Using the efficiency ratio to monitor bank profitability improvements

By Lynn A. David

Community banks have used the efficiency ratio as a key performance measure for more than 20 years. The elements of the widely familiar equation are total non-interest expense divided by net interest income plus total non-interest income. The operational efficiency yardstick measures a bank's operating expenses as a percentage of revenue.

The goal of most banks is to get their efficiency ratio to 50 percent or a little bit less. Achieving a 50 percent ratio means a bank is earning twice as much as it is spending to generate these earnings. Today, striving for the 50 percent optimum goal has become one way to help many community banks remain independent.

Some community bankers and profitability experts believe that as banks grow, it becomes more difficult for them to maintain a low efficiency ratio. Others feel that banks with more locations normally have higher operational costs per assets or per employee, and therefore have a higher efficiency ratio.

United Bank of Iowa, headquartered in Ida Grove, Iowa, has been successful regardless of size and number of locations. Consider these statistics. The bank has total assets of $1.3 billion and 27 locations. Its five-year average efficiency ratio was 48.32 percent, its average pretax return on average assets was 1.85 percent, its average return of average equity was 17.13 percent, and its average equity capital to total assets was 10.45 percent. During the five-year period from December 2010 to December 2015 the bank's total assets grew from $1.1 billion to $1.3 billion, and its equity capital grew from 9.24 percent to 11.14 percent. Its pretax net income per full-time equivalent held constant at more than $92,500 during the five-year period.

None of this happened by accident! United Bank of Iowa's senior management team monitors all components of its non-interest income and non-interest expense on a monthly basis. The three largest non-interest expense items are normally salary and employee benefits expense, premises expense and data processing expense.

During the summer of 2015, the bank analyzed the customer traffic pattern at 25 of its current 27 locations. As a result of this project, the bank decreased its hours of operation at 24 locations from as few as two hours per week to as many as 17 hours per week. The immediate impact was the elimination of most overtime in the retail locations. It is important to note that these changes were implemented without any significant reduction in customer service. The long-term benefit will be a decrease in the bank's required staffing in the retail locations of approximately 20 full-time equivalent positions.

United Bank of Iowa reviews its personal and business deposit products and miscellaneous fees on an annual basis to identify opportunities to improve fee income. The bank also reviews each category of non-interest expense to identify opportunities to decrease expenses. It also pursues a "continuous improvement" process to regularly monitor the efficiency of its operations.

Owen Bolte, United Bank's chief executive officer, says that both efficiency and effectiveness must be considered when making all operational changes. He says the bank reviews industry salary surveys each year to help ensure all of its employees are fairly compensated to help maintain low employee turnover.

During the five-year period from 2010, the bank's non-interest income to assets fell slightly from 0.68 percent to 0.61 percent. However, its non-interest expense to assets remained stable at about 1.94 percent.

Like many banks, its net interest margin fell 29 basis points during the five-year period from 3.73 percent to 3.44 percent. Its loans to total assets remained stable at 80 percent. However, it increased its allowance for loan loss from 1.32 percent to 1.71 percent of total loans.

In summary, the efficiency ratio remains an excellent measurement of a bank's success. However, there is no magic pill or one solution to making operational efficiency improvements. It requires a review of products, services and business processes on an ongoing basis to successfully improve and maintain a strong efficiency ratio.