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## **Bang for your Buck: Principles for Improving Your Return on ABC**

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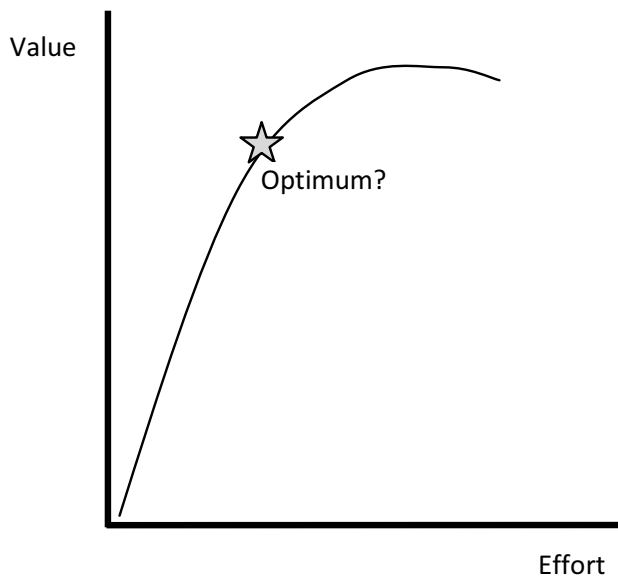
The current economic climate has banks looking to dramatically reduce their spending levels and focus on core, essential services. As such, the need for banks to improve their understanding of cost and profitability dynamics has never been greater. While we might have expected to see a dramatic reduction in the interest levels for cost and profitability initiatives as a result of spending freezes, organizations are continuing to invest in these capabilities, although in fundamentally different ways. Based on our experiences with a number of leading banks, this paper sets out a number of principles that are being followed by these banks as they seek to improve their own Return on Investment from costing and profitability. The principles we have identified are transforming the way we work with banks to strengthen the value provided by Finance.

### **Overall Objective: Building your ROI from Costing**

Successful costing professionals approach cost and profitability initiatives with a keen eye to the tradeoffs between effort and value from their work. There are many points in the evolution of a program where the marginal value created is less than the incremental cost of staff efforts or systems consumed in its production. Finding the “sweet spot” on the Marginal Value Curve (Figure 1) requires more art than science, and comes at many different points:

- the level of activity detail
- the level of resource detail
- the precision of time measurement
- the level of cost differentiation by product or customer attribute, etc.

**Figure 1 - Marginal Value Curve**



## **Principle 1: Cost Study Triage**

The days of the multi-year, multi-phased approach to building profitability information systems have passed. By the time that management decides to invest in profitability information, the need for actionable information is immediate. How can a streamlined team deliver value in the most effective

way? The first principle directs us to focus efforts in a prioritized fashion. The priorities will differ amongst banks. Those with an immediate need to reduce costs may focus on large, actionable cost items – often in operational areas. Others with a strong need to optimize their return on capital may focus on profitable pricing or targeting market segments. In general, there are a number of criteria to support this selection:

- **Size does matter.** Focusing on areas with large staff groups provides the best opportunity to yield substantial improvements in cost. Pilot areas used to initiate new programs, which formerly were identified for being small and isolated, are increasingly being focused on large, complex areas as firms target immediate returns on their costing investments.
- **Scalability and Variability** – simply put, banks need to put their focus on items with highly variable (or step-variable) cost functions, as the timeline to change infrastructure is too long and complicated. By focusing on costs which can be impacted in the short-term, the initial yield from costing can be impactful – thus funding work in other areas.

- **Related Items** – many activities are related to similar cost drivers. We have been working to increasingly relate detailed activity costs to summary drivers of profitability – for example, aligning detailed costs with high-level metrics such as trades. By focusing on the components of Cost per Trade, we can create a better understanding of the factors that cause variability in this important metric – such as exception processing – and create actions to target these costs in a measurable way. By grouping costs together, banks can achieve greater focus and create more impactful cost information.
- **Level of Detail** – a constant optimization quest. In our experience, operational teams often pursue significant precision in measuring activity costs, when in many cases data volumes to support this analysis are not readily available or the level of accuracy of detailed time measures requires multiple assumptions. As a rule of thumb, focusing on the unit cost “to the left of the decimal” provides a good perspective as it relates to the decisions that need to be made.

Triage can also seek to combine expense line items. With staff and related costs often comprising 60% or more of a bank’s cost structure (and in many cases, over 80%), providing substantive detail of non-staff costs produces negative returns. We actively encourage banks to aggregate non-interest expense lines as much as possible – frequently to less than 10 lines per cost center (although this can flex in centers with specific, large flow-through costs or technology items.)

## **Principle 2: Capacity before Costing**

When the bulk of an organization's costs are staff or staff-related – including the provision of space and technology to enable the staff, and the cost of supervisory staff – how can we best manage these costs? Traditionally, staff improvements have come through a focus on improving productivity and efficiency, through improved uses of technology and operational process improvement. But for most organizations, adding or subtracting staff is not something to be toyed with lightly. Hiring and training staff to the point of required proficiency is costly and time-consuming. Removing staff can create strain on critical performance drivers such as Customer Satisfaction and Employee Engagement, and often has a lagging financial effect – especially when augmented by casual or contract staff.

With this backdrop, many organizations have turned to measure and manage staff capacity, most recently through the use of Time-Driven techniques (see more detail below). With an improved understanding of the relationship between key business drivers and the operational staff required, banks can plan their staffing needs better, and create proper structures to optimize staff levels, as well as to cross-train and lend resources. For example, if Trade volumes are expected to rise, and new programs are expected to reduce the rate of exception processing, the organization can better predict the levels of staff needed much further in advance.

What is perhaps newest about this type of thought is that by building strong measures of Capacity utilization and its drivers, the orientation of a bank's cost model can shift dramatically.<sup>1</sup> With the inclusion of a few technology measures – core transaction processing support, application development, end-user computing, and third-party processing costs – between 80-90% of most banks' variable costs can be effectively modeled. Focusing on Capacity is the critical element of triage – improving a bank's “Bang for the Buck”.

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<sup>1</sup> Staff and related costs generally represent at least 50 -70% of a bank's variable cost structure.

Some banks are now focusing their entire efforts *first* on capacity analysis, and then using the relative consumption of time as the basis for cost allocation, with other simplified measures used for the allocation of non-staff costs at a higher level. This approach dramatically improves the value leverage of cost information.

### **Principle 3: Avoiding low-value data - Use Factors instead of Proxies**

Directionally-correct information provided today is worth significantly more than accurate information produced six months hence. Greater computing power, the increasing differentiation and heterogeneity of business processes, and the desire for operational managers to “sweat the details” can often drag costing practitioners into excessive levels of precision. Costing professionals always need to ask if the improved informational precision would improve the quality of the decisions that the information is designed to support. The effort is not only in the initial cost development phase; the ongoing effort for collecting detailed data to support this precision can be significant.

When precision or differentiation is required – because the bank wants to use (not just see) differentiated costs to drive pricing or segmentation - how can we create that precision without creating an ongoing maintenance nightmare, or without burdening the organization with the need for new drivers to be extracted from operational systems? One technique we have been using most recently is to “factor” detailed tasks against a higher level driver (see Figure 2). By monitoring and adjusting the factors periodically, and tweaking the factors based on behavioral cost differentiation, we can create a much more flexible and responsive model.

**Figure 2 - Factoring Volumes from Higher-Order Drivers**

							A	B	C	D = A x B	E = C x D
Activity Name	Task Name	Driver Name	Product	Driver Volume	Factor	Task Unit Time	Task (Factored) Volume	Task Time			
Maintain Accounts	Name/Address Changes	Active Accounts	DDA, Savings	21,000	0.00095	6.0	20	120			
	Service Issues	Active Accounts	DDA	17,000	0.00190	11.0	32	355			
	Service Issues	Active Accounts	Savings	40,000	0.00190	11.0	76	836			
	Provide Statement Copies	Active Accounts	DDA	17,000	0.01430	4.0	243	972			
	Check Orders	Active Accounts	DDA	17,000	0.02850	3.5	485	1,696			
	Balance Customer Checkbook	Active Accounts	Retail DDA	11,000	0.02850	14.0	314	4,389			
Underwrite Loan Applications	Non Automatic Applications (Non-HELOC)	Applications Received	Direct	7	1.00	5.0	7	35			
	Non Automatic Applications (Non-HELOC)	Applications Received	Indirect	12	1.00	3.0	12	36			
	Non Automatic Applications (Non-HELOC)	Applications Received	HE	3	1.00	12.0	3	36			
	Non Automatic Applications (HELOC)	Applications Received	HELOC	1	1.00	12.0	1	12			
	Conditioned	Applications Received	All	23	0.20	2.5	5	12			
	Declined	Applications Received	All	23	0.35	1.0	8	8			
	Rehash Indirect Loan	Applications Received	All	23	0.20	3.8	5	17			

**Explanation:**

Specific volumes are not available on a regular basis at the Task level. An initial survey is made to determine the relationship between Task Volumes and Activity (Driver) volumes; these Factors are then used on a regular basis to support calculations of simulated task volumes and task time.

## **Principle 4: Time Driven Costing - Shift from Unit Cost to Unit Time**

Traditionally, banks have approached costing in a two-stage process: *First*, determine a set of unique activity unit cost rates – sometimes differentiated based on customer behavior; *Second*, apply those rates to activity volumes to determine costs by product or customer. While this is a simple approach, the maintenance of large cost rate tables consumes substantial effort. For example, rates must be adjusted when costs change in a branch, or when the mix of business shifts. In most complex banks, keeping cost rates current is an ongoing task. We have seen banks with many tens of thousands of rates being maintained.

Much has been written previously on the topic of Time-Driven Costing<sup>i</sup>, and we have been pleased to see the movement to increasingly leverage these concepts in bank costing models. The three core changes that we have been promoting are:

- Focusing measurement around unit time standards (e.g., the number of minutes to process a given transaction with specified cost object attributes). As an example, different time standards for a personal checking account deposit at the teller vs. a commercial checking account deposit. These unit times can be standardized across the entire bank using comparable platforms, and need only be refreshed when processes change.
- Unit cost rates are computed *dynamically*, excluding unused capacity. This is an automated approach vs. the manual updates of rates required in a traditional approach. These dynamic rates can be differentiated by branch if needed, to represent the different cost structures associated with alternate branches. As a by-product, of course, this provides information on the cost of used and unused capacity.



- Increasing computer power has allowed cost and profitability information to be computed at lower cost object levels than before – measuring unique transaction costs by specific instruments. This provides the ability to roll-up profitability information to accounts, products, customers and households in simple ways, compared to the traditional top-down allocation approach, or the historical “triad” model which separates out organizational, product and customer information in different models and tools.

Over the past few years, much of the development and practice in this area has been supported by a single ABC software vendor. With a growing acceptance of these approaches by banks (and other companies), some other software vendors have been able to effectively incorporate this approach in their own packages, although in different ways. We are excited to see this new approach being made more widely available, which has great power to lower the cost of ABC implementation and maintenance for adopting banks.

### **Principle 5: Use ABC as a Sustainable Cost Reduction Laser**

When banks engage in cost reduction programs, a first reaction is often to introduce across-the-board cost cuts. Much has been written about the unfairness of this approach, which fails to distinguish between costs of unused capacity, inefficiency, improvement initiatives or value-creating abilities.<sup>ii</sup> In lieu of the cost reduction hatchet, banks can use ABC as a laser to focus on improving profitability through a combination of targeted cost reduction and pricing/market optimization. With a cost program already in place, this can be readily accomplished. But can a bank *without* a sophisticated cost program achieve any benefits with a more targeted approach?

Our comprehensive approach to this uses an abridged form of a functional costing methodology, whose principle steps are shown in the following table.

## Sustainable Cost Reduction Methodology (summary)

### Establish Focus

- Use triage approach
- Identify high potential areas for actionable cost improvement

### Conduct Measurement and Analysis

- high-level process mapping;
- process time and cost development using time-driven principles;
- capturing of key business volumes and calculating usage of FTE s and associated cost by activity;
- analysis of results, focusing on resource consumption by type of activity; productivity measures; capacity utilization; cost of quality measures; etc

### Set Baselines and Targets

- Cr ate bas line r easur s and cost improvement targets through cost analysis, benchmarking and target costing

### Create Action Plans and Measures

- Create specific action plans which target improvements such as:
  - Reducing activity volume - Identifying high-cost activities which can be eliminated, or migrated to lower-cost options (such as self-service)
  - Reducing activity unit time - Identifying opportunities to improve process efficiency through re-engineering and/or improved use of technology
  - Reducing activity resource cost rates - Reduce labor costs through outsourcing of low-value-added functions (such as payroll processing)
  - Improve utilization - Effective resource deployment through staff scheduling
  - Operational Sizing - Elimination of unusable excess capacity

### Continuous Measurement and Improvement

- Use a simplified capacity-driven cost approach
- Provide an ongoing mechanism to measure and improve over time, along with trackable, transparent measures of performance

The overall goal is to provide an efficient, laser-like focus on key profit improvement opportunities, and then to turn it into a sustainable process through the use of “light” costing models until a more comprehensive approach can be implemented. Often, large consulting firms use Excel-based models to identify cost reduction but these models have limited utility after the engagement ends. Our approach seeks to use a methodology and toolset which can produce more lasting value and sustainable profit improvement.

### **Principle 6: Get the Value Out**

With all the effort consumed by a costing program, are you making the most of this information to create value in your bank? Some key ways that banks are looking at this are identified below:

#### *Link to other initiatives and tools*

- Cost and capacity information is highly leverageable for initiatives such as Business Process Improvement or Six Sigma. Information can be used to identify the cost of low-value-added work, or avoidable exception processing, and to quantify and prioritize potential savings for improvement business cases.
- Staff scheduling tools can leverage time-driven capacity measurement information. This creates immediately actionable information in the largest non-interest variable (volume-sensitive) expense item on a bank’s P&L.
- Performance Management dashboards and portals, and Key Performance Indicators, should be based on using profitability data resident in Finance Data Warehouses or the underlying business volumes tracked and used. It is important to pursue “one source of the truth”, so that information is believable.

- We are beginning to see movements to measure and reward lending officer performance based on account or relationship profitability. Integrating cost, profitability, sales management and incentive tools can provide a powerful way to measure and manage an effective sales force.
- Many practitioners have pursued the holy grail of integrated planning, forecasting and profitability. While this remains an aspirational goal for many, the tools and underlying data structures that support this process are becoming more mainstream. We expect to see much progress in this area over the coming years.

### *Leverage the resources outside of Finance*

While the sure sign of failure of a profitability project is one that is staffed by Finance, perhaps the greatest harbinger of success is a program directed or heavily led by staff outside of Finance – most preferably Operations. In large banks, a first step is to involve Finance personnel attached to Lines of Business. In our view, this is good but insufficient.

Costing processes should heavily involve operational groups that manage processes and measure efficiency, productivity and resource utilization. Costing models should leverage the time standards (the mathematical inverse of productivity) as the basis for time-driven costing systems. Workflow systems - the lifeblood for operational management – provide the core systems data to support cost models.

By leveraging operational management and the data they use on a daily basis, the trustworthiness of costing information increases dramatically, as does the likelihood that the information will be used as the basis for decision-making. In a period of constrained resources, leveraging non-Finance teams not only increases the level of project success, but also dramatically reduces the incremental cost of implementation.

### *Shift the focus from costing to analysis*

The system is installed and validated, the celebrations have occurred, the trinkets distributed to memorialize the project with its special name or very own three-letter acronym and the initial report set has been distributed. As children ask on a road trip, “*Are we there yet?*” The ongoing care and feeding of the costing system includes many components – monthly model maintenance, data cleansing, system operation and report distribution for starters. Additional resources are needed for updates to costing studies, to keep up with organizational and process change. But – what are we doing to analyze and deploy the information in decision-making processes?

Building analytical capabilities and competencies (and tools, as discussed below), both within Finance and at the end-user level is a critical element of driving value from costing. Banks are looking to find cost solutions which require less ongoing maintenance, and then shifting those resources into analysis so that the value contained in the information can be unleashed to benefit the organization.

### *Feed the data warehouse*

Costing professionals benefit heavily from the investments that their organizations have made to source, scrub, validate and organize data from source operational systems into various data warehouses or datamarts. Now, Finance is able to contribute operational cost and profitability information back to the organization. The benefits of this approach are numerous:

- Users of cost and profitability information for analysis can use bank-standard tools for reporting and analysis, leveraging the bank’s investments in technology and training, and providing direct access so that users do not place heavy demands on Finance for analysis. This does, however, require Finance to both document the assumptions and structure of the cost information (best practice is to do this within the warehouse’s metadata), and to provide training not only on how to access the information, but more importantly, on how (*and how not*) to use it in analysis.

- Information can be linked to other databases; for example, linking customer profitability information to various geo-demographic attributes, or linking unit cost results to pricing models.
- As information becomes more widely accessible, the value from the use of the information increases, and the demand for new insights rises. Eventually, most organizations will work to align the data with performance measurement and compensation systems. When this occurs, the bank is able to more fully align decision-making around a single source of the truth; discussion shifts quickly from arguing about the accuracy and consistency of the information, to learning what the information *means* and how it can be used in decision-making.

### *Measure the Value Created*

When value is created through costing initiatives, it is critical that the value be measured. Often, teams identify potential savings or profit improvement opportunities but fail to implement them. Only when decisions are actually made and results occur can true value actually accrue to the organization. As is often said, what gets measured gets done.

### **Conclusion**

Banks are rapidly shifting their emphasis on costing and profitability systems to achieve the most value from fewer resources and efforts. By following the principles and approaches above, banks will be better able to optimize their search for improved return on their costing investments.

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<sup>i</sup> See for example, ABC Trends in the Banking Sector - A Practitioner's Perspective, Journal of Performance Management, Volume 21, Number 1; and Leveraging Process Documentation for Time-Driven Activity Based Costing, Journal of Performance Management, Volume 20, Number 3.

<sup>ii</sup> See for example, the recent article by Leslie Kren, Using Activity-Based Management for Cost Control, Journal of Performance Management, Volume 21, Number 2.