Reprinted from

The Nolan Newsletter

People, Process, Technology

Fourth Quarter 2003

Breaking Down the Bank Efficiency Ratio

By Robert L. Keene
Director, Banking Practice
Robert E. Nolan
Company, Inc., Dallas
rob_keene@renolan.com

Banks with the best overall efficiency ratios are significantly better performers in mortgage lending, commercial lending and retail banking than their average peers. Though highly efficient in these key areas and somewhat better in others, top performing banks are less efficient in areas such as consumer lending, mortgage servicing and managed trust. These findings are a product of the recently published Robert E. Nolan Company 2003 Efficiency Ratio Benchmarking Study, based on 2002 data.

The Nolan Efficiency Ratio Benchmarking Study is the only one of its kind in the banking industry. Each year since 1995, banks, thrifts and credit unions with assets over $1 billion are invited to participate in the study by submitting expense, income, staffing and volume data covering the entire bank. Nolan classifies the data into 14 general functional areas such as Administration, Commercial Lending and Retail Banking as well as 80 lines of business that segment these general areas.

The study provides an analysis of efficiency and productivity at a much more granular level than other banking industry peer group studies. Nolan generates 1,100 measures to examine the impact of each line of business on overall bank efficiency. By calculating the efficiency ratio and examining certain productivity measures for each line of business, the study pinpoints participant gaps in performance that, if narrowed, will result in significant bottom-line improvement. Participants use the study results to prioritize their improvement initiatives by narrowing their scope to the areas identified by the study that offer the best potential increase in profitability.

The conclusions mentioned above were derived from the study's pool of data collected from participating banking organizations ranging in asset size from $4 billion to $86 billion. They point to the need for banks to continuously examine performance and implement improvement initiatives even if the total bank efficiency ratio (operating expense divided by the sum of net interest income and non-interest income) ranks high compared to peers. They also lead to further conclusions revealing certain lines of business, no matter how efficient, have little impact on overall bank performance and should be assigned lower priority when scouting areas to improve operations.

To examine the gaps in performance between highly efficient and average performing banks, Nolan developed an index to describe the relative importance of performance that each of the 80 lines of business contribute to total bank efficiency. The Nolan ER Index works like this:

A line of business with a Nolan ER Index value of 100 means that the efficiency ratio gap (calculated as the difference between the expense to total bank revenue ratios) between average and top tier performance is the same as for overall bank efficiency.

A Nolan ER Index value above 100 indicates that the performance gap is wider or that the high performing banks are doing an even better job for a line of business than they are doing overall.

If the Nolan ER Index value is between zero and 100 the top performers are better than average, but the gap is less than the total bank efficiency ratio gap.

A negative Nolan ER Index value means that the highly efficient banks for a line of business are less efficient overall than an

average bank. In other words, the efficiency of a function that has a negative Nolan ER Index value has little or no bearing on the total bank efficiency ratio.

Three significantly high performance areas for top tier banks are:

- Mortgage Lending (Nolan ER Index = 156)
- Commercial Lending (Nolan ER Index = 125)
- Retail Banking (Nolan ER Index = 138)

These areas are segmented into multiple lines of business within the study. Examining performance on a line of business basis revealed some interesting conclusions.

First, mortgage loan origination, or the loan production line of business, is the area that not only drives mortgage lending efficiency but significantly and positively impacts overall bank efficiency. With a Nolan ER Index value of 100, the efficiency of mortgage origination for the banks with the best overall efficiency ratios more than offsets below average performance in the mortgage servicing function. As indicated by a Nolan ER Index value of -175, mortgage servicing is significantly less important in maintaining a high level of overall bank efficiency—a nice break for the top tier banks.

Commercial lending, segmented into administration and market-type loan origination lines of business, also ranks as a highly important component of overall bank efficiency. The Nolan study identified commercial real estate lending (Nolan ER Index = 156) as a highly important and efficient line of business for the high performing banks that, like mortgage loan origination, positively impacts the total bank efficiency ratio. Corporate lending and lease financing are also important areas of efficiency for the best performers with indices of 31 and 13, respectively. Conversely, the small business and middle market commercial lending segments are generally areas that need to improve for the high overall performers, though improvement, due to negative indices (-56 and -63, respectively) may not have much impact on overall efficiency unless there is a significant shift any number of variables (net interest margin, cost structure, production volumes, etc.).

The retail banking area is comprised of retail banking administration, branches and deposit operations. The focus here is on the generation and operational support for retail and commercial deposits. The study concluded that highly efficient banks perform very well in deposit operations and that like mortgage origination and commercial real estate lending, deposit operations efficiency plays a major role in the overall bank efficiency ratio. Interestingly, the branches, though large in terms of overall expense and revenue, rank very low in their relative importance to the total bank efficiency ratio. With a Nolan ER Index value of -88 the retail banking branch line of business, like small business and middle market lending, would require significant variable shifts to singlehandedly improve the overall bank ER.

Consumer lending and managed trust are two areas, along with the previously mentioned mortgage loan servicing line of business, where the most efficient banks overall are not to be found in the top tier.

Highly efficient consumer lenders tend to be less efficient banks overall, though consumer direct lending, the loan production arm of consumer lending, does carry a positive Nolan ER Index value (19). The other three consumer lending segments, consumer loan administration, indirect lending and consumer loan operations, all have negative indices.

Managed trust (our study differentiates managed and custodial trust functions) has a Nolan ER Index value of -31. Although certain managed trust segments have positive index values, the three most significant segments based on total expense and revenue—personal trust, corporate trust and trust operations—all rank low in terms of their importance on the overall bank efficiency ratio.

Nolan is committed to developing research such as this to help our clients simplify the landscape of improvement opportunities. Breaking down the bank efficiency ratio is an effective way to prioritize those opportunities so that the value of the improvements may be realized faster.

For more information on the Robert E. Nolan Company's Efficiency Ratio Benchmarking Study, visit www.bankbenchmarks.com.§