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Does Fee Income Diversity Devine High Performance?

Earnings Performance Consulting

M&A Integration | Risk & Compliance

For the Intelligent Banker

2015 Intelligent Bank Management Series

The 2015 Intelligent Bank Management Series focuses on insights, strategies and development priorities for improved profitability, operating efficiency, compliance and risk management at U.S. financial institutions.

Another Look at Non-Interest Income

Financial organizations understand the requirement to develop fee revenue sources to supplement net interest revenue. This month we look at whether the existence of diversified fee income sources can be linked to high performing institutions.

Previously, we analyzed the clear differentiation between two populations of financial institutions reporting higher than 2.25% return on assets pre-tax, versus a second population reporting less than 1.00% return on assets pre-tax. Twenty eight organizations of $2B-$20B in Total Assets were chosen and split evenly between the two income performance metrics using FDIC Call Reporting from December 31, 2014.

Our analysis concluded that both groups demonstrated a surprisingly similar net interest margin, even though the financial performance of the higher earning group more than doubled the return reported from the lower group.

Non-Interest Income diversification has been a historic differentiator between organizations. Those that had robust Trust organizations, Mortgage or other subsidiaries or specialized business lines often held a profit differential over organizations without such areas of specialization. Our initial thesis was that income diversification, or lack thereof, would help explain the earnings differential between these two groups of institutions.

Non-Interest Income Sources Categorization

In reviewing the non-interest income sources from the two populations, seven sources were identified as follows:

1. The presence of Fiduciary revenue
2. Deposit Service charges that equal or exceed 30% of total Non-Interest Income
3. The presence of Investment Advisory fee income
4. The presence of Insurance revenue
5. The presence of loan servicing income
6. Loan sale income that exceeds 30% of Other Non-Interest Income
7. Other Income that exceeds 30% of Other Non-Interest Income

The intent was to ensure that a revenue source document a presence of organizational focus. The Other Income category typically is the catch-all where non-interest income from such strategies as ATMs, merchant services, credit cards, specialized cash management, etc. are consolidated.

Our expectation was that there would be an

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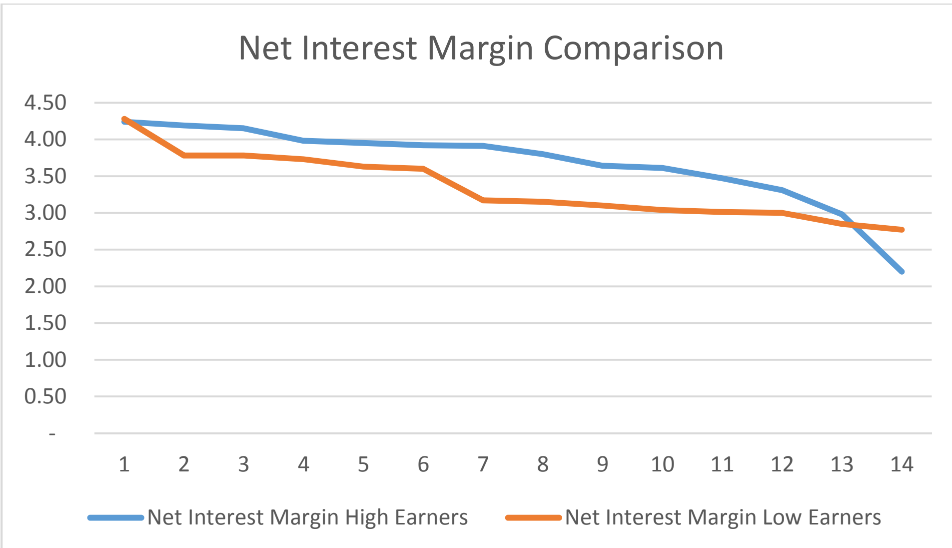
identifiable variance in non-interest income sources between the two populations, which underlies the differentiation in reported performance. With one exception, this was not the case. The higher earning group exceeded the reported income sources from the lower earning group only in loan sales. 64% of the high earning organizations reported 30% or greater contribution to Other Non-Interest Income from loan sales, while with the lower earning group only 29% reported similar contribution from loan sales. The remaining results of non-interest income source diversity *favored* the low performing group. The lower performing group were almost twice as likely to offer Trust Services, Investment Advisory and significant Other Income sources.

Comparison of High versus Low Performance Net Interest Margins:



The following is the tabulated participation rates, based upon our definition:

	Fiduciary	Deposits (30%)	Investment	Insurance	Servicing	Loan Sales (30%)	Other (30%)
High Earning FIs	35.7%	28.6%	50.0%	71.4%	71.4%	64.3%	57.1%
Low Earning FIs	64.3%	35.7%	85.7%	71.4%	100.0%	28.6%	92.9%

If income diversity is not the differentiator between high versus low performers, what is the driver of higher profitability? It would seem that the efficiency in non-interest income production holds the key. The low earning Financial Institutions had an equal or greater basis for the creation of non-interest income, yet their expense base to produce this income is far higher.

How does this reflect as a strategic statement? Here are a series of thoughts to consider:

Do not take on a business subsidiary or product line that falls outside basic block and tackle banking as a hobby. Ask yourself this question when presented with your next proposal.

Is it better to partner with ancillary income sources, than to own subsidiaries, such as insurance or investment advisory? Said another way, is it better to be an agent versus an owner?

As shown with loan sales, is this an essential component to higher earnings if built with a clear set of efficiency ratio targets?

Is staffing effectiveness and efficiency a focus with traditional fee-based businesses?

Is this an indictment of the lack of Strategic Sourcing and attainment of market pricing for services received with low performers?

How can expenses be divested from Trust, Investment Advisory and Insurance businesses?

Do specialized services, with fee income typically consolidated in Other Non-Interest Income, have an efficiency ratio that would justify their existence as a stand-alone business?

If not, how many loss leader products or business lines can an organization absorb?

Do you analyze the efficiency ratio of the bank independent from your non-banking subsidiaries or divisions?

Do you calculate the value being 'donated' by the bank as contribution against the earnings recorded by non-banking subsidiaries?

Do you have the data to perform this analysis?

Is Management Accounting a need at your organization, to be able to evaluate and answer these questions across the many components of income and expense?

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