CORNERSTONE
ADVISORS

PLAYING SMARTER, NOT BIGGER

How Small Credit Unions Compete on Efficiency

A WHITE PAPER
COMMISSIONED BY

OnBase®
by Hyland

INTRODUCTION

> “Small credit unions can carve out an advantage in the market by playing smarter, not bigger.”

You might not think that this is a good time to be a small credit union. Between 2009 and 2015, the three largest banks in the country grew deposits by $1.27 trillion, while the remaining 11,000 banks and credit unions in the U.S. generated $1.84 trillion.[1] In other words, the top three grew by an average of $423.3 billion each, while other FIs averaged growth of just $167.3 million.

New regulations emerging after the financial crisis didn't benefit smaller institutions. According to the Kansas City Federal Reserve:

> *“Today, banks face new and higher costs to both implement complex new regulations, especially those introduced after the 2007–09 financial crisis and recession, and transition to new electronic banking platforms. For small banks, these higher fixed costs are spread over a smaller asset base, which may put them at a competitive disadvantage relative to larger competitors.”*

CEOs at community-based financial institutions are quick to identify the challenges and disadvantages they face:[2]

> *“To do well financially, you have to have a good critical mass of business and be very cost-conscious. With the escalating expense of regulatory requirements, it's becoming more difficult to profitably serve customers.”*
>
> —Dave Nelson, CEO, West Bank (IA)
>
> *“With a host of new regulations, deciding which businesses to focus on is important because we can't build the infrastructure to be compliant and operationally excellent in everything.”*
>
> —William J. Pasenelli, President and CEO, Community Bank of the Chesapeake (MD)

“Banks greater than $1 billion in assets enjoy 20-year advantages in loan growth, deposit growth, and fee income.”

The debate over the viability of smaller institutions has been going on for 20 years. It is true that banks greater than $1 billion in assets enjoy 20-year advantages in loan growth, deposit growth, and fee income, the FDIC concluded in a study:[3]

> *“While community-based FIs do experience reductions in average cost as they grow in size ... much of the benefit can be achieved at a scale as small as $100 million. Economies of scale, however, are probably not the most important factor that determines the viability of smaller institutions. Between 1985 and 2011, more than 60% of community banks weathered two banking crises and finished 2011 with less than $200 million in assets. Therefore, community banks of relatively modest size appear to be not only viable, but resilient.”*

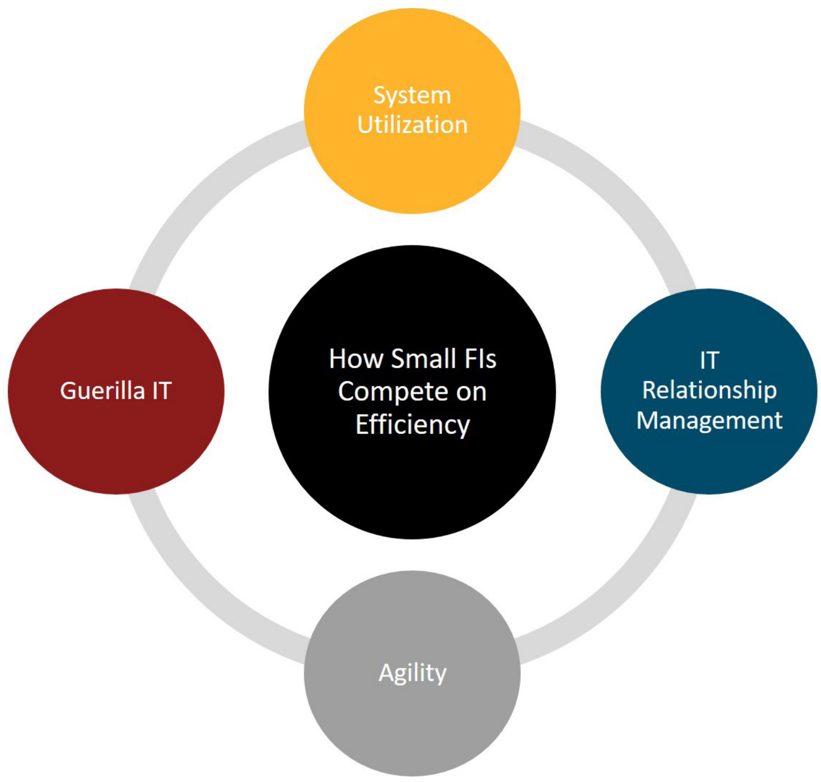
Despite the challenges and disadvantages facing smaller financial institutions, Cornerstone Advisors believes small credit unions can carve out an advantage in the market by “playing smarter, not bigger”—i.e., creating efficiencies in delivery processes that many would think would only be available to larger institutions with deeper pockets.

PLAYING SMARTER, NOT BIGGER

One question facing smaller institutions looking to achieve efficiency is: How do we get there without having to merge or in the absence of market growth?

Through interviews with successful small credit unions and analyzing our *Cornerstone Performance Report* benchmark data, Cornerstone Advisors has identified four ways successful small credit unions have achieved superior levels of efficiency (Figure 1): 1) System Utilization, 2) IT Relationship Management, 3) Agility, and 4) Guerilla IT.

Figure 1 | How Small FIs Compete on Efficiency



Source: Cornerstone Advisors

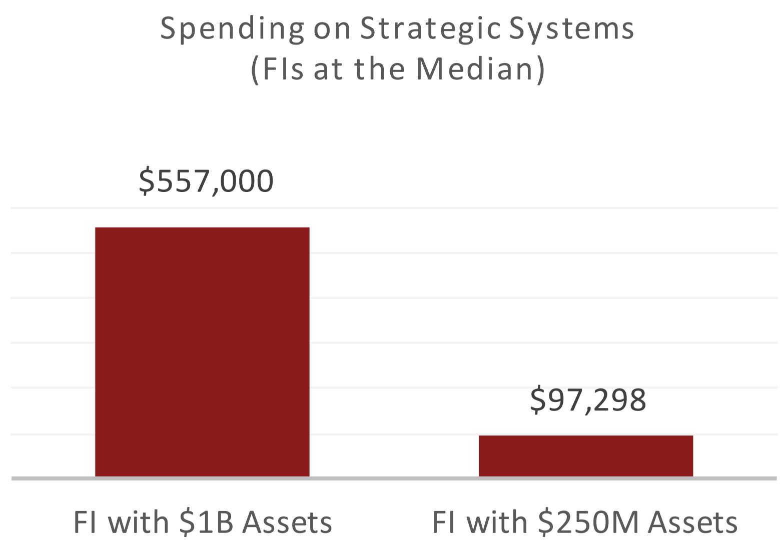
> Small credit unions must constantly work at finding new ways to more fully utilize the systems they have.

SYSTEM UTILIZATION

Larger institutions have the luxury of discretionary funds they can invest in new systems and technologies to meet perceived needs. Small credit unions, on the other hand, must constantly—and consistently—work at finding new ways to more fully utilize the systems they have.

Based on Cornerstone Advisors' *Performance Report* benchmarks, at the median, a $250 million credit union spends just shy of $100,000 annually on strategic systems, while an institution four times larger invests more than five times as much (Figure 2).

Figure 2 | Strategic Systems Spending



Source: 2016 Cornerstone Performance Report for Credit Unions

As a result, making the best use of where the money goes is important to smaller organizations. Execs at one credit union told us:

> *"We lack capital resources, offer a limited set of products, and don't have a staff of programmers. We have to make better use of the applications we invest in. For example, we originally purchased a system to do document imaging. The user group provided ideas for other uses, specifically to better streamline document scanning. We then started using the system in accounts payable where the staff had paper copies that needed to be signed. We've found that use of the system snowballs within a department after its initial use case."*

Effective system utilization also involves making the tough decisions to shut down technologies that are no longer strategically critical. At one institution that we spoke to, we heard:

> *"We sunsetted our interactive voice response system. We surveyed our customers, and analyzed the type of calls we were getting. We realized that our customers didn't like the experience, so now we have a person who answers calls. The analysis we did led to the development of a "quick balance" feature on our online banking platform."*

SO WHAT

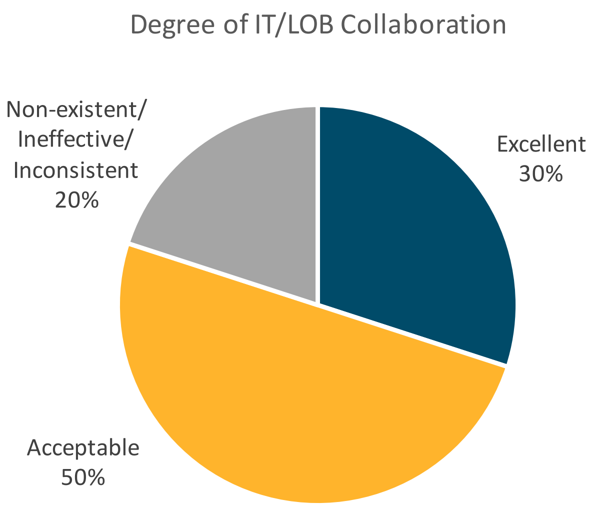
Efficiency doesn't come from just a focus on cost reduction. For small credit unions faced with resource constraints that limit their ability to invest in an ever-widening range of technologies, efficiency comes from more effective use of the technologies they've already invested in, and finding new and creative ways to utilize those systems.

> “Successful small FIs develop close, effective relationships with IT vendors.”

IT/LOB COLLABORATION

A study from Aite Group found that just 30% of community-based FIs rated the coordination between their IT department and line-of-business functions to be “excellent,” while one in five considered the degree of coordination to be nonexistent, ineffective or inconsistent (Figure 3).

Figure 3 | Degree of IT/LOB Collaboration



Source: Aite Group

Why is this important? Because, as Aite Group found, community-based FIs that achieve high levels of IT/line-of-business coordination—in combination with a commitment to using IT strategically and accepting a reasonable amount of technology risk—demonstrate superior business results.

One CIO told us:

> *“At too many financial institutions, IT doesn’t understand what the staff needs. IT has the mentality ‘we’re here to fix it’ but they’re not very involved in the design of the solution in the first place. That’s what’s different about this bank. IT sees staff as its customers, and we get involved with designing business solutions—not just technology solutions.”*

But IT relationships don't just apply to internal staff connections. Successful small FIs develop close, effective relationships with IT vendors. At one small bank:

> *"We don't just log tickets—we try to develop a relationship with our vendors' account managers. We do a lot of research to ensure that the calls we make are valid. We also get their attention by attending the user meetings, and utilizing their products."*

Successful small FIs are shifting from vendor risk management to vendor performance management. This new model incorporates risk, but factors in cost and benefit assessments with organizational accountability and oversight. Risk, technology and compliance execs may be good assessors of vendor risk, but CFOs and line-of-business leaders are the right assessors of vendor cost and benefit, respectively. As a result, smaller financial institutions should have an advantage in adopting this new model by virtue of their simpler, more integrated organizational structure.

AGILITY

Many small financial institutions will say that they compete with larger institutions by being more agile—but can they they prove it?

Agility doesn't come just from being small. As Cornerstone Advisors Partner and Co-founder Steve Williams wrote:[4]

> *"One of the biggest risks that mid-size financial institutions have today is that they recruit so many big bank executives to run the place they end up instituting the artery-clogging practices of organizations 100 times their size."*

McKinsey and Company identified five traits that characterize agile companies: 1) Role Clarity, 2) Top-Down Innovation, 3) External Idea Capture, 4) Process Capability, and 5) Operational Discipline.

"Process and operational discipline can help provide role clarity and achieve added efficiency."

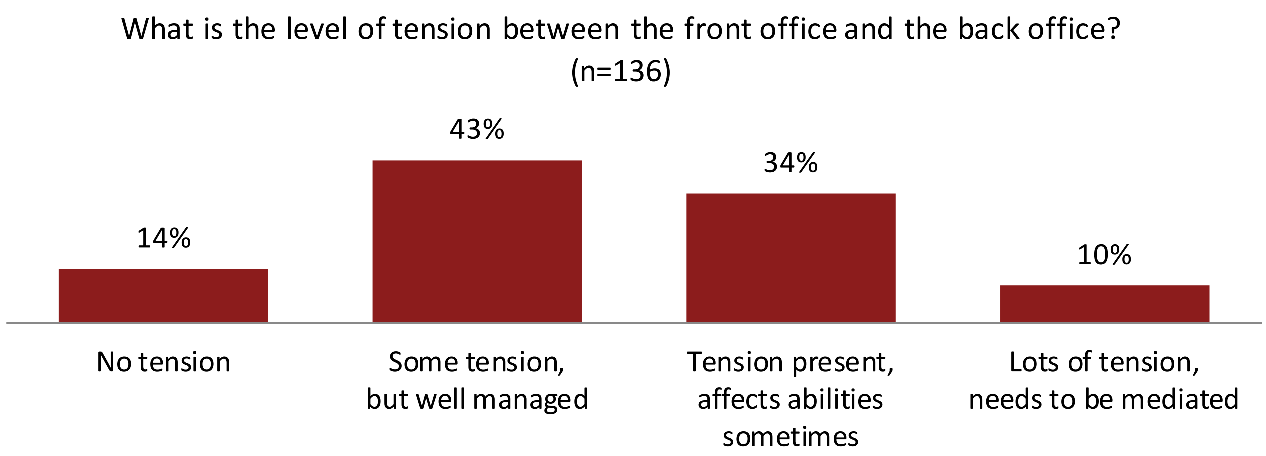
SO WHAT

Interviews with senior executives of successful small credit unions revealed a particular focus on process capabilities and operational discipline driven by their smart use of technology:

> *"We have highly efficient processes that other FIs don't have. For example, our wire process has been greatly improved. We used to send a courier to accounting, which would go find approval, fill out a form, then route for approval. We've taken that from several hours to minutes. One added benefit has been in the review process. Instead of a query to pull and view reports, reports are put in a review queue with a proactive notification to managers to review. It's made it easy for auditors to review, as well."*

Process and operational discipline can help provide role clarity and achieve added efficiency. In a survey of loan operations executives conducted by Cornerstone, just 14% of respondents said there was no tension between the front and back office in their shops, while almost half said there was tension present (Figure 4).

Figure 4 | Front and Back Loan Operations Office Tension



Source: Cornerstone Advisors

Based on survey participants' responses, we created two groups: 1) "Low Tension" FIs experiencing "no" or "some" tension, and 2) "High Tension" FIs, which report that the level of tension has affected their abilities, or needs mediation. Differences between the groups emerged regarding (Figure 5):

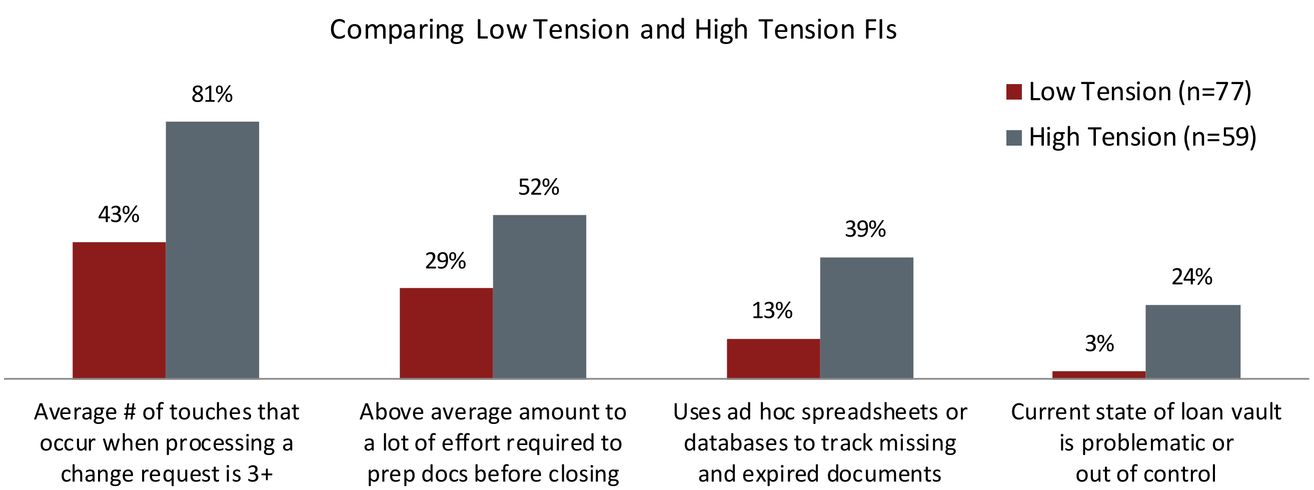
- **Change request processing.** Eighty-one percent of High Tension FIs—but just 43% of Low Tension FIs—require three or more touches when processing change requests.

- **Document preparation.** Three in 10 Low Tension FIs require an above-average amount to a lot of effort to prep docs before closing, in contrast to half of the High Tension FIs.

- **Technology used to track missing and expired documents.** Almost four in 10 High Tension FIs use ad hoc spreadsheets to track missing and expired documents. Only 13% of the Low Tension FIs do so.

- **Current state of loan vault.** Nearly a quarter of High Tension FIs say their loan vault is problematic or out of control. Just 3% of Low Tension FIs say that about their loan vault.

Figure 5 | Low Tension Versus High Tension Loan Operations Groups



Source: Cornerstone Advisors

SO WHAT

Successful small credit unions create high levels of agility not just through process capabilities and operational discipline, but through flexibility in staff and resource allocation. To become more agile, Cornerstone advises small FIs to:

- **Strengthen internal commitments.** Small agile banks avoid the political environments that characterize big banks. While not everyone needs to agree with each other in an agile bank, it needs to be very clear what "critical commitments" executives and managers owe to each other. In agile banks, every line of business and support area clearly defines "excellence" with key performance indicators (KPIs) visible to the whole organization and clearly defined milestone commitments that they will hit at specified deadlines. As one executive at a high-performing bank once told us, "We're successful because people know they actually have to do what they say they are going to do around here."

- **Adapt external innovations.** Agile bankers are often lazy—and that's a good thing. They have no interest in reinventing the wheel and instead constantly reach out to peers and experts to figure out how others address emerging challenges. Agile bankers are good at building a rolodex of "rebels" in the industry who try stuff early and have a track record of innovation. For instance, a bank payments manager recently avoided a great deal of trouble in rolling out EMV by embracing the lessons learned by three bankers who had done it ahead of him. Are you an agile banker? If you can name three peer banks that have best practices your organization should embrace, you might be.

- **Develop knowledge at all levels.** Agile banks are successful because they have a lot of people who know specific stuff. Banks can become more agile when they identify who needs to go deep to develop knowledge in critical areas. Here's an example: banks today should be developing towering knowledge in areas such as mobile payments, social media, business analytics and paperless mortgages. Is your executive team comfortable with your organization's level of knowledge in these areas? Do they have a game plan to deepen their brainpower further?

GUERILLA IT

There's a "scrappiness" that characterizes many successful smaller credit unions. They find workarounds to problems, and are willing to use whatever tools they can find to get the job done. Cornerstone calls that "Guerilla IT."

This Guerilla IT attitude was demonstrated by credit unions who told us:

> *"We don't have an enterprise-wide customer relationship management system, so when help desk management became too hard to track through spreadsheets, we found a free, on-premise help desk app to fill the gap."*
>
> *"As the number of initiatives we launched increased, we found ourselves in need of a project management system. But we didn't have the time to go through an evaluation process, or the resources to make big investments in a system, so we use BaseCamp, which is not only very inexpensive, but we get a discount for being a not-for-profit credit union."*

"The leaders of successful small credit unions know that sometimes you have to go with your gut."

SO WHAT

Executives sometimes believe that every management decision needs to be a well-considered decision, with a data-gathering and evaluation process supporting each decision. The leaders of successful small credit unions know that sometimes you have to go with your gut, make a quick choice, and move on to the really important stuff.

CONCLUSION

Mark Twain famously said, "Reports of my death have been greatly exaggerated." Small credit unions can make the same claim. Those that demonstrate strong system utilization, effective relationship management, agility, and a Guerrilla IT attitude can survive and thrive in today's banking industry.

ENDNOTES:

[1] Source: FDIC

[2] https://www.bai.org/banking-strategies/article-detail/challenge-and-opportunity-for-community-banks

[3] https://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf

[4] http://www.gonzobanker.com/2016/03/building-the-agile-bank/

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