KaufmanHall AXIOM

2020 Outlook for Financial Institutions:

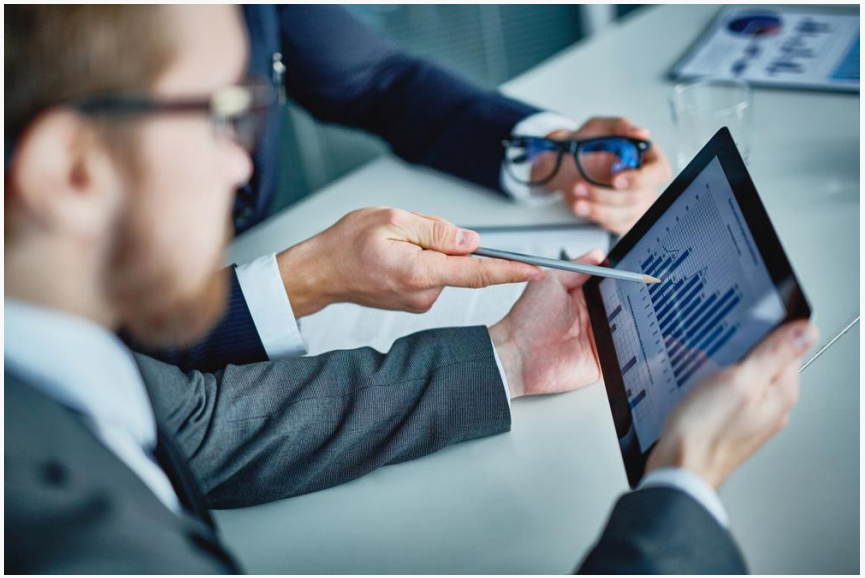
Addressing Economic Uncertainty and Competitive Pressure

If it feels like storm clouds are gathering over your financial institution, you're not alone. The combination of economic uncertainty and unprecedented competition from an increasing number of sources has darkened the business outlook of many leaders in the banking industry.

In June 2019, the economic expansion that started in June 2009 officially became the longest in history.[1] However, much of that expansion has been weak, with lower growth numbers seen for the past several years. Trade wars between the United States and several other nations, an upcoming presidential election, and three cuts to the benchmark lending rate during 2019 underline this uncertainty.[2]

Competition for deposits and loans has heated up from local financial institutions as well as tech companies like Google and Apple, which now offer banking and payment services such as PayPal, Venmo, Zelle, and Cash App. Many bank customers prefer online banks, which can offer better loan and deposit rates because they don't have the same overhead as brick-and-mortar branches.

A flat yield curve makes it difficult for institutions to manage spread, creating the temptation to loosen credit requirements to win business. The CEO of a bank holding company indicated that lenders in the current climate are getting "increasingly irrational" and that some competitors "are willing to accept risk that we consider foolish."[3]



The roles played by chief financial officers (CFOs) and other senior finance executives of traditional financial services institutions are increasingly important as institutions strive to maintain margins during this time of uncertainty. Using high-quality performance management tools and processes is critical to turn an institution's financial data into actionable intelligence to drive short- and long-term decisions.

This report examines the challenges and opportunities that CFOs and other senior finance executives say they are facing with their broad performance management functions. Read on for the survey findings and our recommendations on the best path forward.

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[1] America's economic expansion is now the longest on record." The Economist, July 2, 2019. https://www.economist.com/graphic-detail/2019/07/02/americas-economic-expansion-is-now-the-longest-on-record (retrieved Dec. 13, 2019).

[2] Last month, Fed officials said the 3 rate cuts of 2019 were enough." The Washington Post, Nov. 20, 2019. https://www.washingtonpost.com/business/economy/last-month-fed-officials-said-the-3-rate-cuts-of-2019-were-enough/2019/11/20/59cae5e4-0bb5-11ea-bd9d-c628fd48b3a0_story.html (retrieved Dec. 13, 2019).

[3] Davis, P., Dobbs, J. Race to the dumbest': "Irrational terms creep back into lending." American Banker, Oct. 23, 2019. https://www.americanbanker.com/news/race-to-the-dumbest-irrational-terms-creep-back-into-lending. Accessed Dec. 16, 2019.

Top Priorities and Challenges for Financial Institutions

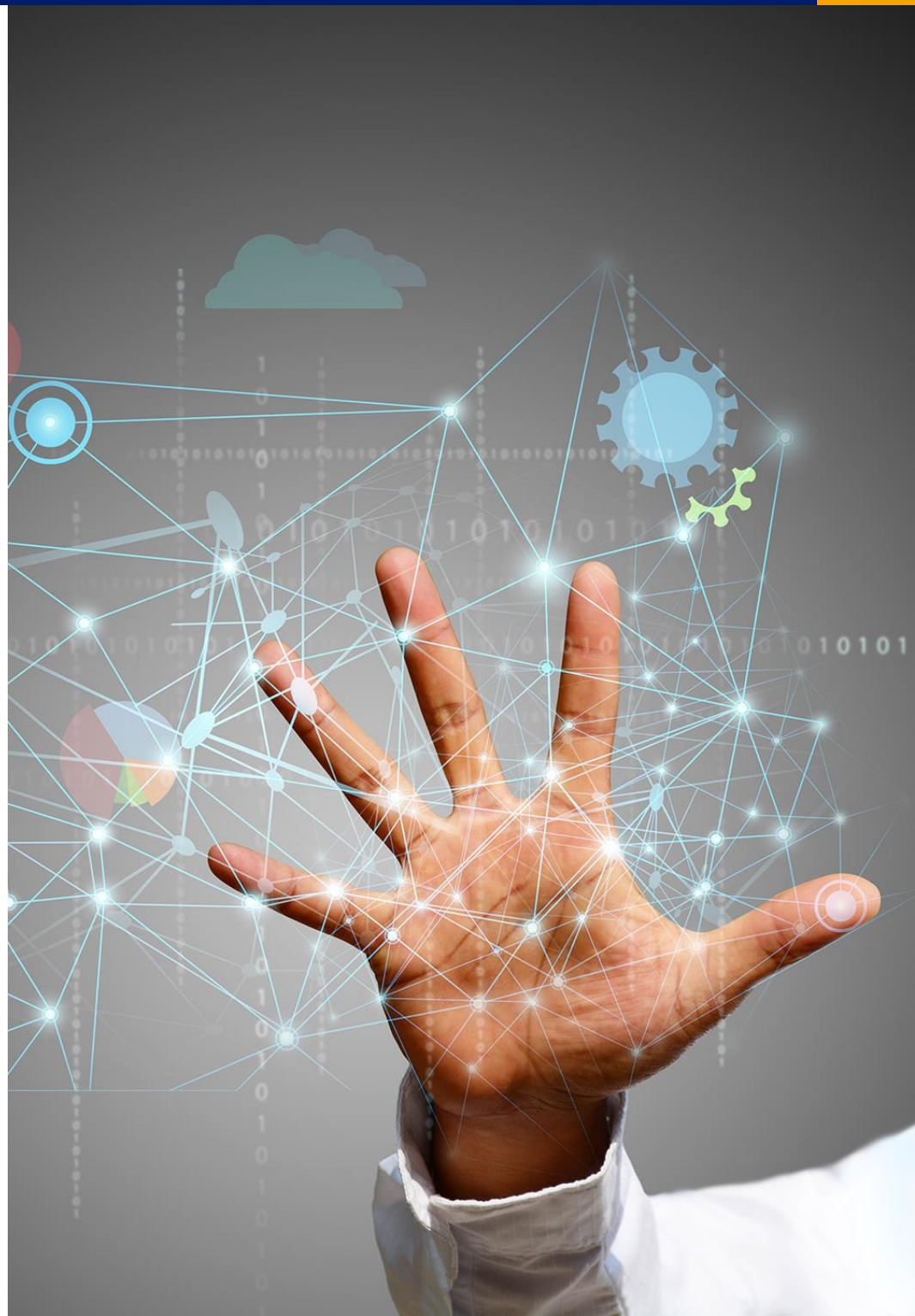
1. Finance teams need better data to compete in 2020.
2. The need to truly understand and leverage what drives profitability has never been higher.
3. Inadequate resources, processes, and tools hinder the ability to compete in today's market.

Opportunities Exist for More Robust Profitability Analysis

4. Many institutions lack sufficient profitability insights to know where to focus and invest.
5. There is a significant gap between what finance leaders feel is important to monitor and what they actually measure and track.
6. Relationship pricing is underutilized for supporting the value exchange.
7. The way employees are evaluated often does not align with how the institution is measured.

The Planning Process Must Continue to Evolve

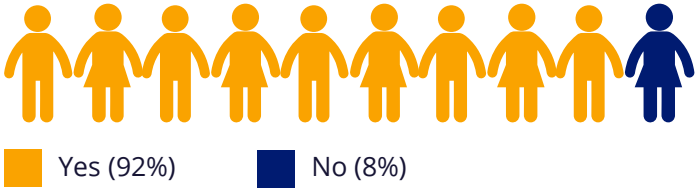
8. Use of cash flow-based planning, funds transfer pricing (FTP), and scenario planning can improve a finance team's ability to be nimble.
9. Outdated budgeting processes and systems contribute to long budgeting cycles and inaccuracies.
10. Capital project tracking lacks appropriate discipline and follow-through to ensure efficacy.



1. Finance teams need better data to compete in 2020.

CFOs and finance professionals are feeling the pressure to deliver better insights into how financials impact overall business strategy, with 97% expressing that sentiment in the survey. The problem is never a lack of data. Rather, it's the inability to merge data from disparate systems into a single source of truth to fuel better decision-making. That may be why 92% of respondents feel their institution should be doing more to leverage financial and operational data to inform strategic decisions.

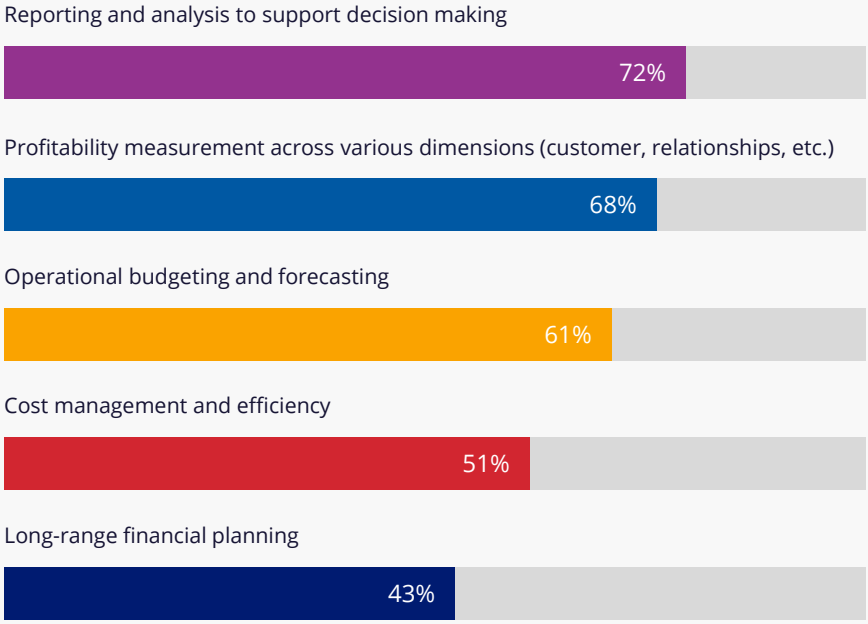
Do you believe your institution should be doing more to leverage financial and operational data to inform strategic decisions?



It logically follows that reporting and analysis to support decision-making remains a top priority again this year, showing a slight increase over last year (72% versus 69%). But not all reports are created equal. Consider the various reports a financial institution produces. How many of them pass the "so what" test — why do these results matter, what can be learned from the numbers, and how can management make better decisions based on these reports?

Reports for the sake of reporting won't move the needle to help an institution better understand any part of the business, much less empower better decision-making.

Which of the following financial planning and analysis initiatives is your institution planning to improve in 2020? Please check all that apply.



When asked what capabilities are important in planning software, 72% of respondents prioritized reporting and analysis, and ease of use above all others. Data integration (with GL, payroll, and other source systems) was cited by 69%, up from 60% last year. This suggests that financial institutions better understand that tying these systems to performance management software supports their top two priorities by empowering teams to easily create reports by bringing together data from disparate systems. But doing so remains a major challenge.

As in 2019, the top two reporting challenges in 2020 are pulling data from multiple sources and creating better dashboards and visuals — which suggests that institutions have made little if any progress overcoming this in the past year.

Top challenges cited around reporting in 2020 include:

1. Pulling data from multiple sources into a single report (64%)
2. Creating better dashboards and visualizations (62%)
3. Drilling into reports to understand underlying data (59%)
4. Accessing clean, consistent, and trusted data (55%)
5. Delivering meaningful ad hoc reporting for end users (51%)

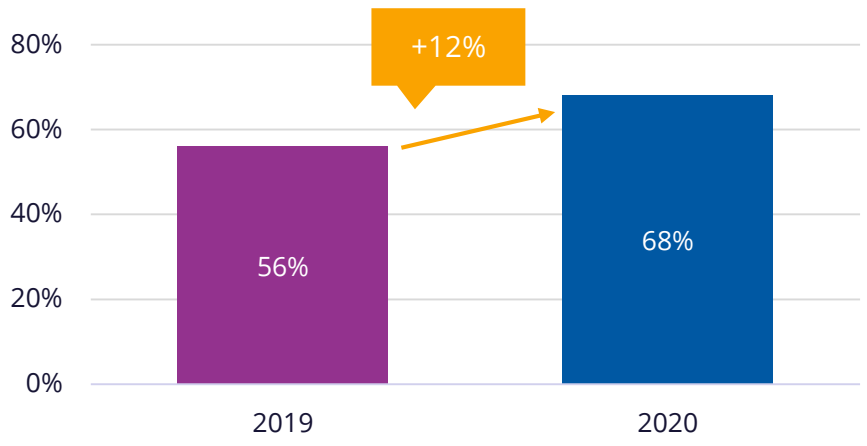
OUR POINT OF VIEW

The top challenges that financial professionals cite center on the difficulty of bringing data together, trusting that it is accurate, and being able to manipulate it properly for reporting and analysis.

These challenges can be addressed, at least in part, by a financial performance management system that offers budgeting and forecasting, reporting, and profitability analysis on one platform, and ties into source systems such as payroll, general ledger, and loan and deposit systems. Data can be drawn into one report, with the ability to drill-down to get the “so what” insights provided by underlying data. Reduction of duplicate data entry and import improves consistency and trust, while having consolidated data also supports dashboards and reports that help institution leaders problem solve.

2. The need to truly understand and leverage what drives profitability has never been higher.

My institution plans to improve profitability measurement across various dimensions (customer, relationships, etc.) this year.



Continued tight margins put the squeeze on profitability, so it's no surprise that significantly more institutions (12%) plan to improve profitability measurements in 2020 than reported in 2019.

Understanding margins is especially critical during times of uncertain economic conditions, but savvy financial institutions recognize its importance year in and year out. Profitability should be measured by branch/department, product, channel, officer, and banking relationship.

OUR POINT OF VIEW

Starting at the account level and aggregating to the desired dimension or desired level help maintain consistency across these analyses, which builds trust in the data. Institutions should include the same components in profitability analyses across dimensions: interest income/expense, FTP credit/charge, provision for loan loss, non-interest income and expenses, and capital allocation.

One area in which many institutions under-invest is technology to identify and monitor the top-performing relationships in the portfolio. Gaining an understanding of the value of individual relationships can help institutions make more-informed decisions to enhance profitable relationships or curtail low margin or unprofitable relationships.

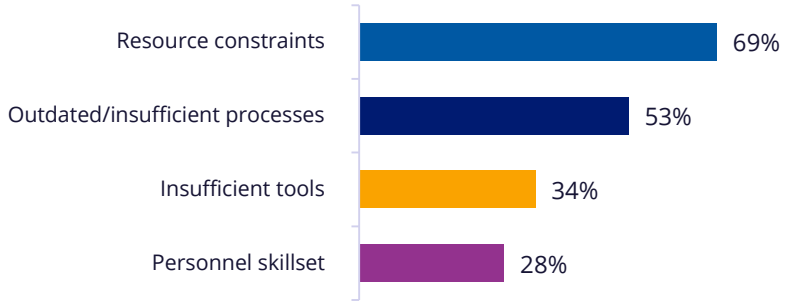
With this understanding, financial institutions can deliver an increased level of service, identify opportunities to expand the relationship, and carefully monitor runoff so maturing accounts can be profitably replaced. Conversely, looking at low-profit, high-balance relationships lets institutions cross-sell more profitable products to increase the overall relationship value.

3. Inadequate resources, processes, and tools hinder the ability to compete in today's market.

Resource constraints (69%) and outdated/insufficient processes (53%) are the biggest hurdles to financial planning and analysis. Interestingly, these may be holding back employees who have the education or prior experience to perform more advanced analysis than their resources support, as only 28% say personnel skillset hinders financial planning and analysis.

Updating and streamlining processes (as described later in this report) can free up time for value-added analysis and problem solving.

What challenges does your institution face with financial planning and analysis? Please check all that apply.



OUR POINT OF VIEW

When economic conditions are uncertain, there are two schools of thought related to technology investments. The first, of course, is to minimize "unnecessary" spending until conditions improve. The second is to invest in the people, processes, and tools to put an institution in much better shape to adapt during the uncertain times and excel when conditions improve. These investments have proven wise on numerous occasions. Here are a few examples:

A CFO at a mid-sized credit union says the proper software tools allow analysts to "spend the majority of their time on strategic analysis and running 'what if' scenarios versus creating and fixing reports and Excel spreadsheets, which is a much more impactful use of their time. We've already seen significant benefits from the ability to leverage one single source of truth."

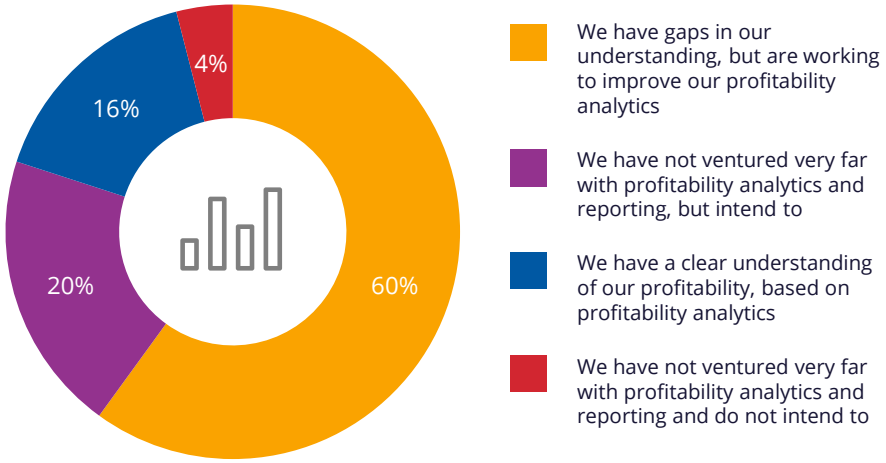
The Vice President at a mid-sized bank said the institution formerly could only forecast production at the bank level, using that forecast to calculate aggregate numbers for loan interest income, and deposit interest and expenses. Following a software investment, the bank can allocate by department, apply assumptions for runoff and interest rates, create variance reports, and hold commercial loan teams accountable for individual loan rates.

Investing in the right tools and technology helps turn the tide during difficult times by giving financial leaders the insights and information they need to get ahead of the competition and maximize profitability across all revenue streams. For example, understanding with high accuracy the products, branches/departments, officers, and relationships that drive profitability can help institutions find precious basis points when margins are tight. The right tools and processes also create efficiencies when resources are scarce, allowing more time for analysis.

4. Many institutions lack sufficient profitability insights to know where to focus and invest.

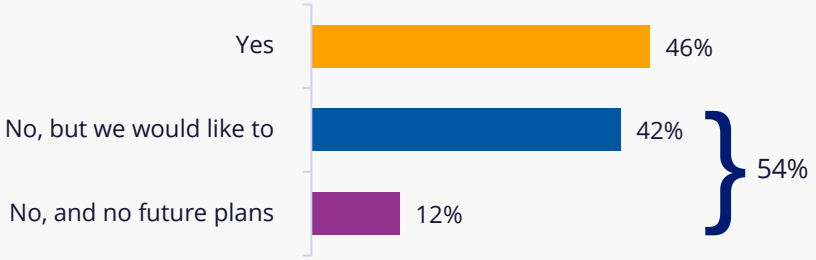
Only 16% of respondents have a clear understanding of their performance based on profitability analysis. Sixty percent say they have gaps in their understanding but are working to improve, and 24% have not ventured far with profitability analysis.

Which statement best describes your profitability analytics reporting?



One glaring gap even for those institutions that have profitability analysis tools is the inability to calculate the risk-adjusted return on capital (RAROC), cited by over half of respondents (54%). Without factoring in risk, institutions hinder their ability to accurately analyze which branches, products, customers/members, etc., drive profitability.

Are you able to calculate the risk-adjusted return on capital (RAROC)?



OUR POINT OF VIEW

The typical general ledger-focused view of an institution limits what an organization can learn from their data. Profitability analytics and reports provide a deeper understanding of what truly drives performance, and can help guide decisions about where to focus attention and investments.

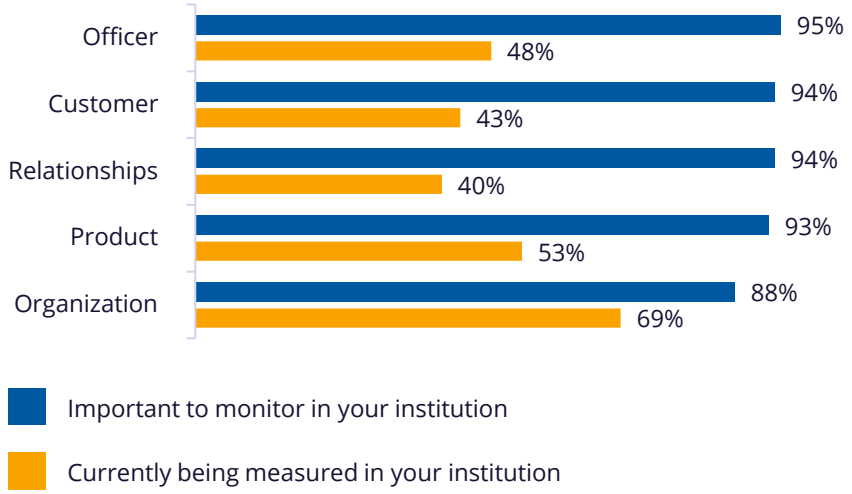
The most meaningful insights come through an actionable profitability framework, which can help answer questions such as:

- Which products, customers, channels, organizational units, products, officers, channels, or market segments are profitable?
- What is the true contribution to the institution of products, customers, and relationships, after accounting for risk?
- How do changes in volumes and mix of products impact contribution?
- How do we effectively price our products and services?
- How can we best manage our net interest margin?
- What is the cost of providing our products and services?
- How can we better manage resources while maintaining or improving service levels?

5. There is a significant gap between what finance leaders feel is important to monitor and what they actually measure and track.

This disconnect between what should ideally be measured and what in reality is monitored is quite stark and reflects a multi-year trend. This year's survey, for example, shows that 94% of respondents feel it is important to monitor relationship profitability, but fewer than half (40%) actually do so. Most (95%) feel strongly about monitoring officer profitability, but only 48% monitor it. The disconnect for measuring customer profitability is similar, with 94% believing it important and just 43% monitoring this critical metric.

Which profitability dimensions are: Important to monitor vs. currently being measured



Gauged year-over-year, the percentage of respondents who believe it's important to monitor these aspects of their institutions has been increasing, while those who actually do has remained the same. According to the 2019 report, 87%-91% responded that monitoring relationships, customers, and officers was important. However the rates of those who monitored these dimensions varied widely for relationships (43%), customers (41%), and officers (55%).

OUR POINT OF VIEW

This continuing disconnect likely ties back to institutional hurdles around resources, processes, and tools — which supports the need to make investments that enhance capabilities and efficiency to empower more meaningful analysis.

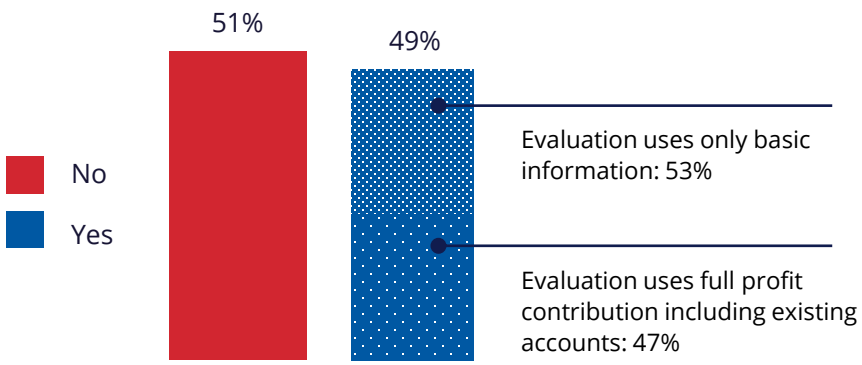
In today's uncertain economic times, as institutions struggle to find every basis point of margin, it is critical to accurately understand what is driving profitability within the institution. Knowing, for example, that five-year auto loans currently are your most profitable loan product might pave the way for a big marketing campaign. Identifying the most (and least) profitable branches, especially with trend reporting over time, can also support data-driven decisions, such as helping to evaluate whether to close a particular branch.

6. Relationship pricing is underutilized for supporting the value exchange.

Relationship managers are unable to evaluate the impact of new business on a customer's overall relationship at just over 50% of financial institutions. Even among those who say they can, over half can only conduct an evaluation using basic information.

Interestingly, there's a 9% gap between the respondents reporting that they currently monitor relationship profitability (40%, shown on previous page) and the 49% who say relationship managers can evaluate the impact of new accounts on a customer's overall relationship, This suggests that more respondents could be monitoring relationship profitability, but elect not to do so — perhaps feeling it is too time-consuming or complex.

Do your relationship managers have the ability to evaluate the impact of new accounts on a customer's overall relationship?



To create a culture of profitability across the organization, financial institutions must not overlook any opportunities. By bringing relationship profitability information from the back office to the front lines, institutions can leverage data to drive day-to-day decisions that improve relationship value and customer service. (Learn more)

OUR POINT OF VIEW

Building on your understanding of a client's sphere of influence and empirical profitability, each deal you make must add value rather than dilute it.

Coupled with an understanding of the customer's current profit contribution to the institution, the ability to understand how proposed new business impacts profitability hurdle rates (such as RAROC) and to compare pricing scenarios before making a deal empowers relationship managers to achieve a win-win for the organization and for the customer.

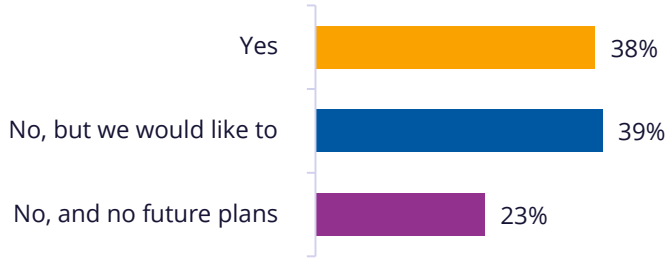
For the institution, value can be created through enhanced earnings (perhaps adding fees or new deposits to offset a lower interest rate), profitable growth, retained or improved relationships with top clients, and an efficient process for loan officers and relationship managers. Customers benefit, too, through faster decisions, options to meet their needs, and a stronger relationship with the institution, focused on long-term value.[4]

[4] Levey, K.: "Squeezing More Margin from Your Portfolio: It's All About Relationships." Kaufman Hall. https://www.kaufmanhall.com/ideas-resources/article/squeezing-more-margin-your-portfolio-its-all-about-relationships (retrieved Dec. 20, 2019).

7. The way employees are evaluated often does not align with how the institution is measured.

Only 38% of respondents say they include profitability as a metric in calculating incentive compensation for their employees. About as many (39%) would like to include profitability as a metric in calculating incentive compensation, but do not currently do so. This is likely because those institutions cannot accurately determine the profitability of a client, a single piece of business, or a portfolio, which is needed to calculate profitability-based compensation.

Does your institution include profitability as a metric in calculating the incentive compensation of employees?



For most institutions, losing even one top relationship can seriously impact margins. A majority of value is generated by the top 1% of relationships, and only 20% of clients, on average, create economic profit.[5]

Especially during times of economic uncertainty, it's critical for institutions to understand the value of each relationship, tying the profitability of those relationships to the compensation strategy for relationship managers.

[5] Huber, J.-A., Steclik, I., and Olsen, T.: "How Leading Banks Manage Corporate Client Profitability." Forbes, June 5, 2017. www.forbes.com/sites/baininsights/2017/06/05/how-leading-banks-manage-corporate-client-profitability/#2fec1d8f78fb (retrieved Dec. 20, 2019).

OUR POINT OF VIEW

Using profitability to calculate incentive compensation may seem difficult, but it's actually quite manageable with the right tools and strategy.

One financial planning Vice President recommends ensuring that relationship managers are incentivized on net contribution, the same basis as the institution. Ranking reports based on 12-month contribution can show which relationship managers deliver the most value, rather than traditional volume-based metrics. "There are no payouts to officers with unsatisfactory profitability or no net growth," said the Vice President.

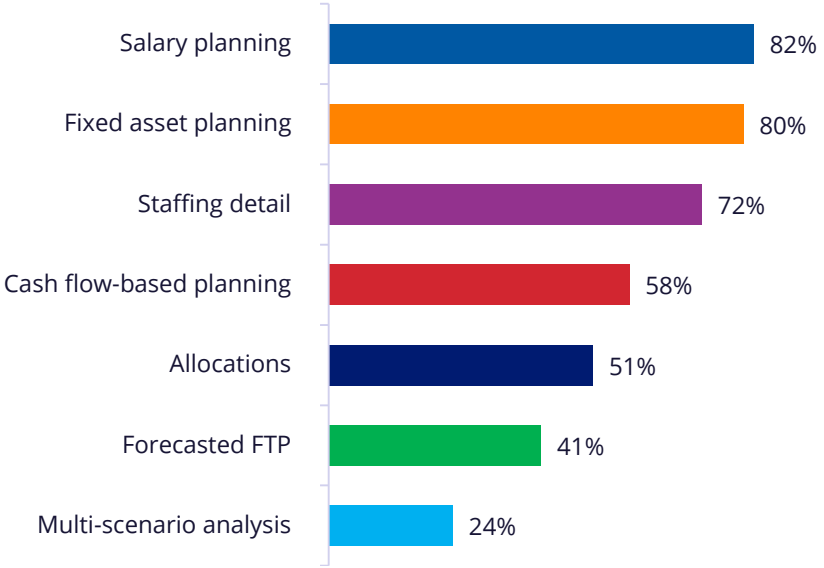
The most effective portfolio management starts at the relationship level, employing best practices to optimize profitability through relationship value by:

- Understanding the makeup and value of each relationship
- Empowering relationship managers to drive value
- Pricing and managing business based on relationship value
- Generating consistent profitability data across all dimensions

8. Use of cash flow-based planning, funds transfer pricing (FTP), and scenario planning can improve the finance team's ability to be nimble.

Citing the various components included in their budgets, surprisingly few survey respondents include multi-scenario analysis (24%) and forecasted FTP (41%). Also, the majority of respondents are only somewhat confident (66%) or not at all confident (5%) in their teams' ability to quickly and easily make adjustments to financial strategies and plans if business circumstances change suddenly. This lack of confidence seems to align with not including scenario analysis data in the budgeting process.

Which items do your budgets include? Please check all that apply.



OUR POINT OF VIEW

The lack of multi-scenario analyses is troubling. As part of the budget process, finance executives in progressive institutions run stress scenarios and forecasts to gauge the impact of specific pressures — such as a continued decline in interest rates — on deposits and loans. This allows analysis of stress scenarios at a granular level and provides an opportunity to modify the budget and develop appropriate targets and mitigation plans throughout the year.

Forecasted funds transfer pricing (FTP) informs the budget, enabling the finance team to better plan for margin changes by understanding the expected net interest margin (spread) and income (dollars) by initiative and segment. Reported FTP use is down, however, from 48% last year to 41% this year, indicating reduced agility to react to market changes.

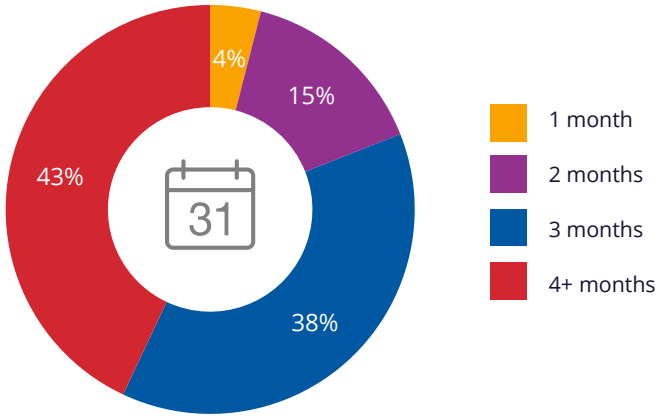
Cash flow-based planning was included in budgets by 58% of finance teams, up from 46% last year. While still low, this is a positive trend; cash flow-based planning increases plan accuracy with regard to balances, net interest income, and margin projections. It also offers enhanced focus on both the volume and spread of incremental new business.

9. Outdated budgeting processes and systems contribute to long budgeting cycles and inaccuracies.

Among survey respondents, 43% of institutions cited budget cycles taking four months or longer.

It appears that such long budgeting cycles are due in part to reliance on spreadsheets. More than a quarter of respondents (27%) primarily use spreadsheets for budgeting and performance management, slightly up from last year's responses (25%).

What is the length of your budgeting cycle, from initial roll out to board presentation?



Those institutions are missing out on a variety of benefits, including:

- A faster budget cycle, leaving more time for analysis
- Increased accuracy, as spreadsheets are error prone
- Better version control and scalability
- Improved data integration and integrity
- Enhanced workflow, process controls, and collaboration
- More secure data access, with permissions access by role
- Ease of publishing and reporting data

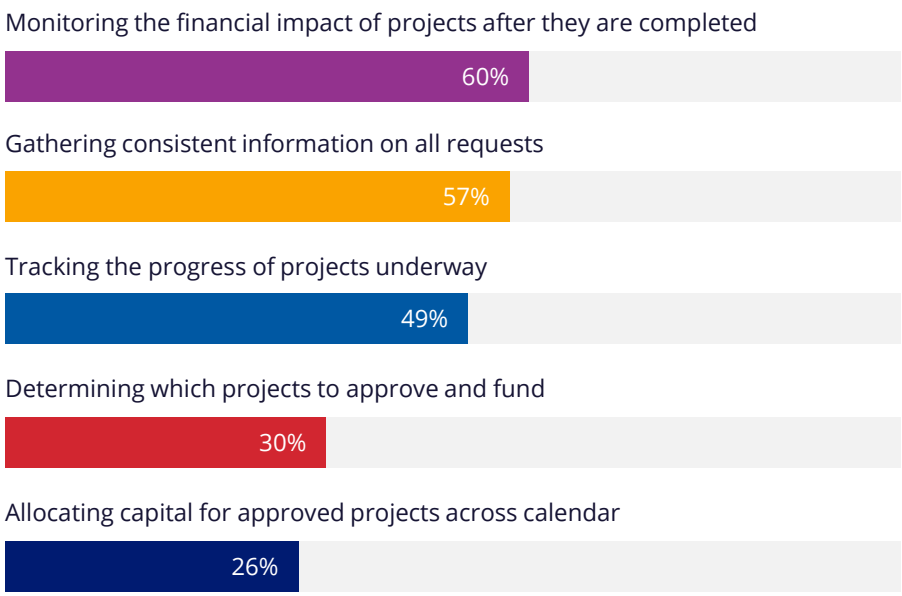
When budgeting starts to consume more than a calendar quarter, there is a recognized need for change. In addition to moving away from spreadsheets, efficiencies can be gained by moving to a unified data platform and automating processes for data collection and report distribution.

10. Capital project tracking lacks appropriate discipline and follow-through to ensure efficacy.

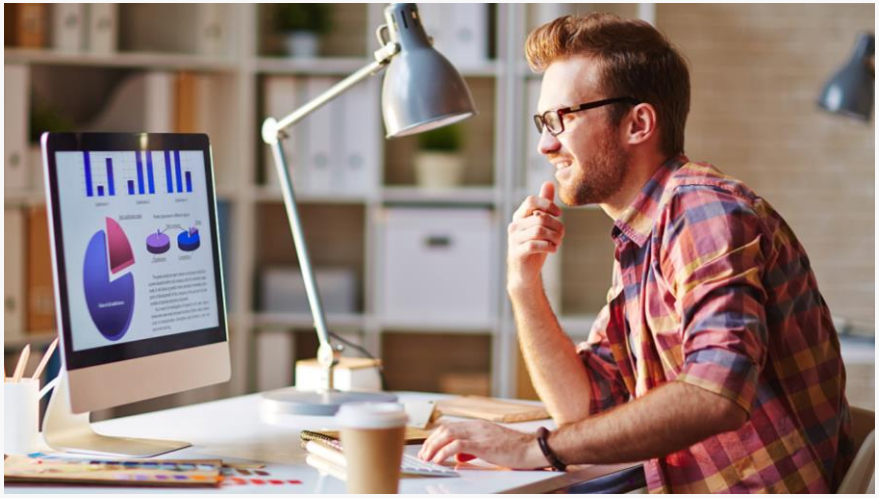
It's not surprising to discover that financial institutions keep much better track of the day-to-day operational metrics than they do of longer-term metrics, such as capital project tracking. Many institutions are challenged by monitoring outlays for such capital projects as building a new branch or upgrading ATMs.

Monitoring the financial impact of projects after they are completed was identified as a challenge by 60% of respondents. Other difficult tasks include gathering consistent data on capital requests and tracking the ongoing progress of projects.

Top 5 challenges related to planning and managing capital projects



Compounding the failure to monitor the financial impact of capital projects post-completion, most financial institutions (70%) also do not compare project costs to projected targets defined when the project was approved.



OUR POINT OF VIEW

Capital project tracking capabilities can be significantly enhanced through technology. Purpose-built systems improve fiscal accountability, for example, by tracking variances from budget during a project and after completion.

Because a capital project tracking system can integrate projects with budgets and forecasts, it can also eliminate siloes and empower project managers and executives to assess the impact to unit-level and enterprise goals.

In the face of economic uncertainty and increased competition from payment services, retail apps, online banks, and more, institutions of all sizes need strategies to maintain a healthy net interest margin and thrive in 2020 and beyond.

Based on the survey data, financial institutions should focus on 11 strategic priorities to overcome challenges and maximize opportunities to grow profitably:

Addressing Economic Uncertainty

1. Gain actionable insights for data-driven decision-making, creating and managing planning models that are connected to market and operational drivers.
2. Better predict net interest margin and improve accuracy of predicted cash flows.
3. Increase profitability by understanding where profit is coming from across customers, relationships, branches, channels, officers, and products.
4. Ensure that profitability analyses and pricing adequately consider portfolio concentration, credit, and reputation risks.
5. Accurately assess the profitability of customer relationships and create portfolio management plans for each relationship tier.
6. Design incentive compensation plans that fuel profitable growth, measuring employees on net contribution.

Gaining a Competitive Edge

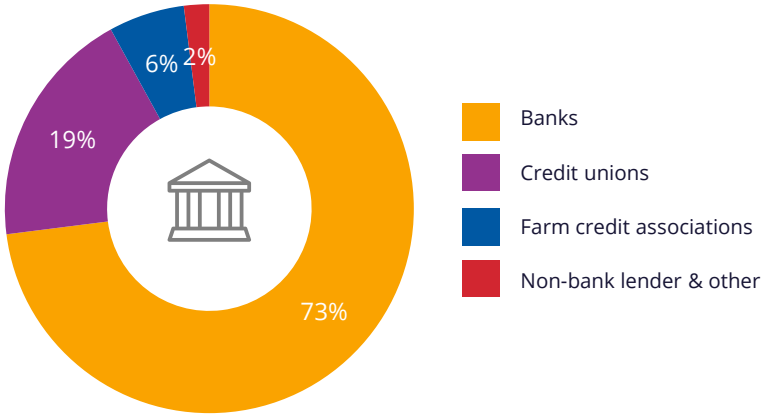
7. Follow industry standards by encompassing cash flow-based planning, funds transfer pricing, and scenario planning as routine elements in planning processes.
8. Improve accuracy and transparency using a single platform for financial performance management.
9. Enhance reporting and analytics through dashboards that help executives better understand why results matter.
10. Create more time for analysis and innovation by automating processes for data collection and report distribution.
11. Prioritize portfolio management by identifying top-performing relationships, products, and relationship managers.

Now is the time for financial institutions to invest in technology that delivers efficiency gains, so employees have more time for value-added analysis and can focus on activities that drive the most profitable growth.

To assess progress with performance management in the nation's financial institutions, Kaufman Hall surveyed CFOs, vice presidents of finance and treasury, directors of finance, and other senior finance professionals[6] in the nation's banks, credit unions, and farm credit associations.

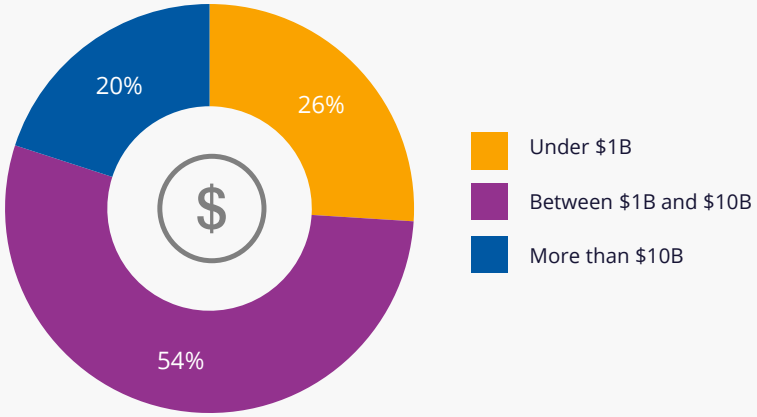
This publication is the fourth annual outlook report. Kaufman Hall conducted the survey for the 2020 report from Sept. 17-Oct. 11, 2019.

Executives from different types of financial institutions participated, with representation as follows:



A little more than one-quarter of respondents (26%) were from institutions with assets under $1B; more than half (54%) were from institutions with between $1B and $10B in assets, and 20% were from institutions with more than $10B in assets.

This report presents 10 key survey findings and their implications.



[6] When reporting the results, we use "CFOs" or "senior finance executives" to describe all respondents.

Ken Levey

Ken Levey is a Vice President with Kaufman Hall, with a focus on the firm's Axiom Financial Institutions Software products for banks, credit unions, and farm credit associations. His responsibilities include setting the vision and strategy for Kaufman Hall's financial institutions software business. Mr. Levey leads product management for the Axiom Financial Institutions Software Suite and works across functional groups to ensure the success of our software customers. He has more than 35 years of experience in the financial institutions industry. His areas of expertise include analytics, business intelligence, asset/liability management (ALM), funds transfer pricing, and enterprise performance management.

Prior to joining Kaufman Hall, Mr. Levey was Senior Director for Banking Analytics at SAP BusinessObjects, where he was responsible for developing performance management and analytic applications for the banking industry. His previous experience includes serving as Vice President of Asset/Liability Management at Seamens Bank and Vice President at IPS-Sendero (Fiserv), where he led development of the ALM system and managed the company's ALM and funds transfer pricing implementation and consulting departments.

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