

# A Practical Approach to Designing and Executing Bankwide Efficiency Programs

By Claude A. Hanley Jr.

*What factors separate successful and unsuccessful efficiency efforts?*

Corporate efficiency programs are back in vogue as the banking industry responds to significant earnings challenges. These programs will become more widespread in the coming quarters as executives struggle to offset the effects on performance of weak revenue growth and higher credit costs. But these programs never completely went out of style, as they remain an important tool for better aligning cost structures with revenue opportunities.

When properly executed, an efficiency program is an effective means to improve financial performance. Conversely, a poorly conceived or executed efficiency program can demoralize employees, impair the bank's ability to generate revenue and undermine the company's viability as an ongoing, independent concern. Several banks were victimized by ill-conceived cost-cutting programs in the early 1990s, and those banks no longer exist as going concerns.

This article takes a look back and examines factors that separate successful efficiency programs from unsuccessful efforts. While the objectives of these programs are generally straightforward—to slow the rate of growth in operating expenses, generate hard-dollar operating efficiencies and shift resources toward revenue-generating activities—the execution is complex. Typically, these initiatives are intensive, companywide efforts lasting several months, entailing a combination of workforce reductions, a review of business practices, reengineering of processes and streamlining of the organization structure.

In working with banking companies of all sizes over the last 20 years, we have found five factors to be critical to the success of bankwide efficiency programs:

- The process must challenge entrenched business practices, organization structure and current resource allocations.
- The analytics, benchmarking and best practices comparisons used to identify opportunities must be transparent and their limitations understood in order to obtain buy-in to decisions.
- Any major changes proposed must be considered in terms of the bank's strategic plan and must not impair the bank's ability to achieve its longer-term strategic objectives.
- The process for managing the implementation of efficiency projects must be as highly organized and structured as the process for identifying and approving the projects.
- The executive management team must lead the effort—from analysis through execution—and remain steadfast in monitoring program results.

This article explores the common pitfalls to avoid during a bankwide efficiency program and provides practical tips for financial institutions to enhance the success of these initiatives.

## Survey of Selected Efficiency Programs

Exhibit 1 contains a list of banks that announced the implementation of efficiency programs between 2004 and 2006. These announcements came after the banks had identified and quantified the specific efficiency

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Exhibit 1: Selected Efficiency Programs Announced by Banks and Thrift Between 2004 and 2006<sup>1</sup>  
Sorted by program start date, earliest to most recent

Institution	Total Assets (\$ Billions) Quarter Prior to Launch	Estimated Quarter of Program Launch	Salary & Benefits Expense/AA (%)		Non-Interest Expense/AA (%)		Efficiency Ratio (Tax-Equivalent Basis) (%) <sup>2</sup>	
			Quarter Before Launch	Change (basis points)	Quarter Before Launch	Change (bps)	Quarter Before Launch	Change (bps)
Bank of Hawaii Corp. Honolulu, HI	9.5	2004Q1	2.09	1.83 (0.26)	4.17	3.64 (0.53)	62.10	58.22 (3.88)
Old National Bancorp Evansville, IN	9.3	2004Q2	2.13	2.13 0.00	3.48	3.68 0.20	69.36	66.08 (3.28)
M&T Bank Corp. Buffalo, NY	52.9	2005Q1	1.50	1.47 (0.03)	2.63	2.77 0.14	49.46	55.13 5.67
Wachovia Corp. <sup>3</sup> Charlotte, NC	493.3	2005Q1	1.90	1.82 (0.08)	3.27	3.07 (0.20)	60.77	75.95 15.18
National City Corp. <sup>4</sup> Cleveland, OH	140.8	2005Q2	1.82	1.74 (0.08)	3.31	4.10 0.79	57.90	79.51 21.61
PNC Financial Services Group Inc. Pittsburgh, PA	90.8	2005Q3	2.59	1.64 (0.95)	4.73	3.60 (1.13)	68.82	72.76 3.94
Sun Bancorp, Inc. Vineland, NJ	3.3	2006Q2	1.42	1.32 (0.10)	2.77	2.59 (0.18)	72.80	60.15 (12.65)
Provident Bankshares Corp. Baltimore, MD	6.4	2006Q4	1.71	1.66 (0.05)	3.24	3.22 (0.02)	62.52	67.07 4.55
Sovereign Bancorp, Inc. Philadelphia, PA	90.2	2006Q4	0.82	0.75 (0.07)	1.83	9.08 5 7.25	57.27	53.41 (3.86)
Industry <sup>6</sup>							67.43	70.64 3.21

1. Announced date of the implementation phase. Excludes programs arising primarily from merger integration efforts, such as that of Regions Financial Corp. and AmSouth Bancorp.  
 2. Efficiency ratio is the summation of salary and benefits expense, office and equipment expense and other noninterest expense excluding amortization of intangibles divided by the summation of total interest income minus total interest expense on a tax-equivalent basis, income from fiduciary activities, domestic deposit charges, foreign transaction gains, gains and fees from assets held for trading and noninterest income not including gains on sale of available-for-sale and held-to-maturity securities.  
 3. Wachovia Corp. completed its acquisition of Golden West Financial Corp. on October 1, 2006. This acquisition may materially influence Wachovia Corp.'s expenses.  
 4. Since the start of its program, National City Corp. has acquired four firms totaling together over \$19 billion in total assets. These acquisitions may materially influence National City's expenses.  
 5. This was materially influenced by a goodwill impairment of \$634 million and \$943 million, respectively, in Sovereign's Shared Service Consumer and Metro New York business segments.  
 6. Figure for the industry is the median observations among banks and thrifts.  
 Source: Programs were identified from various secondary sources, including press releases, and Securities and Exchange Commission filings. Financial information is from SNL Financial LLC 2008.

initiatives they intended to pursue. In each case, the senior management team announced a target dollar financial benefit that would result from its program. (Any programs announced in 2007 or later are excluded from consideration as insufficient time had elapsed for these programs to produce discernible results.)

To capture a cross section of the industry, we assessed banks ranging in total asset size from community institutions, such as Sun Bancorp of Vineland, New Jersey, to superregionals like Wachovia Corp. To measure each bank efficiency program's effectiveness, the change in certain key performance metrics was calculated between the quarter immediately prior to announcement of implementation and the fourth quarter of 2007. Metrics are stated on a relative basis for comparability, although it could be argued that the greater scope of operations and more involved organizational structures found among larger banks make implementation of efficiency programs a more complicated undertaking than at small banks, and therefore, comparisons must be limited.

As Exhibit 1 shows, eight of the nine banks profiled succeeded in reducing the relative level of salary and benefits expense. Most notably, PNC Financial Services Group reduced the ratio of salary and benefits to average assets by an astounding 95 basis points. Part of the explanation for such a large reduction was that the company had the greatest margin for improvement. Among the nine banks shown, it had the highest level of salary and benefits expense to average assets prior to the program announcement.

The more typical experience among banks on the list was a modest reduction in salary and benefits expense of five to 10 basis points of average assets. It should come as no surprise that personnel costs declined after the launching of an efficiency program. While it is not accurate to characterize the term "efficiency program" as a euphemism for a reduction in force, it is true that to achieve meaningful expense reduction, salary and benefits expense often must be reduced, as it is one of the biggest expense categories at most banks, typically comprising over 40 percent of noninterest expenses.

Program results were less impressive when noninterest expenses were considered in totality. Only five of the nine banks reduced its level of *total* noninterest

expense relative to average assets. It would seem that outside of staff reductions, institutions struggled to achieve reductions in other major expenses, such as occupancy or technology. Perhaps the reduction in staff was accomplished primarily through use of third-party service providers, which may have merely shifted costs from one category to another but not did reduce them. Alternatively, the overall level of expenses may not

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have declined due to one-time restructuring charges, or expenses may have been redirected intentionally into investments that are expected to generate future revenue. Regardless, it seems clear that to achieve meaningful cost reductions,

a bank must pursue a combined reduction in both salary and benefits expense and nonpersonnel expense.

Finally, the efficiency ratio, which expresses the relationship between noninterest expenses and revenue, improved at only one-third of our sample banks. There are a variety of possible explanations for this disappointing result. Cost reductions may have impaired the ability of some institutions to generate revenue, especially where frontline sales force numbers were reduced, employee morale issues arose or reputational issues may have adversely affected the bank's sales and retention performance. Alternatively, the realized cost reductions may not have been sufficient to offset reductions in revenue already in progress due to external factors such as increased competition or to ultimately offset expense increases due to acquisitions and other major strategic programs. Nevertheless, if the goal of an efficiency program is to better align expenses with revenue production—and not simply to reduce personnel expense—the results among our sample group of banks indicate that the majority of efficiency programs fail.

### Common Pitfalls of Efficiency Programs

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Failure to set well-defined and quantifiable objectives is one of the most common problems afflicting efficiency programs. Without a clear end goal in mind, employees may pursue individual agendas without ensuring that the project

## Designing and Executing Bankwide Efficiency Programs

Exhibit 2. Long-Term Trends in the Efficiency Ratio and Net-Interest Margin Among FDIC-Insured Institutions

Efficiency Ratio <sup>1</sup>				
Asset Tier	1992	2000	2007	Change 1992-2007 (basis points)
Total assets less than \$1B	65.61%	63.78%	67.42%	181
Total assets \$1B-\$50B	64.77%	57.01%	57.21%	(756)
Total assets greater than \$50B	65.44%	57.78%	58.94%	(650)
Net-Interest Margin <sup>2</sup>				
Asset Tier	1992	2000	2007	Change 1992-2007 (basis points)
Total assets less than \$1B	4.41%	4.25%	3.88%	(53)
Total assets \$1B-\$50B	4.05%	3.98%	3.46%	(59)
Total assets greater than \$50B	3.85%	3.35%	3.10%	(75)

Notes:

- Efficiency Ratio is defined as noninterest expense, less the amortization expense of intangible assets, as a percentage of the sum of net interest income and noninterest income.
- Net-interest Margin is defined as total interest income less total interest expense (annualized) as a percentage of average earning assets.

Source: FDIC Statistics on Depository Institutions, 2008. Notes:

- Efficiency Ratio is defined as noninterest expense, less the amortization expense of intangible assets, as a percentage of the sum of net interest income and noninterest income.
- Net-interest Margin is defined as total interest income less total interest expense (annualized) as a percentage of average earning assets.

Source: FDIC Statistics on Depository Institutions, 2008.

is correctly aligned with business objectives. The potential number of areas to evaluate at a typical bank, as represented by the seemingly infinite number of cost centers on the general ledger, can be overwhelming. Consequently, project teams may get detoured into evaluating inconsequential opportunities or they may pursue too many opportunities or both. This can also cause an unnecessary degree of internal distraction.

Program goals must be stated clearly and communicated to all individuals involved in the effort. One important goal to include: Focus the analytic phase of the efficiency program on material items, such as facilities and nonearning asset levels, staffing costs versus productivity and technology spending and process efficiency. Spending time trying to find cost savings opportunities that won't provide a material contribution to bottom-line earnings is an unnecessary distraction.

Another common pitfall in program execution arises from engaging in excessive analysis. With-

out question, business decisions must be made based on facts and the objective assessment of staff performance data, process work flows and financial results. Basing such decisions solely on anecdotal evidence and intuition can lead to biased conclusions. However, waiting for perfect information or for more data than needed leads to missed deadlines, postpones decisions and delays the realization of benefits. Decisions need to be made when the data are sufficient but not necessarily perfect.

### Steps to Executing a Successful Efficiency Program

Any successful bankwide efficiency program has three key phases—launch, analysis and implementation—each of which has its own set of critical success factors.

## Launch Phase

Before launching an efficiency program, it is important to first revisit the corporation's strategic objectives. A thoughtfully conceived corporate strategic plan is meant to serve as the long-range map for the organization to follow. Ideally, the plan should enumerate the significant growth opportunities, articulate the bank's competitive advantage and style of doing business, identify its core services and specify the major investments and infrastructure requirements that are deemed critical to achieving the objectives. Revisiting the strategic plan will help to ensure that the opportunities identified during the efficiency programs are consistent with the strategy. It will also make it easier to identify businesses and practices that fall outside of the core strategy and are therefore candidates for sale or elimination.

To avoid wasting time on immaterial opportunities, at the commencement of the program executive management should specify the overall financial contribution that the efficiency initiative is expected to generate and the timing of the contribution (for example, opportunities identified during the efficiency program are expected to produce \$10 million pretax next year and \$15 million thereafter). The financial goal may be further delineated into the portion that is expected to come from cost reductions and the portion expected to come from revenue increases. This will ensure that revenue lift opportunities will not be overlooked. Setting forth the financial expectations serves as an invaluable touchstone for project teams to better prioritize opportunities and to minimize resistance based on emotion.

At program launch, it is also critical to establish a clear organizational structure for the project and clearly define roles for project participants. While many individuals may participate in the process, the project organization can be relatively simple. At its most basic, the project structure might comprise the following distinct pieces:

- **Project steering committee.** This group is the governing body for the project. It should comprise executive managers. The committee has primary responsibility to set the overall project direction, review project status, provide input and guidance to assessment efforts, resolve conflicts, review and approve recom-

## Have Banks Become More Efficient?

A great deal of management time and attention is devoted to the goal of becoming more efficient. Presumably, a significant portion of the more than \$100 billion spent annually by financial institutions on IT is for solutions to improve efficiency. Have these efforts borne fruit?

For the larger asset tiers of banks, the answer is yes, according to the trend in the efficiency ratio shown in Exhibit 2. Over the last 15 years, the efficiency ratio among banks with assets greater than \$1 billion improved dramatically; however, among banks with assets less than \$1 billion, the efficiency ratio became worse. The improvement in efficiency among the larger banks is more impressive in light of the contraction in the net-interest margin that has occurred among banks of all sizes during the same time period.

mendations from the core project team and set priorities for implementation.

- **Core project team.** This team is comprised of bank personnel designated to participate and help to lead assessment efforts. It should be cross-functional in its membership composition; ideally, members should be influential in the organization. The core project team gathers and reviews information, conducts and reviews analyses, participates in regular meetings about the project, reviews findings and helps to develop recommendations for presentation to the steering committee. These individuals will need to devote significant time to the project.
- **Internal project manager.** This individual has day-to-day responsibility for helping to organize the project, acts as primary liaison to any outside experts hired to support the program, schedules meetings and communicates with the core project team and steering committee. This individual should have proven skills in managing large projects.
- **Designated specialists.** These individuals are bank personnel in key analytical and operational

areas who help the core project team with analysis and act as subject-matter experts. These individuals are called upon on an as-needed basis.

- **Outside experts.** Often, it is more effective for a third party to assume the role of facilitator for the efficiency program as it is unencumbered by organizational biases and can act in several capacities, including as a resource for industry best practices and as an objective party who can ensure standardization and rigor on program analytics, help to facilitate discussions and generally act as the agent for change. In addition, outside experts with specific subject-matter expertise (technology, process, finance, *etc.*) can add value to internal work teams as they assess opportunities and consider implementation challenges.

This structure provides the flexibility to involve personnel throughout the bank without being overly bureaucratic and clarifies the roles and responsibilities of all internal personnel—including the oversight/decision-making role of the senior executive team.

### Analysis Phase

As mentioned previously, efficiency programs can yield significant benefits *via* a combination of organization redesign, changes in business practices, reengineering of processes and expense reductions. Typically, the analysis phase of the program consists of five components.

**1. Earnings momentum.** Overall bank earnings and the contribution to earnings of key businesses must first be assessed in order to determine the financial targets for the efficiency program. As a first step, the bank CFO can assess current earnings performance vs. projected growth in earnings given current “momentum” in the businesses (that is, with no additional investments and doing business as it is done today without major strategic changes). This earnings momentum forecast should be done at the total bank level and for each major line of business at the bank. Results are compared to the target earnings performance levels, and the gap (target minus momentum) provides a good starting point for determining the target efficiency improvement needed to meet financial performance objectives.

**2. Financial management practices.** The balance sheet should be reviewed and compared to peers to

identify potential opportunities to improve balance-sheet management. Potential opportunities might include the sale of loans or securities to improve liquidity or improve the interest margin, retirement of higher-cost borrowings, the reduction of cash balances or sale of bank-owned real estate in order to reduce the level of nonearning assets.

Budgeting and planning processes can often be strengthened in ways that provide better insight into efficiency levels and opportunities for performance improvement. Common tactics include the following:

- Employ a consistent process and standardize the templates used by all departments for annual strategic/financial plan review and submission.
- Monitor and review monthly reports on performance relative to budgets.
- Provide specific incentives to business-line managers based on their ability to generate efficiencies over and above budget goals, where the budget includes allocated and unallocated costs.
- Review bankwide financial performance each month at the executive committee level to understand trends and variances, evaluate risk/return trade-offs and decide on appropriate action where financial performance is at risk.
- Require that capital investments (for example, ATM upgrades) are supported by business plans, budgets and return calculations, and the cost and returns on these investments are monitored through completion.

Financial management practices related to expense control—spending authorization levels, reimbursement policies and centralized vs. decentralized control—should be reviewed and strengthened where necessary to ensure a highly disciplined expense control culture.

**3. Organizational effectiveness.** There are often significant opportunities to make changes that will result in a more efficient and effective organization. Organizational effectiveness, including empowerment, speed to market, innovativeness, client-centricity and the like, can often be improved by reducing the number of committees and layers of management. To determine if there are too many of the latter, look at spans of control among managers and at the number of management layers between the customer and executive managers. When management layers are reduced, the flattened orga-

nizational structure can often yield significant cost savings—and also lead to a higher revenue result.

Another focal point for efficiency gains: the shared services and administrative functions at the bank, including operations, information technology (IT), finance, human resources (HR), marketing, legal and compliance. With respect to organizational effectiveness, a valuable exercise is to review the staffing complements of these areas of the bank and compare to best-in-class peer staffing levels and costs. Where costs are in line with peers from a staff expense standpoint, attention can be turned to ensuring the efficiency and effectiveness with which these departments carry out their internal service missions or are perceived to do so.

**4. Performance and cost benchmarking.** When benchmarking performance and costs, a note of caution is warranted. Indisputably, the exercise is useful but can be overemphasized. There are many reliable sources for benchmarks, but recognize that every peer comparison or benchmark has limitations. Understanding the biases will help to use benchmarks effectively. Benchmarks are best used in conjunction with best practices, as the latter are the reason for achieving best-performance benchmarks. Where relevant, look beyond the banking industry for best practices.

Technology expense is often the largest and most difficult category to bring into alignment. A first step is to calculate the amount of expense required to maintain in working condition the current technology infrastructure of the institution. This provides the baseline expense level. Any incremental funding should go strictly to projects that improve efficiency or generate revenue. To enforce this, incorporate a performance metric into the performance scorecard of the IT unit that expresses technology expenses as a percentage of the bank's total revenue. It should decline over time.

Facilities also represent a large expense category at most banks. Opportunities to centralize and consolidate operations and administrative centers or branch offices must be assessed with detailed cost and performance data (and with market data in the case of branch offices; more on this below). In addition, managers can look for opportunities to sublet excess space and sell and lease back owned space where economically attractive.

Branch networks represent significant investment and ongoing expense. A key component of any efficiency program is the evaluation of branch performance vs. the market potential. A performance ranking analysis can be conducted, and the outcome of the evaluation should be to identify branch performance improvement opportunities, opportunities to reallocate resources and identify branch candidates for sale or consolidation.

Often at banks where efficiency ratios are steadily creeping upward, we find discretionary expenses—such as subscriptions, cell phone charges, travel expenses and the like—are trending up at fast rates. Benchmarks exist for discretionary spending categories and, when coupled with an analysis of the rate of growth of each item, can provide for significant expense savings opportunities. Department heads should be required to reduce any nonessential expenses, especially where they are out of line with benchmarks. However, caution should be exercised when reducing expenses related to business development efforts for personnel with sales responsibilities. The finance group should develop policies and procedures for ongoing control, monitoring and reporting of spending patterns. This helps to foster a culture of expense control.

**5. Process analysis.** An assessment of the efficiency of administrative and operational processes can yield significant time and expense savings. Operational efficiency, work flows and staffing levels should be compared to benchmarks and best practices. A staffing analysis should be conducted taking into account historical and projected volumes, unproductive time allowances and paid-time-off standards. The results of these analyses should be used to size the potential opportunity for cost savings related to staff reductions and the elimination of work steps and redundant activities for specific operational process flows under assessment. Outsourcing of operational processes should also be considered as they might provide for substantial cost savings. Likely candidates for outsourcing include item processing, call center operations, mortgage processing, core processing, the mailroom, couriers and Internet banking.

As part of the line-of-business review, it is important to conduct performance benchmarking and

assess the productivity of the sales force in each line of business, evaluate their compensation structure and possibly develop customer data analytics and sales targeting programs to boost sales.

### Implementation Phase

The business assessment is complete, decisions have been made, and the plan for efficiency improvement is clear. Now the real work begins: implementation. The implementation effort is a significant undertaking and should be facilitated by a central team using standard project management disciplines. This project management office is charged with structuring and managing an approach to effective implementation of approved programs and also with being the key liaison with senior management regarding the quality of the effort under way and its likelihood to yield desired financial results.

As a first step, the project office must support the development of task plans across key initiatives in order to assess resource requirements. Often, major strategic or efficiency initiatives fail to achieve results due to lack of effective execution. This, in turn, is often the result of a lack of clarity around resource requirements—and a lack of commitment to dedicate the resources needed to get the jobs done. Once key initiatives are properly scoped and resourced, the project office must take the lead in reporting and tracking progress and communicating with the senior management team. This group should help to control the program both companywide and by operating division.

### Communication of the Efficiency Program

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The communication of the efficiency program, both within the company and with external stakeholders and investors, can be as important as its substance. While expense reduction does not hold the same allure for investors as revenue growth, in a challenging economic environment investors will still look favorably upon banks that grow earnings, whether it comes on the expense side or the revenue side. Management must quantify and provide details of the initiative and be sure to communicate that revenue growth is considered a key part of the program.

The challenge is that executives must convince investors that efficiency will improve without discouraging employees. They must convey a message that makes clear they understand the key drivers of efficiency issues and intend to take decisive action without hurting employee morale or doing things that are inconsistent with the company's overall strategy. Starting with stating the financial benefit expected from the program at the time of launch, executive management should provide regular internal updates to employees concerning progress.

### The Role of Finance

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The CFO and the finance group play a critical role throughout the project. The finance group should take responsibility for ensuring that the financial methodology and analysis is consistently applied when estimating identified opportunities. Finance must incorporate the estimated cost savings or revenue enhancements into the profit plans of operating units and track progress against the targets. The finance staff must be at the forefront of institutionalizing efficiency by putting appropriate policies in place that make it difficult to spend money unwisely, performing ongoing monitoring and reporting of spending patterns and advocating linking program results to executive compensation.

### A Vital Element of Continuous Process Improvement

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When properly executed, efficiency programs are not just an effective means to align expenses with revenue—they are also a vital part of continuous process improvement in an industry marked by contracting margins and consolidation. Because of their complexity, execution of these programs is difficult, and many programs fail to achieve their desired goal of improving overall efficiency. By taking time to set the appropriate guidance at the program launch, instituting a simple but flexible project structure, conducting focused performance assessments in key areas and devoting appropriate resources to support implementation and ongoing tracking, executives can significantly improve their chances for success.