

ESTABLISHING A PROFITABILITY DISCIPLINE WITHIN YOUR COMMUNITY BANK

Kelly Lutinski, CPA, Principal Banking Consultant

ESTABLISHING A PROFITABILITY DISCIPLINE WITHIN YOUR ORGANIZATION

Creating shareholder value in the financial industry has never been easy. It was hard 20 years ago, it's tougher today and – with a renewed focus on risk costs, pinched net interest margin, regulatory obligations, and fierce competition – will be even more difficult in the future.

The simple adage of borrowing short and lending long no longer applies. Instead, firms must build a single, rational and actionable view of what supports the organization's long-term profits so that all contributors drive toward the same strategic goals.

This view should be consistent and based on the same assumptions, whether the perspective is that of the CEO assessing profitability of a specific line of business, a branch manager looking at branch performance, or a lending officer assessing the profitability of a customer.

The consequences of inconsistent management information—incensing the wrong opportunities, managing by exception, and driving strategies in silos—are set out in Figure 1. It's surprisingly easy for this kind of inconsistency to thrive in financial firms. Internal systems such as general ledger, budgeting and planning and data-warehouse provide fragmented perspectives and do not provide the detail necessary to support the analysis used to drive increased shareholder value.

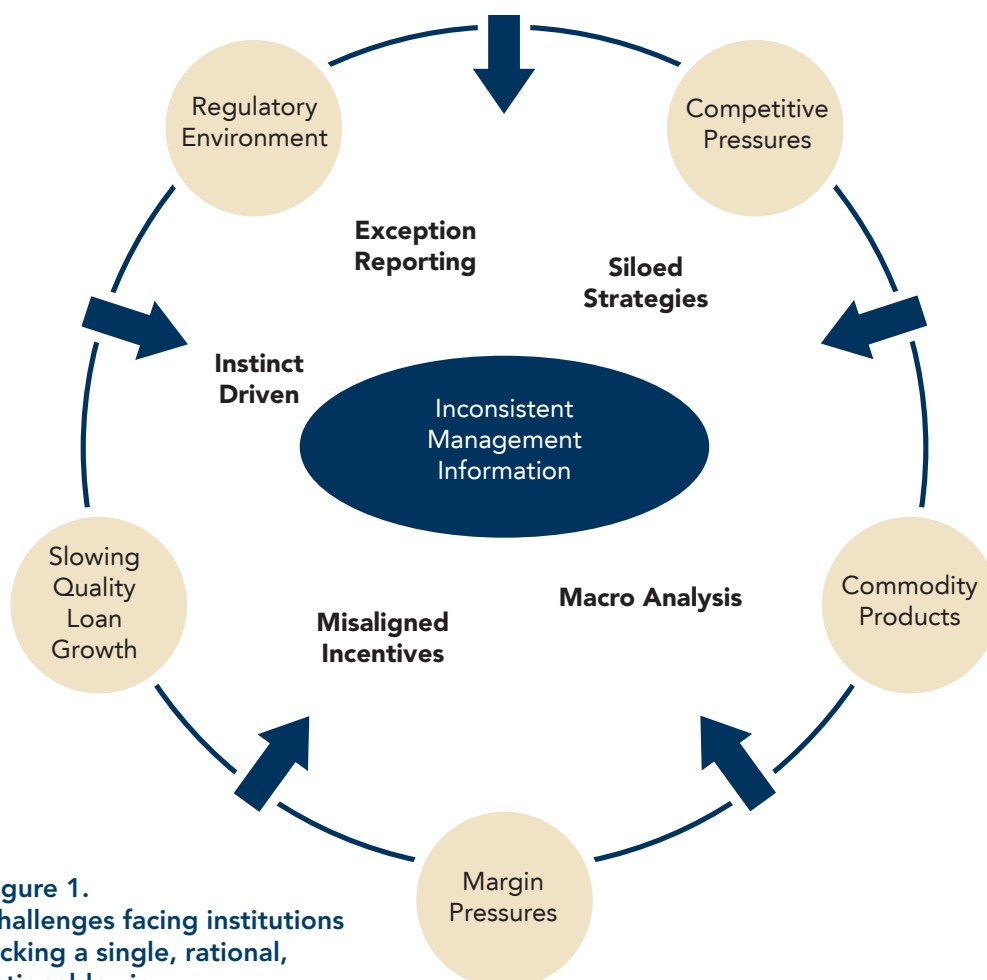


Figure 1. Challenges facing institutions lacking a single, rational, actionable view.

There is also a lack of consistency in the meaning of profitability within organizations. Financial institutions have historically measured profitability using Profit Contribution, Net Profit, the Efficiency Ratio, Return on Assets (ROA), or Return on Equity (ROE), to name but a few. While all of these can be valid measurements for regulatory or external reporting, they do not provide a full enough story to support strategic decisions and they do not incorporate the impact of risk and risk costs.

Understanding the risk of a transaction or strategy in economic capital terms—and the impact on profitability through risk-adjusted performance measures such as risk-adjusted return on capital (RAROC), Shareholder Value Added (SVA) or Economic Value Added (EVA)—is critical for firms who want to improve use of capital.

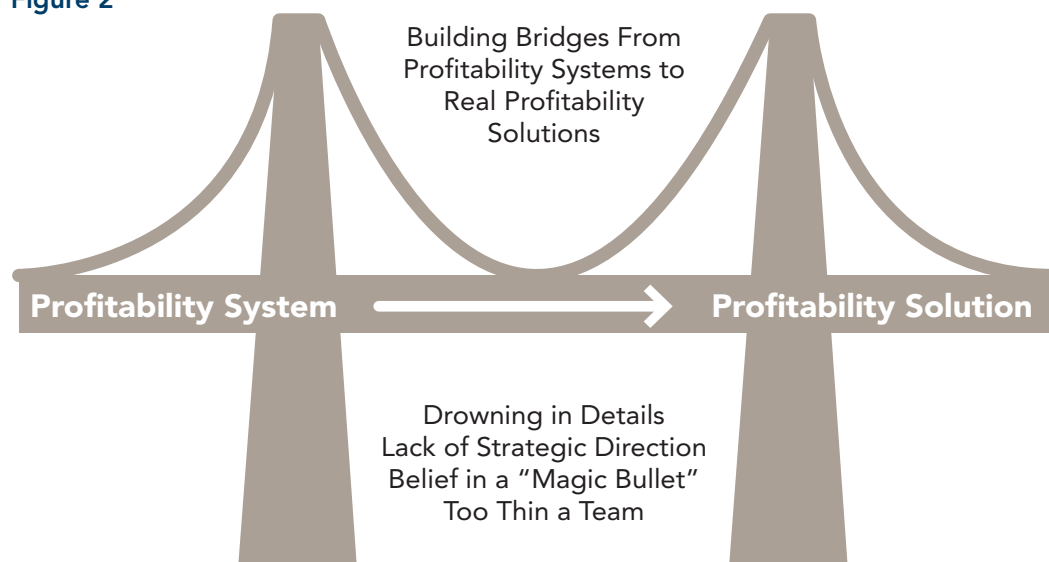
OVERCOMING THE OBSTACLES

While many forward-thinking financial executives agree on the need for risk-adjusted profitability analytics, few are aware of the obstacles that institutions routinely encounter when implementing a profitability system (Figure 2).

Firms must bridge these obstacles through a mix of cultural change and sure-footed implementation to ensure they end up with a profitability solution that drives a shared understanding of the organization's goals – rather than a profitability system that remains at the periphery of the organization's strategy building.

Here are the three most important pillars of this bridge-building exercise.

Figure 2



1. OBTAIN STRATEGIC DIRECTION

Profitability is not a "plug and play" solution but a long-term strategic initiative. The informed support of executives is therefore critical to any profitability solution's success. Management must be able to explain the need for a profitability solution, how the information will be used to drive decisions, and why a profitability system is the right tool to carry this out. Without an understanding of how the information will be used in making strategic decisions, contributors will flounder in their attempts to determine the system's structure and components and will take a "best guess" approach to implementation decisions, which could endanger the project's success.

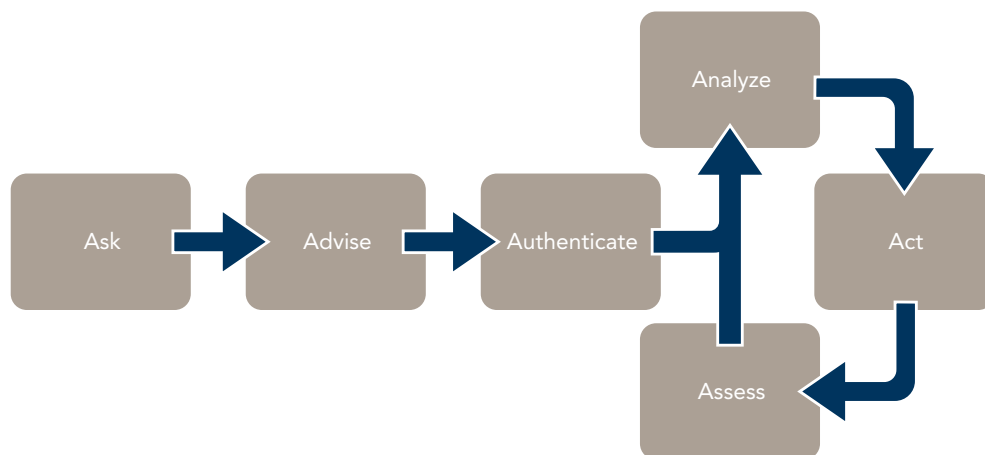
Senior executives also need to pace the project. An enterprise-wide, fully implemented profitability solution can take years to mature. Executives should focus on implementing strategically important components within much tighter timeframes to validate the investment. For example, many banks initially use profitability systems for net interest margin analysis and then implement costing, loan loss provision and other components as these become priorities.

2. USE AN IMPARTIAL ADVISOR AND THE "SIX A'S"

To help firms gain an initial understanding of the advantages and challenges of a profitability system, we suggest that executives consider appointing an impartial individual well-versed in profitability methodologies to ask probing questions and listen objectively – a Profitability Advisor.

This Advisor should interview key players in the organization and then advise senior executives on the value a profitability system can bring to the organization and the priorities for implementing specific profitability components. We think of this process in terms of the Six A's: Ask, Advise, Authenticate, Analyze, Assess and Act.

The "Six A's" to implementation



ASK: Identify the key issues and challenges the firm faces while fostering open communication with stakeholders

ADVISE: Help management determine main goals, benefits and requirements of system

AUTHENTICATE: Data and detailed calculations from profitability systems must be integrated and validated

ANALYZE: Verify that summary results are directionally correct and reflect the bank's overall position

ACT: Owners of initiatives put plans and Key Performance Indicators (KPIs) in place using profitability information

ASSESS: Regularly review the success of plans and KPIs and modify strategies and assumptions as necessary

3. ASSEMBLE A BROAD CROSS-FUNCTIONAL TEAM

Accounting, finance and information technology groups often assume the leadership of profitability initiatives. But it would be a mistake to exclude areas of the organization – business units that will ultimately use the profitability results.

Profitability systems are inevitably based on assumptions about businesses and their data, as well as scientific calculations, which is why profitability analysis can elicit attacks regarding the validity of the assumptions and of the underlying data. Some of these objections can be countered during Authentication and Analyze implementation stages. Profitability systems quickly lose credibility if the underlying data and assumptions have not been authenticated, and if initial results are not analyzed and their implications assessed. For example, if a manager has determined through other reliable means that the institution's commercial loan pricing is sub-par, the profitability system should show this too.

Other attacks on the assumptions underlying the system may be the result of misinformation or misunderstanding. Time must then be spent re-educating stakeholders on why design decisions about the profitability system were made. . . time that would be better used discussing how profitability results can be applied to drive shareholder value. To avoid this, assemble a cross-functional team right at the start. Regardless of how the assumptions are derived, the elements that drive an assumption must be disclosed, discussed, documented and supported by this team.

CONCLUSION: DON'T LET DETAILS DERAIL THE PROJECT

The results of any profitability analysis will sometimes conflict with the results of other internally generated reports (e.g., financial, regulatory). This is both inevitable and welcome – there would be no point in investing in a profitability system unless the information it gave to management differed from other kinds of analysis.

The implementation process we've outlined is designed to make sure that the users of any profitability system recognize that, while these systems are both art and science, the system's key assumptions have been agreed to and are backed by executives.

At the moment many institutions are driven in the wrong direction by a poor understanding of what creates long-term shareholder value – business volume rather than risk-adjusted value. With a carefully prepared profitability system in place that supports the organization's goals, executives can be sure the firm will make decisions that are generally correct, rather than exactly wrong.

This article was contributed by Kelly Lutinski, CPA, Principal Banking Consultant at SunGard, who welcomes your comments at Kelly.Lutinski@sungard.com

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