

Functional Cost Analysis

A Tool of Bank Management

High interest rates on time deposits, rising salary and wage expenses, and increases in other cost factors affecting earnings have made it increasingly difficult for banks to employ available funds in areas that will yield a return large enough to pay the interest and other costs and still produce adequate profits.

For a bank to obtain the total cost or the total income for a year's operation is a relatively simple task. Information in the aggregate such as this does not lend itself readily to analysis by management, however. Before any meaningful evaluation can be made, income and expense figures must be allocated to the proper functions. As a result of these allocations, management can more readily answer such questions as:

What does it cost to maintain demand deposits and time deposits?

Where can expenses be reduced for a particular function if they are considered excessive?

What is the average cost of making a loan?

What is the average cost of processing each loan payment?

Do we have more tellers than are needed for our volume of transactions?

What are the break-even points on our consumer instalment loans?

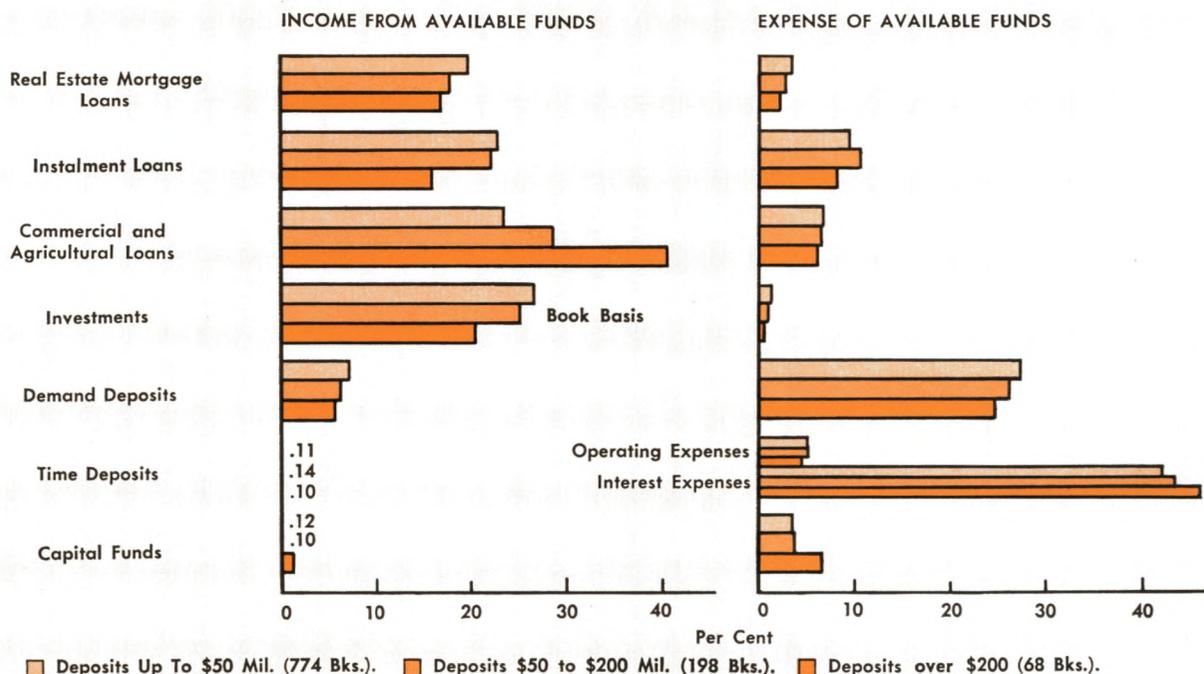
What is the cost of issuing a certificate of deposit?

What is the officer expense per \$1,000 of loans?

Functional Cost Analysis To assist management in answering these and related questions is the overall objective of Functional Cost Analysis, a cost accounting service that eleven Federal Reserve Banks sponsor for the member banks in their respective Districts. Although Functional Cost Analysis has been in existence since 1956, it has grown significantly only in the past three years. In 1964, 279 banks in three Federal Reserve Districts participated in the program. In 1966, however, 1,022 banks in eleven Federal Reserve Districts took part in the voluntary study.

The program is offered without charge each year to member banks. Even though participating banks are not required to remain in the program in con-

SOURCES AND DISTRIBUTION OF INCOME BY SIZE OF BANK



Note: 1. Calculations Exclude the Computer, Trust, Safe Deposit and Other Non-Fund Using Departments.
 2. Available Funds Are Defined As: Total Liabilities and Capital Less Fixed and Other Assets.

secutive years, experience has shown that there is very little attrition from one year to the next. One of the advantages of participating in consecutive years is that comparisons are given for each bank with its own year-ago figures. To participate, all a bank must do is fill in the five reporting schedules that are supplied by the Federal Reserve. The time required to fill in the schedules varies, of course, from bank to bank depending on the size, accounting procedures, and operational set up that each bank has.

Functional Cost Analysis has two primary objectives. First it is designed to give an itemized list of the various current income and expense items as they relate to the major banking functions. Also, comparative figures for groups of other banks are provided to aid in the analysis of an individual bank's performance. The uniform reporting of all participating banks makes possible interbank comparisons that are not generally available in any other cost program. Where overall comparisons are made—such as between balance sheets—banks are compared with other banks that have a similar dollar volume of total deposits and a similar percentage of time deposits.

The work schedules are filled out on a calendar year basis and returned to the Federal Reserve Bank for processing in February of the ensuing year. About six weeks later the finished report, consisting of 28 computer printout pages and several printed pages, is mailed to the participating banks. The report gives an analysis of three fund-providing functions, four fund-using functions, and four categories of nonfund-using service departments.

Fund-Providing Functions Demand deposits, time deposits, and net capital funds are considered to be the fund-providing functions. The demand deposit analysis includes a detailed breakdown of the processing, administrative and overhead expenses. This analysis, like all others in the Functional Cost Analysis report, is developed from information supplied to the Reserve Bank on the reporting schedules and includes information such as the average cost of handling a home debit, a deposit, and a transit check. Demand deposits are also segregated into, and an analysis is given for, regular and special checking accounts. Information for determining the average break-even balance on a checking account is also pro-

vided. This is expressed as the average annual balance required to pay: (1) the account maintenance, (2) the home debits cost, (3) the transit checks cost, and (4) any added services cost. A deduction is made for any activity income earned on the account.

In addition to the comparisons with its own year-ago figures, interbank comparisons are also given. For the demand deposit function, demand deposits of ten banks—five having a dollar volume of demand deposits just above and five having a dollar volume of demand deposits just below the subject bank—make up the group average.

For the time deposit function, the average cost per transaction of a deposit, a withdrawal, opening an account, and closing an account is given. A separate analysis, complete with information for determining the average annual break-even balance, is given for passbook savings, certificates of deposit, and Christmas and similar club accounts. The group average for the time deposit analysis consists of average time deposits of ten banks with similar dollar volumes.

The third fund-supplying function, net capital funds, consists of capital and valuation reserves plus "other" liabilities and borrowings less fixed and "all other" assets. Federal funds purchased are analyzed as part of the capital funds function.

Fund-Using Functions The fund-using functions consist of real estate mortgage loans, instalment loans, commercial and agricultural loans, and investments. For each of the fund-using functions, the clerical expense per thousand dollars is given along with such miscellaneous information as the average cost of making a loan, the average cost of collecting a payment, the average volume of loans serviced per person, and the break-even points for the consumer instalment loan function. Gross yield on investments and liquidity loans are included in the analysis of the investment function. Liquidity loans are restricted to Federal funds sold, commercial paper purchased, brokers' loan participations with a correspondent, purchased certificates of deposit, bankers' acceptances and commodity credit certificates of interest.

For each of the fund-using functions, as was the case with the fund-providing functions, a comparison is made with ten other banks that have similar dollar volumes of the particular function being studied.

Service Departments The computer, trust, and safe deposit functions are service departments that do not use balance sheet funds and are included in the non fund-using section of the report. Interbank comparisons for the computer department are made with ten banks that have a rental expense for computer hardware similar to the subject bank. Comparisons for the trust function are with banks that have similar 5-year average incomes, while total number of boxes is used for selecting group average banks in the safe deposit analysis.

Summary Reports Two reports in addition to those for individual banks are produced by the Federal Reserve. The "National Average" report and the "Performance Characteristics of High Earning Banks" report both contain virtually the same information as the individual bank report except that the "National" report contains average figures for all banks in the program and the "High Earnings" report contains average figures for banks in the top earnings quartile.

A review of all three reports will give a fairly accurate evaluation of how a bank is doing on the national level as well as how it compares with the best earning banks.

While participation in Functional Cost Analysis is limited to Federal Reserve member banks, the "National" and "High Earnings" reports are available free of charge to non-member and non-participating banks upon request.

Conclusion There are many ways of costing a bank. The important thing, however, is that a bank is doing some type of costing. Today banks are offering more and more services to their customers beyond the traditional banking functions of receiving deposits and making loans, and the trend will no doubt continue in the future. It is no secret that banking is becoming more complex and competitive, and the banker that has more detailed and reliable cost and income information has the advantage.

The Federal Reserve's role, so far as Functional Cost Analysis is concerned, is to diagnose—not prescribe. Once a bank has its cost report, it has a medium of unlimited potential as a management tool. The report can be a prelude to budgeting, profit planning or any other use that management can determine with its discerning eye.

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