

Enhancing Profitability Without Taking Additional Risk

Banks focus on improving their efficiency.

Continued upheaval throughout the financial sector caused sharp volatility in most community bank stocks this past quarter as continued concerns over credit, capital, liquidity and earnings quality each took a dramatically greater importance. With many financial stocks still awash in red ink, companies such as Bear Stearns, Countrywide Financial and others selling into distressed valuations, Freddie Mac and Fannie Mae requiring governmental support, and IndyMac failing, investors remain apprehensive about even the most stable financial companies.

While this probably represents a great opportunity for healthy community banking companies to aggressively repurchase their stock, many management teams are finding their capital to dear. They recognize that the last thing investors and regulators want is for them to increase their risk by reducing their capital levels significantly. Unfortunately, community banks remain effectively blocked from issuing through trust-preferred pooling, once an efficient source of capital.

As a result, many bank holding companies are purchasing back less stock than they would like at these low valuations. However, to buttress their companies' stock prices and stabilize their profitability, many community banks are undertaking focused initiatives to improve the efficiency of their core business lines.

The management team of VIST Financial, a \$1.3 billion bank holding company headquartered in Wyomissing, PA, is meeting this challenge by thoroughly examining its core operating system. "Despite this difficult economy, one of our core

objectives is to substantially enhance the proportion of our company's non-interest income while improving the company's overall profitability", said Robert D. Davis, the company's president and CEO. "We recently engaged Lodestone Banking Consultancy, a firm out of Syracuse, NY, to conduct a forensic diagnosis of our company's core operating system to discern ways to meaningfully improve our operating efficiency."

Davis described the process: "Starting with our company's general ledger and policies, they followed the flow of data down to the individual account level. During the course of the engagement, Lodestone not only discerned meaningful pockets of income opportunity, but also conservatively demonstrated several instances where we had been overly generous to our

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customers without our bank deriving any economic benefit." He went on to say, "They provided us with a surprisingly large amount of data to back up their findings and provided considerable insight and information on our competitors."

"We're bankers with extensive experience improving revenues through banking system audits. For example, a couple projects ago, we discovered a post-conversion error that had been costing that client a considerable amount of annual income." said Lodestone's CEO Shahin Clark, who began her consulting career managing Marine Midland Bank/HSBC's internal consulting group. While her company generally focuses on banks with \$1 to \$10 billion in assets, Clark knows that even the largest banks can benefit substantially from undertaking the process, which the company has service-marked as

Advanced Earnings Methodology or AEMSM. Far more encompassing than merely focusing on overdraft protection, the company has a track record of discovering revenue opportunities throughout clients' core operating systems and deposit and loan operations.

Unlike many efficiency consultants, Clark emphasized, "We won't say to our clients, 'We'll help you enhance shareholder value through firing personnel or raising fees.' Our clients don't need anyone from the outside telling them to do that." Instead, Clark maintains that Lodestone "partners with our clients to unearth overlooked revenues. I just get so excited finding pockets of recurring revenue that banking clients have overlooked, especially in this very difficult environment."

How much revenue? Clark said that they typically can generate \$100 thousand per \$100 million (in assets) in additional annual income for their clients and their track record proves this out. (Example: A Lodestone client with \$3 billion in assets was offered Lodestone's \$1 million guarantee. For this client, Lodestone presented over \$3 million spread over 20 sound banking recommendations.) While Davis would not make forward-looking statements, he expressed confidence that Lodestone's recommendations should help him accomplish some of his objectives during the next several quarters.

According to Davis, "Any bank holding company that's been an active acquirer should benefit from undergoing this sort of forensic examination of their core operating system." Clark agreed. "Post-acquisition system conversions have their own complexities. While system providers are experts on their systems from an IT perspective, they're not bankers," she said. "As a result, we oftentimes find pockets of income that have been overlooked – what we call 'leakage' – long after a consolidation. When you add all these revenues up, the impact on the bottom line often is significant."

Another smart step Davis took to improve his company's efficiency was re-branding. Rather than have a lot of different names out there in the marketplace, Davis unified several companies under a single name, VIST. This move enhanced the customer experience, reduced marketing expenses, and positioned the company well in the community

going forward. "Commercial clients are much more receptive to referrals into our insurance unit, for example, as they now see it as dealing with the same company rather than another entity." This consolidation also should enable the company to leverage its name while making the company's marketing efforts much more efficient.

One more example is Union Bankshares, a \$2.3 billion bank holding company headquartered in Bowling Green, Va. According to Charles Driest, the company's director of strategic planning and corporate development, Union is heavily focused on improving the efficiency of its core business. Driest explains that Union doesn't have the extensive credit problems experienced by many of its competitors, so the bank is proactively building net income now while much of the competition is reeling.

"Our approach is two-fold," he explained, focusing on aspects of the bank's business that management can control. "The past several months we've taken a tight look at expenses, asking what we can do to reduce costs. We're reworking our contracts. We're reviewing our under-performing branches and evaluating what efforts are required to bring their performance to acceptable levels. We're getting smarter in our marketing, keeping what works and abandoning what doesn't."

But Driest explained that "cost control is only a part of the picture. We're placing a greater importance than ever on our customer relationships. For example, we're willing to take on some additional costs by investing in new technologies if they help improve our customer relationships, and we're already getting some nice results."

While the challenges are considerably different than those faced just a year ago, many bank executives are focusing on improving their companies' efficiency. However, as the examples above indicate, this doesn't necessarily mean scaling back or sacrificing customer relationships, and it may just be one of the keys toward supporting solid performance now and in the years ahead.