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The Banking Revolution

Robert G. Stevens

In a time of rapid change, the banking industry is at the forefront in experiencing an acceleration of change that is affecting organization, scope of services, and methods of bank management. One of the most compelling factors leading to this revolution is a growing demand for the elimination and simplification of paper work necessary to complete a business transaction. The adoption of MICR (Magnetic Ink Character Recognition) by the banking industry represents a milestone in this trend toward more efficient ways of conducting business transactions.

This is only the beginning of the bank's role in this great movement. The banks must be involved in this movement simply because of their unique position in the community. On the one hand, banks handle the primary medium of communication between companies — the check. The volume of checks being processed is staggering —(about 1,250,000 items per day at one large New York bank). In the long run this means of communication of financial transactions must be improved and new business conventions and laws must evolve in order to develop new methods of exchanging value acceptable to the business community. While this exchange function is vital in and of itself, it is also recognized that any other function which can be performed during the same handling of this exchange, or during the creation of this information, provides a further opportunity for the elimination and simplification of paper work.

The bank also has another unique relationship in that it often has access to and communication with both participants in a business transaction. That is to say, for example, the banking industry is a servant both to you as an individual and to your retailer with whom you make many of your expenditures. Thereby it may be possible to clear all of your transactions with your retailer through your bank. Since the bank in order to process these transactions must go through certain steps which in turn a customer may also perform, it is in a position to assert that the duplication can only be eliminated if it alone performs these steps. This is significantly different from being a service bureau. A service bureau does not have these unique relationships or a position of trust within the community.

At a time when this great technological trend is having its effect on banking, the banks are also experiencing a decline in demand deposits as a result of the efforts of corporate enterprise to keep its resources in some form of an earning asset. Instead of holding large bank balances, today's corporate treasurer invests in treasury bills or other short term governments. Time deposits are growing and the interest rates paid on them are at a long term high. A large segment of the potential banking business has been lost to the savings and loan associations, finance companies, credit unions, leasing companies, and other specialized financial institutions because of the failure of the banking industry to meet the needs served by these other institutions.

In short, banking is caught up in a movement that is now changing and will continue for some time to change its customs and conventional ways of doing business; it is experiencing new and aggressive competition. It is caught in the profit squeeze, and to make things interesting, it is facing the possibility of audited financial statements by certified public accountants. Today there are action, dynamics, and excitement in banking.

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Before joining TRB&S he was an instructor in accountancy at the University of Illinois and served with the United States Air Force as cost accountant and instructor for the Military Air Transport Service. He joined our Detroit office in 1958, and later served in the Executive office and in San Francisco. His work includes profit planning, budgeting, work measurement, cost standards, and cost analysis for products and functions.

Mr. Stevens is a member of the American Institute of CPAs, the Institute of Management Services and the National Association of Accountants.

A Unique Contribution by TRB&S

Since our firm serves the banking industry, these great economic forces are of concern to us. It is this long term trend toward work simplification through transactions being integrated by banking institutions that seems to affect us the most. The every day working reaction to this trend comes in the form of providing customer services. Prior to 1960, banks were entering the customer services field by offering account reconciliation, credit cards, lock box services, and even a few payroll applications. Except for the Bank of America, almost no bank, to our knowledge, provided these services voluntarily.

It was about this time that the late Jesse M. Lynch,* of our firm, began to visualize customer services as more than something that a bank provided in order to sell some idle time on its computer or to satisfy the pressure from a given customer. In 1961 and 1962, under Mr. Lynch's direction, we conducted a survey of most of the major banks in the United States to document their experience with the individual customer services which had grown up almost on an accidental basis. The experience of these banks was coupled with the firm's knowledge of the retail industry, and a projection was made of what the inter-relationships between a bank and a retailer might be in 1970. Four things were clear from this work.

1. Customer services can be a part of the technological trend toward the elimination and simplification of paper work.
2. Banks can be the vehicle for this trend. They can perform services not as a typical data processing bureau but perform services as an extended but integral part of traditional banking relationships.
3. Success in developing customer services will, in the long run, determine the total success and profitability of the individual bank.
4. The capabilities and the existence of computers are the key to this new era.

Our views were shared by one of the largest banks in the country, and our firm participated in developing what was probably the first formal, long range planning strategy for determining, designing, marketing, and organizing for the future in customer services. No longer were customer services to be something that a bank offered as a side line simply to please a customer. They became an intricate part of banking services, a device for growth and improvement of competitive position, and a step forward in meeting the long term needs of the business community. We can take pride in our contribution to this pioneering effort and our role in defining these fundamental forces affecting the banking industry. It is appropriate that here in the QUARTERLY, we give credit to the late Jesse M. Lynch, whose imagination, creativity and drive first directed us into this area.

Planning for Customer Services

Many people within the banking industry are arriving at opinions that are essentially in agreement with this proposition; many banks are now aggressively entering the customer services field. Only a few banks, however, are approaching the problem of customer services with the aid of formal planning. The need for formal planning, however, is becoming apparent. The decisions to add services, once made, are not easily retracted. The

* Jesse M. Lynch left our firm in 1963 to join Security First National Bank in Los Angeles as vice-president — development and planning. After a short illness he died in September 1964.

bank must spend considerable time and effort in evaluating and planning for entry into new areas of service in order to avoid costly long term mistakes. On the other hand lack of action may result in being left behind on the road of progress; poorly planned actions may cost the bank severely in both prestige and profits.

A bank should be encouraged to analyze its customers and its community in order to determine the needs of its marketing area. In some cases, there are opportunities for the bank to increase its participation in the transactions of an industry that may be predominant within its marketing area. It might be possible to take a specialized transaction within this industry, eliminate paper work, speed up the transaction, and as a result attract new customers for the bank from that industry. Now is a time to evaluate the profitability of existing services to customers; a time to develop costing techniques; a time to develop systems for the control of cost; a time to improve systems and procedures; and the time to evaluate the effectiveness of the organization structure of the bank to meet the needs of the future.

In all cases any proposed new service needs to be reviewed in terms of its:

- ★ Expected volume
- ★ Effect on the costs of the bank
- ★ Effect on loans and deposits
- ★ Potential profitability
- ★ Effect on the organization of the bank
- ★ Effect on the bank's competitive position

Bankers make planning decisions every day: they make decisions to put money in governments, tighten up on mortgage money, expand installment loans, offer 4% certificates of deposit or decide to change the interest rate on time deposits. Planning cannot be avoided. Most banks, however, have avoided the searching, evaluating, and defining that is necessary to layout a formal plan for the development of services and the relation of these services to the attraction of deposits and allocation of resources. There are a few bankers who feel that the greatest potential for improvement in bank earnings is through the deliberate effort to plan loans, services, and deposits and to develop specific programs for the achievement of these desired results. These ideas are not widely accepted, but they are being tried in a few banks at least on a limited scale.

A substantial demand for people experienced in financial planning and control is developing in banking very quickly, and the aggressive banks in the country have attracted many men from industry and public accounting. The need exists and is growing. Technology for making better decisions and planning in banks is available, and will come into use. These small rumblings of today are a portend of the future when it will be commonplace for bankers to have modern information systems, and modern planning and control systems. Bankers will be using these systems as a basis for making management decisions.

The Cost of Services

While the impact of customer services has caused some banks to think first of planning and organization, others are not yet quite aware of the broader aspects of the problem. But almost all banks are becoming keenly aware of the immediate need for knowing the costs of bank services. The need may arise in terms of the profitability of money orders or travelers checks. It may relate to special checking accounts, types of trusts, or services performed for correspondent banks. In any event, this need usually arises from some specific, day-to-day problem. Information for that problem either does not exist, does not seem reliable, or needs to be up-dated.

We have not observed any bank that has a continuous cost determination system equivalent to that which might be found in a manufacturing company. Very few banks have standards that can be translated into the cost of services. Therefore, almost all costing in banks is done on a special analysis basis. The bank which does some cost analysis work will typically prorate its semi-annual or annual revenues and expenses to various functions or departments. These prorations are sometimes made upon direct identification, but more often they are based upon floor space, number of personnel, or other such factors. Even if these assignments are made judiciously, the results are usually valid only under a particular set of circumstances. Many costs would change, for example, if the bank had a 20% increase in volume. Costs in a bank are also affected by the loan and deposit structure of the bank. A change in the structure would also change the costs that the bank may have used in determining the cost of various functions or services. Common costs and joint costs are the rule in banking. The interrelationships between deposits and loans are complex.

In our opinion, the costing problems of banks rank among the most complex of any industry. A recent project with a bank demonstrates this point rather dramatically. This bank has a large installment loan department. Most of the loans serviced by this department, however, are in a classification called indirect automobile loans. These are loans that are actually made by automobile dealers under their own names or the names of their own captive finance companies. This bank buys this paper

from these dealers, usually with recourse, and at a rate that is somewhat lower than that shown on the face of the paper. The bank processes the monthly payments and provides auditing and credit and collection services.

As has been done in many banks, the installment loan function had been singled out for profitability analysis, and a functional profit and loss statement was prepared annually. This bank had an opportunity to buy the paper of a very large automobile dealer in their community. The functional profit and loss statement indicated that installment loans were profitable. To make this decision, the bank required information as to the profitability of this particular type of installment loan. The functional statement in no way could be interpreted to mean that an increase in volume or a change in the mix would be equally profitable to those loans in the installment loan department at the last time an analysis of profit was made. The decision, therefore, required a new set of numbers that would adequately reflect the profitability of this specific kind of loan and adequately reflect the effect of a change in mix and a change in volume on the operating costs and revenues of that department.

In doing this more detailed analysis, it became obvious that indirect dealer loans was not a meaningful description or classification to use in making this decision. Within this function, profitability had to be measured in terms of expected yields and expected time periods of individual loans. In arrangements such as this, the bank also withholds a certain reserve from the proceeds of these loans to serve as a cushion for bad debt losses. The rate of deduction for this reserve is, in effect, a pricing decision. Since the reserve balances represent deposits, the bank is provided with a source of funds for investment (cash flow is of no consequence). The value of these deposits had to be considered in evaluating the profitability of this business. A systems study was required in order to differentiate between the service requirements on these indirect loans as compared to other installment loans. The end result was not a single figure for the profitability of this category of loans, but a matrix which could be used to evaluate the potential profitability of this individual dealer. Thus, this particular arrangement was set up in a manner that would be reasonable to the dealer and, at the same time, profitable to the bank. Other existing arrangements were reviewed by this same method and negotiations were made with a number of dealers to bring them into a profitable category.

As a part of this study, it was recognized that some elements of cost within the installment loan department were affected by the activity or volume of a particular service while other costs were incurred because of a particular service but not related to the volume of that service. Other costs were simply related to the installment loan business in total but not necessarily to any one of its segments. These facts are a commonly accepted basis for product profitability analysis in Profitability Accounting, but these were unique and new ideas in bank cost analysis.

Cost Control and the Profit Squeeze

Each of us react to a situation somewhat differently and the same is true in banks. For some banks their paramount interest falls not in the area of planning, or in the area of determining the unit cost of services, but falls in the area of cost control and cost reduction. The cost control problem in banks can be thought of in three categories.

1. The level of cost in a bank relates to the kinds of services it chooses to render and the kinds of deposits it seeks to attract. If the bank decides to be in installment loans, to offer lock box service, or to issue certificates of deposit, this decision automatically affects cost. Each of these key decisions has its price. Therefore, everything we have talked about under customer services could be considered to be one approach to cost control. One way to control cost is to carefully evaluate the addition of new services and to eliminate unprofitable services or other sources of business.
2. After a bank offers a service, the next major determinates of cost are the systems, procedures, equipment and other facilities used by the bank in performing its chosen functions. These are areas of decision that affect the bank over a period of years. A bank will never be able to perform any better than the limits imposed upon it by the tools with which it chooses to work.
3. Within the framework of the services and the systems for performing these services, there is an obvious need to control salaries and expenses. This is a control of performance and productivity.

The best control of cost is through good planning, and that we have discussed to some extent. In order to control the second determinate of cost, every decision to buy equipment or to change systems and procedures should be given a thorough technical and economic review. A bank should have a formal procedure to ascertain that this review is done. Banks should do return on investment analysis just as we propose in Profitability Accounting for a manufacturing company. Capital budgeting, therefore, should be an important part of cost control in a

bank. This kind of control can be obtained with a minimum of systems and procedures effort.

Integrated variable budgets based on work measurement have proven to be ideally suited to the control of salaries and expenses in banking institutions. COMP is a system of variable budgeting based upon work measurement standards which provides information for scheduling and also provides unit cost information on operations and functions. When COMP was developed, it appeared that it should be particularly useful to companies with large clerical workloads. Banks are obviously in this category. Before recommending this program on a broad scale to banks, several pilot studies were undertaken to determine the operating feasibility of COMP in banks and to be certain that it met the needs of bank management. These pilot tests were evaluated in terms of five objectives:

1. Would this form of Profitability Accounting enable banks to determine the cost of functions and services on a current and accessible basis.
2. Would it provide a tool for staffing and scheduling.
3. Would it provide a useful tool for cost control.
4. Would it provide a reliable measure of performance.
5. Would it aid in the reduction of cost through improvements in systems.

On the basis of these pilot studies, it was concluded that the system would provide a means for determining on a routine, but specific analysis basis, the cost of various classifications of loans, deposits, and customer services. In the future, the system would provide the information required to determine the profitability of loans, deposits, and customer services offered by the bank or any of its departments and branches on a continuing, as opposed to a specific analysis, basis. Likewise, the data could be used to evaluate the profitability of any planned level or mix of loans, deposits, and customer services.

When installed the system would also provide the cost information required to charge branches and departments on a sound economic basis for the services performed by computer centers and other service departments.

It was the experience in the pilot studies that supervisors using good standards significantly reduced the cost of getting work done through better scheduling without sacrifice of deadlines. The variable budget idea did provide reliable measures of performance, provided reasonable goals, and stimulated performance.

As was true in manufacturing companies, it was found that the work necessary to establish variable budgets and work measurement standards provided an independent and coordinated review of systems that produced recommendations for improvements in systems and procedures resulting in reduced costs.

How to Succeed in the Revolution

The forces compelling banks in a direction of change represent dynamic forces in the economy. Even if you are not impressed with the significance of these forces as they have been described in this article, you must be impressed with the rapidity with which change is taking place in our economy. There are many ways in which a bank may prepare itself for these changes which are bound to take place in the immediate future. The banks which are most likely to succeed in this era of change are those whose top management becomes involved with the problem today. We would recommend a six step approach:

1. Evaluate the concepts of management planning and control. What is it, how does it work and how will it affect the way in which the bank is managed?
2. Start some formal profit planning even without complete knowledge of costs, forecasts or responsibility.
3. Establish a program for expanding management planning and control. Coordinate this plan with plans and priorities in electronic data processing. Refine formal plans and definition of responsibility as steps of the planning and control program are completed.
4. Establish formal control over expenditures for systems equipment and facilities. Refine as subsequent steps are completed.
5. Define responsibility and develop an effective system of reporting historical information by responsibility. Challenge existing organization structures in light of the computer and customer services.
6. Start budgeting costs and begin longer term program of building variable budgets based on work measurement.