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## The Seven Hard Principles: Proven Methods to Reduce and Control Non-Interest Expenses at Your Bank

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### Introduction

Banks face uncertain times with volatility in the economic, credit, and regulatory environments. And with uncertain times come uncertain profits. But expenses are a certainty – inflexible, fixed, and even trending upward. Some see this as a fact of life while others take action to undo it, striking out at the entrenched behaviors and cultures at their banks.

Listen carefully to the anecdotes and study the leadership lessons taught by global business leaders and practiced by consultants worldwide and you will discover there is a simple roadmap to profitability and earnings growth for your bank. The real question is whether you can muster the energy required to motivate the behavioral change needed to make these tools work.

### The Seven Hard Principles

The following principles represent processes and philosophies that have repeatedly been proven to create great results. Pick up any business guide and you'll see embedded within its pages of case studies, leadership examples, research studies and tutorials on becoming a good manager, illustrations of these concepts working individually or in unison with one another.

As an intelligent, thoughtful, executive leader and sponsor of change in your organization you know every one of these principles to be true. So why are no more than two of these principles typically in use at any U.S. bank at any given time?

#### **The Seven Hard Principles**

*How to reduce and control non-interest expenses at your bank*

- 1. Manage Vendor Expenses and Contracts**
- 2. Limit Discretionary Spending**
- 3. Eliminate Budgetary Entitlement and Zero-Base Your Budgets**
- 4. Evaluate Your Marginal Efficiency Ratio on Every Project**
- 5. Establish Cross Boundary Governance for Your Investments**
- 6. Streamline by Ten Percent Every Fifteen Months**
- 7. Manage Risk and Seek to Avoid Conflict**

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No surprises here, right? It's not that these are hard to understand, they are just hard to do. From where a lot of leading consultants sit they see inaction and an inability to begin and sustain these initiatives – often for a variety of reasons. Most companies need a good jump-start combined with a strong commitment from their executive management.

## Hard Principle #1

### Manage Vendor Expenses and Contracts

We might as well tackle the big money first. A quick examination of your accounts payable records will show how much money is spent with third party vendors. The average bank will spend roughly 40-45% of its non-interest expense with its vendors. The only segment of spending that is larger than this will be your employee-related spending on salaries and benefits.

The best run companies worldwide maintain centralized or center-led information systems that continually monitor vendor performance, supply chain risks, innovation, costs and cost variances. Contracts are competitively bid as a matter of routine, not simply renewed. And if you don't know the distinction between centralized and center-led, you should. For it is this concept alone that enables programs to overcome the myriad symptomatic and systemic patterns of resistance and ingrained behavior that make it difficult for management to implement this hard principle.

The development of strategic sourcing and supply chain expertise in banking is still relatively new. It wasn't until the mid 90's that business leaders with track records of success in sourcing and supplier management started to move from industrial companies mature in their supplier programs into the banking industry ripe with opportunity. Putting the relatively juvenile (ten years old) state of strategic sourcing and vendor management for banks in context with other major management revolutions such as the Deming-based quality movement in Japan in the postwar period and the Statistical Process Control and JIT/Demand Flow movements in the 80's and 90's – all of which were used effectively to improve supplier performance, enhance quality and reduce costs – is to understand just how far behind most banks are. In forty or so years of supplier development taking place side by side with the implementation of advanced operating and manufacturing practices, businesses in other, non-banking vertical markets moved from a mindset of preventing failures to one of creating new successes. Today in banking, only suppliers seem to drive that kind of innovation and excellence, and it is often at their slow pace. Banks should be driving this movement because they have the most to gain or lose.

Because of the maturity of contracting, supplier management and strategic sourcing in the globalized industrial industries there are exceptional, proven toolsets, analytical methods, data and expertise to be acquired that will enable cost reduction and supplier performance improvements at your bank. These methods and tools should be adapted shamelessly. You should be using these as a part of your core business processes and decision-making strategy. If you do not begin now you may trail your peer group in the next two years.

Let's turn back to the analysis of your accounts payable records for a moment. A comparison of the current-year versus previous-year expenditures will reveal how many suppliers your bank paid both this year and last. Your bank has a recurring relationship with these vendors and has – or should have – a contract with that vendor. We might expect to see between 65-80% of your vendor expenses recurring with the same vendors from year to year, which means that your bank has a lot of contracts and vendors to keep track of.

Fewer than five out of 10 banks today have a centralized database of vendor contracts that is formally and consistently managed in a well-documented, controlled business process. Perhaps this explains why in a recent study by CMPG with banks ranging in asset size from \$0.5 Billion to \$25.0 Billion, banks on average incurred cost

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“leakage” of more than 7%. Cost leakage was measured by the inefficiencies in understanding and managing contract renewals, market pricing trends, supplier billings, rebates and incentives that led the banks to incur greater costs than they should have.

One big problem has been that most banks do not know which business group should own these activities. Often as banks reorganize their personnel, vendor management is tossed like a hot potato between Legal, Facilities, Administrative Services, Purchasing, IT/Operations, Compliance, and HR departments. A secondary factor behind the suboptimal performance of vendor management is that many vendor management and sourcing-related initiatives are seen as special projects, which means that they are assigned to project managers with advanced skills. As they complete these projects they move on to other top business priorities and once again sourcing and vendor management is displaced and finds itself without strong leadership. A recent example of this is the risk scoring exercises many banks have completed with their vendors in response to regulatory and bank examiner pressures. Most are just happy to have the task completed and have not given much thought to how these risk assessments will be monitored, updated and maintained.

One advantage to the visibility created by center-led reporting and vendor management is that you can challenge the status quo. Expenditures with a vendor may creep up over time – sometimes because of new services and other times unjustifiably. It is important to break down the comfort that your staff might have about how big a vendor relationship has become.

## Hard Principle #2

### Limit Discretionary Spending

This is probably the easiest of the hard principles to understand. Put simply...just don't spend it. Turn off the faucet. What if during the next budget year you decided that there would be no more subscriptions and publications purchased by the bank? Or no more travel to industry events? Would you lose customers? Would you fall behind? Are there substitutes? More practically, what if you limited the aggregate expenditures to ¼% of your non-interest expenses? What about charitable donations? Sometimes certain spending habits are taken for granted or viewed as untouchables.

Consultants can give you a perspective and some actual data that can help justify reasonable, industry standard spending levels that may be lower than what you spend today. In a competitive environment, with increasing regulatory guidance and legislation and with technology, credit and fraud risk breathing down your neck how can you justify spending any amount that is not absolutely essential?

It is important to batten down the hatches in both good times and bad because the cultural styles and behaviors you create with your budgeting and spending constraints (or lack thereof) are hard to unwind in a strong nor'easter.

Granted, determining exactly what is discretionary and excessive can be difficult but that's why great leaders must make great decisions. Just don't forget to communicate “why” and “how” to your people. Put it another way...you might easily save \$40,000 or \$250,000 right now instead of spending 135 man-hours debating how to reorganize to downsize one budgeted headcount. Chances are your employee communications meetings will go smoother.

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## Hard Principle #3

### Eliminate Budgetary Entitlement and Zero-Base Budgets

Many companies run the first iteration of their budgets based off of the current year spending or previous year budgets. And often, shared services such as IT and facilities budget in response to the strategies and needs articulated by the lines of business. As a result the starting point for budgets is always higher than where they ultimately end up. Why can't the starting point be lower?

Often these first iterations become the basis for "negotiations" and posturing that take place during budget reviews. In addition to having an artificially high starting point, many bank management styles and the budget process they utilize enable strong negotiators to get more of the budget pie. Altering the budgeting *process* at your company can affect the *outcome* of your operating and capital budget, often favorably.

Zero-based budgets require the budget owner to justify – from the ground up or "zero" – each line item expenditure they want authorized for the coming period. This requires the manager to understand their business or business function well and to be able to articulate in simple language the requirements and spending needs. It is important in this exercise to replace anticipatory spending, or spending for what might happen, with predictive spending – spending based on statistical analysis of the likelihood of an event. An example of this would be budget allocations for preventive HVAC maintenance as opposed to allocations based on a failure analysis of equipment and a prescriptive PM budget allocation.

Managing lines of business to profit contribution measures rarely results in cost-optimal behavior or outcomes. Each line of business or profit center at a bank is unique in its own measures of success, market performance, ROA, ROE and efficiency. However, the expense base of each of these profit centers is often shared with a common set of suppliers, technologies, systems, facilities and sometimes people and this must be leveraged as much as possible in today's competitive climate.

Zero-basing budgets every two to three years eliminates comfort and waste and teaches the finance and executive team about the sophistication of its managers. Reducing the starting point and eliminating negotiating advantage yields results. The principle behind this process is that if there is less money in the bank account there is less spending. Banks should understand this well.

## Hard Principle #4

### Evaluate Your Marginal Efficiency Ratio

Banks are focused on the efficiency ratio as a primary measure of success. They complain that it is hard to compare their ratio to that of their peer banks. They find easy explanations as to why it is high often citing their own uniqueness and customer dynamics that their peers do not have to contend with. Yet project after project, investment after investment, they fail to estimate the marginal efficiency ratio of that investment.

How will the added dollars of non-interest expense generate more non-interest income? Why should we invest in a project, technology, branch, software, or product if it only generates a marginal efficiency ratio of 70% when our target is 62%? These are questions every finance manager and executive team should be asking during their strategic planning and capital budgeting reviews.

Every good investment has an internal rate of return, payback, and net present value of cash flows. But what are often overlooked is whether the investment is accretive or dilutive to the core efficiency ratio and how that ratio tracks as a baseline without that investment. Companies that evaluate and segment their investments into

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categories like “maintain/comply”, “build/develop” and “strategic” come the closest to understanding, or at least projecting and measuring, the revenue and profit growth generated by the initial investment and the subsequent ongoing operating expenses it creates.

## Hard Principle #5

### Establish Cross-Boundary Governance

Bank executives looking to improve performance often see three choices when they determine it is time to “challenge” the company and make sweeping reforms to improve earnings. Build it, buy it or bond it. Using the build-it strategy, internal stars and key managers are tapped to study the company and identify cost savings, productivity gains, customer gains, staffing adjustments, fee income opportunities, and process improvements. Methods such as Six Sigma may be trained in the organization to enable these efforts and create some sustainable ongoing abilities of the organization to self heal.

Adopting the buy-it approach, executive leaders tap outside consultants to bring their knowledge, insights, data, and various problem solving and coaching techniques to the bank – often in exchange for high fees. What is interesting about this exercise is that because the fees are so high, once engaged, the client team really wants to get benefits. The motivations offered by the consulting team pale in comparison to the sheer will and desire of the executive to make sweeping changes that will result in cost reductions and revenue growth in excess of the consulting fee. In essence, they’ve considered the marginal efficiency ratio and have taken more risks to attain it.

A third strategy is to pair internal resources with external resources, piecing together a team of cross-boundary consultants. This strategy blends the internal knowledge of employees and their natural biases toward safe solutions with the more aggressive area-of-expertise knowledge of outside experts. With each person on the team assigned to the right area of analysis the bank gains from knowledge it does not have yet retains control over the analysis process and vetting of ideas. Acceptance rates among the existing employees for major changes increase.

All of these solutions have merit and for the reasons cited perhaps one has an advantage; yet each is focused on analytical talent and not a governance process that will fundamentally change the way decisions are made on an ongoing basis. Such an oversight.

But naturally there is a fourth approach and one that very few executives know about. It is similar to a bond-it approach but with less emphasis on external consultants except during the initial design stage. It also contrasts with the other three approaches by being *process-centric*. It brings together all of the right things you know you should be doing. But as with all great solutions, it requires a healthy investment of time, energy, and know-how to get started. This outstanding management principle embodies executive leadership of a cross-functional, boundary-less, transformation effort that uses existing employees, only relying on outside consultants for specific points of expertise in limited areas.

A key aspect of this hard principle is that the forward-thinking solution embraces the creation of an enterprise-wide PMO, or Project Management Organization, that does not reside in an IT or Operations group but rather is an extension of the executives themselves. The approach engages executives and senior managers, creates transparency, drives accountability, focuses on time, facilitates employee communications, and breaks down silos. It uses a fairly sophisticated toolset and some unique, proprietary tools I have helped develop more recently but each of these can be taught and learned easily. A natural outcome of this unique approach is that it emphasizes cross-boundary opportunities and these are the opportunities that inherently reflect market differentiation strategies, and bring customers closer to operations. Everyone plays an important, contributing role and no one governs.

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## Hard Principle #6

### **Streamline by 10% Every Fifteen Months**

This principle is overwhelmingly intuitive to every consultant on the face of the earth and it should be to you also. After all, that's why you set aside emails and voice messages (10% go away eventually), postpone decisions (10% become irrelevant over time), and decide that it is okay to miss a regularly scheduled weekly meeting to attend to another priority every two months or so (11% this time). It is because people are rarely if ever utilized to 100% of their collective capacity.

Technology and your people are a part of your business processes just like machines and people are a part of a manufacturing process. Operations management techniques like Just-in-Time manufacturing showed the world that when you lower inventory levels, process constraints are revealed. These constraints, like the rocks on the bottom of a riverbed that are exposed when water levels drop, prevent the timely and efficient flow of production and information. A bank's people hold inventory - information, new accounts, customer inquiries, transactions and payments. As staffing is streamlined, constraints are revealed as inventory levels and it becomes easier to identify productivity solutions.

Unfortunately when it comes to people, no one likes to be the bearer of bad news. Often the message is "we will be downsizing" instead of "we will be upgrading." "We will be discovering what prevents us from being more productive, where our problems lie, exploring our boundaries so we can beat our competition and win more customers, make more profits, ... pay you more!" (Hurray! The crowd cheers in your employee cafeteria.)

I've often wondered why if I had a department of 60 people making an average of \$40,000 why I wouldn't be willing to shed 10% after two years (save \$240,000) and give half of that back to the remaining employees the next year (\$2,000 each...a nice 5% raise) with the understanding that it was going to require some extra effort until we all reached equilibrium again. We would learn. We would work smarter and faster. We would have more constructive debate. And we would be 5% more efficient.

The bottom line in this exercise is that companies achieve big rewards and unexpected results and they learn to innovate. It's just that no one can or will do it except under the mandate of the executive suite. Remember that being competitive means that you can't afford to be blind and ignore that 60% chunk of your non-interest expenses.

## Hard Principle #7

### **Manage Risk and Avoid Conflict**

One of the most costly aspects of running any business is fire-fighting risks that have reared their ugly heads and manifested themselves as problems. This is especially true in banking given the high stakes of protecting information, processing transactions, and keeping systems running and customers happy. The problem is that most departments approach these problems with an open wallet, shamelessly spending money to resolve glitches and failures. Also problematic is the tendency of these same departments to treat symptoms rather than the causes. After all, these problems are unexpected and un-budgeted and their time-sensitive nature often tempts managers to forego obtaining a competitive quote or an evaluation of alternatives in the interest of making the fix.

Avoiding conflict with others stands out as a cost management principle that is closely related to risk management. Conflict resolution consumes time, energy, and frequently a lot of money spent with outside counsel. This means that if your bank's culture does not emphasize setting clear expectations, monitoring progress, and holding people accountable in your organization and in other organizations, you have a prime training opportunity.



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Organizations that routinely monitor and audit risks, and don't shy away from the problems and instabilities of current processes and systems ultimately enjoy the best operating costs over the long run. Similarly, those organizations that communicate clearly and directly with their customers, business partners, and suppliers leave much less room for conflict resolution to occupy a slice of the non-interest expense base.

## Summary

Whether you seek to transform your company into a world-class entity or make small gains toward excellence, challenge the fundamental strategies of the bank and explore boundaries of performance or refine your current efforts, the Seven Hard Principles can get you there. They are hard because they require introspection, alignment, accountability, and the willingness to make tough decisions. They consume some up front time and save a lot of money in the long run.

Most companies cannot enable or sustain a multifaceted renewal effort that embodies these hard principles and will turn to outside help, namely consultants or new executive teams, to get the job started. You should too. Companies and executives before you have accomplished amazing feats of earnings using these principles and you can too.

Light a fire of performance in your organization and leave a contrail for others to navigate by and you will be recognized as the leader you know you can be.

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## About the Author

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Grant is an Executive Partner with Cost Management Performance Group (CMPG). He is a founding partner of the firm and works with executive teams and senior managers to help them build sustainable business practices and achieve excellence in profit-related disciplines. CMPG provides a comprehensive set of services and solutions tightly focused on improving earnings performance for banks. CMPG also serves Fortune 500 companies in other vertical markets by executive request. CMPG's services include executive consultation, cost management leadership, spend and contract analysis, benchmarking, and turnkey outsourced solutions for vendor risk management and compliance.