer and staff member.

Is it easy to achieve high performance in banking? Obviously not, or more bankers would do it. No bank is "average" because its executives want it to be average. But let's say that, today, your bank is achieving average numbers across most performance metrics. In that case, it's overwhelming to think that you face an uphill climb in nearly every facet of the business. Naturally, it's unrealistic to think that in six months you will somehow move from average to high performance by doing the same things you've always done. It follows that for many transformational change is overdue; for others, serious tweaking and refining of performance will provide an adequate lift in performance.

But steady, incremental improvement is absolutely possible for all banks! The banks that embrace performance impacting change will still be here when the consolidation is "finished" (probably 2020), looking back to these challenging years as the genesis of great change. ■

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