206.
Performance Management
Introduction

To place the importance of performance management for retail banks in its appropriate context, it is necessary to consider the process of setting the bank’s strategy. While this topic is covered in full in Retail Banking III, we outline the fundamental issues that serve our limited purpose here.

Strategy in retail banking involves devising a unique value proposition and market position and preserving it by creating a culture of customer care. This customer focus is facilitated by the 3Ps – professional and ethical people, efficient processes and innovative products.

The implication of this strategy statement is that competitive advantage is created and preserved by an emotional bond between customer and bank – a central component of the Kaminsky philosophy.

The emphasis on the role of customer-centricity for bottom-line success means that bank executives and, in particular, HR experts must take action to align divisional, team and individual performance with the bank’s strategic objectives. This is the core objective of performance management – to ensure congruence between actual performance at the lower levels of the bank with that expected from the strategy. This will increase the chance of achieving strategic clarity for all employees as they see how individual performance is aligned with organisational performance.

Performance management may be defined as a management role whereby the HR function plays a coordinating role. It is a process whereby the bank’s strategy is linked to its strategic objectives. In other words, performance management plays a moderating role between strategy and desired outcomes.
Performance management creates clarity between high-level strategy in the bank and its desired objectives. This key role implies that HR must take action to align performance at the individual, team and organisational level with the corporate desired outcomes.

The HR task of ensuring that strategy is translated into the right action, with every team member playing their part is possibly the most significant challenge that the HR team faces. It is worth emphasising that the key steps to making sure strategy converts to right action are:

- **Strategic Clarity**
  An unequivocal statement of strategy, with measurable objectives and clearly articulated performance measures.

- **Processes**
  Systems and processes that enable strategy to be communicated in a consistent, relevant and appropriate way to all units and individuals of the bank.

- **People**
  A professional and ethical bank staff that is functionally capable, equipped and competent to act on the strategy.

- **Key Performance Indicators (KPIs)**
  A limited number of appropriate KPIs that permit effective and fair evaluation of performance at all levels – individual, team and divisional – to provide organisational alignment.

- **Feedback**
  Feedback on performance will permit personal and organisational learning and create opportunities for people development.

We now consider the strategic objective of ‘economic profit’ that is also an important shareholder objective. It is important to stress that this is a long-term objective as opposed to the short-term focus of increasing earnings per share quarter after quarter. The generation of economic profit is consistent with serving the long-term needs of customers; the short-termism of increasing quarterly earnings per share has the potential for mis-selling with resulting damage to the bank’s reputation as well as hitting the bottom line. Indeed, the now notorious case of mis-selling at Barclays reached unprecedented levels. Here is an excerpt from *Lafferty Retail Banking Insights* (February, 2013):
UK banks face further mis-selling penalties

UK banks face another crippling round of mis-selling penalties – this time for pushing inappropriate products to small- and medium-sized businesses.

The Financial Services Authority (FSA) has confirmed that Barclays, HSBC, Lloyds and RBS will start the full review of their sales of interest rate hedging products (IRHPs) to small businesses.

In June 2012, the FSA announced that it had found serious failings in the sale of IRHPs, and after a pilot exercise testing IRHP sales; the banks must now review individual sales and provide redress to customers based on FSA rules overseen by independent reviewers.

The work on the pilot has confirmed the FSA’s initial findings of mis-selling of IRHPs. The FSA looked at 173 sales to non-sophisticated customers and found that more than 90 percent of the sales did not comply with at least one or more regulatory requirement. A significant proportion of these 173 cases are likely to result in redress being due to the customer.

Martin Wheatley, CEO designate of the Financial Conduct Authority, said, “Small businesses will now see the result of the review as the banks look at their individual cases. Where redress is due, businesses will be put back into the position they should have been in without the mis-sale. But it is important to remember that this review is firmly focused on the particular circumstances of each sale. These will determine whether there were failings in the sales process and, if so, whether redress is due.”

The FSA has also been reviewing sales of IRHPs by Allied Irish Bank (UK), Bank of Ireland, Clydesdale and Yorkshire banks, Co-Operative Bank, and Santander UK. They will begin the same review and compensation process later this month.

The remainder of this module is organised as follows: Chapter 1 deals with the relationship between performance management and long-term value creation while Chapter 2 considers various approaches for measuring performance and provides examples of Key Performance Indicators (KPIs) in Retail Banking. Chapter 3 presents methods for managing divisional performance where the role of transfer pricing is emphasised. Chapter 4 presents the structure of a bank branch dashboard. The module concludes with a summary and multiple choice questions.
Chapter 1:
Performance Management for Long-Term Value Creation

Long-term value creation is based on the notion of economic profit. Before we define economic profit, consider the following example for Nedbank (full year 2011):

Profit after tax: R 5,506m ($623m) and Total Equity: R 42,987m

This represents a return on equity (ROE) = R 5,506m / R 42,987m =12.8 percent

Note that the bank made an absolute level of profit after tax of 5,506 million rand and a return on equity of 12.8 percent. But from a shareholder perspective, the cost of equity (COE) is still to be reckoned. Nedbank will make positive economic profit if its ROE exceeds its COE. Any level of COE above 12.8 percent in this case will lead to economic loss, although there is an accounting net profit of more than $623m.

It is worthwhile presenting a quick reminder regarding the shortcomings of a popular measure – return on equity (ROE). As presented in Module 102, return on shareholder equity is defined as ROE = Net Profit / Equity and hence, a measure of shareholder profitability. For example, an ROE of 15 percent means that net profit is 15 percent of the book value of shareholder equity.

One of the main drawbacks of ROE is that, as a profitability measure, it does not account for the risk that is taken to earn the profit on equity. Clearly, a bank could obtain a high profit by taking a high level of risk to earn, for example, trading income.

The ROE could be very high in such a case, but on a risk-adjusted basis it could reflect a relatively poor performance. There are other limitations. In the case of asset impairments or write-downs, the book value of equity will decline and with no increase in profit, the ROE could rise substantially.

We now continue to explore a better measure than ROE which is also applicable to lines of business (LOB).
Illustration of Economic Profit at the Business Unit (Division) Level:

We illustrate this key long-term value creation metric for a business unit as follows:

- Economic Profit ($)
- Cost of Capital ($)

In this diagram, cost of capital measured in monetary units ($) is equal to cost of capital in percentage terms multiplied by the value of invested capital. For the business unit, the cost of capital (in percent) is given to it by treasury and so is exogenous to the business unit.

Also Return (percentage) is defined as net profit divided by invested capital, that is, Return = Net Profit / Invested Capital.

When the invested capital is replaced by capital at risk, or what is commonly called economic capital, then we obtain RAROC, which is an acronym for risk-adjusted return on capital. That is, RAROC = Net Profit / Economic Capital. This is an example of a risk-adjusted performance metric (RPM).

Formally, Economic Capital is the capital allocated by a bank to absorb unexpected loss for a specified period (typically one year) and for a specified degree of confidence. Hence, RAROC is a measure of net profit per unit of risk. Such a conclusion cannot be made if we retain the ‘invested capital’ in the denominator.

Also note that Net Profit = Revenue – Operating Costs – Risk Costs – Taxes

Economic Capital is derived from an estimated loss frequency graph as follows:
In the graph above, EL = expected loss and UL = unexpected loss. Economic capital may be considered a risk premium that should be invested at the riskless rate (e.g., LIBOR). Hence there is a capital benefit to the net profit.

So we define RAROC = Net Profit / Economic Capital where:

Net Profit = Revenues (excluding income on actual capital) – Operating Costs – Expected Risk Costs + Capital Benefit – Taxes

where capital benefit = Economic Capital * Risk Free Rate.

Economic profit is the profit that is left after accounting for the cost of capital. Hence:

Economic Profit = [RAROC (%) – Cost of Capital (%)] * Economic Capital ($).

For a bank where the cost of capital is 8% and a RAROC of 11% for a level of economic capital of $200 million, the economic profit = (0.11 – 0.08) * $200 million = $6 million.

Formally, we denote economic profit as follows:

**Economic Profit = Revenues (excluding income on capital) – OPEX – Expected Risk Costs – Taxes + Capital Benefit – Cost of Capital**

We see immediately that economic profit can be improved by appropriate managerial actions as follows:

a) Growth of sales revenue that may be achieved through a strategy of market penetration where banks seek to deep sell and/or cross-sell to existing customers.

b) Reduction of expenses by creating a more efficient set of processes and using optimal talent management of bank staff.

c) Reduction of risk costs through the client underwriting process as well as risk monitoring actions after, for example, a loan is granted.

d) For the business unit, the cost of capital is given but treasury of the bank should seek to obtain the lowest possible funding costs of debt and equity.
These tactics will serve to enhance the economic profit of the business unit and lead to long-term value creation.

**Open Question #1**

*Here is some data for a real case. Some modifications are made to protect the confidentiality of the source. It is an example of how to conduct performance management at the business unit level.*

The Business Division is in leasing and factoring and it comprises five lines of business (LOB). An analysis of each LOB shows the following where entries are in basis points. Neglect the capital benefit.

<table>
<thead>
<tr>
<th></th>
<th>Yachts</th>
<th>Vendor-Financing</th>
<th>Real Estate</th>
<th>Equipment</th>
<th>Wheels</th>
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<td>130</td>
<td>90</td>
<td>62</td>
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<tr>
<td>Other Income</td>
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<td>-11</td>
<td>-10</td>
<td>-12</td>
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<tr>
<td>Cost of Capital</td>
<td>-10</td>
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<tr>
<td><strong>Economic Profit</strong></td>
<td><strong>-10</strong></td>
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<td><strong>-10</strong></td>
</tr>
</tbody>
</table>

a) Fill in the Economic Profit (EP) for each LOB

b) What are the main drivers of LOB financial performance in each case?

The long-term financial performance of the bank is determined by the ability of bank staff to create economic profit. This is equivalent to the case where RAROC exceeds the bank’s cost of capital. Hence economic profit is a key performance indicator (KPI) of long-term value creation.
Chapter 2:
Approaches to People Performance Measurement

We note some guiding principles that underlie people performance management and measurement. These are:

a) Performance measurement has a personal, team and company element.

b) The higher in the organisation performance management is conducted, the heavier is the weighting for team and company results.

c) Personal targets weigh more heavily for frontline staff.

d) Performance measurement is the basis for determining variable pay.

Key Performance Indicators are defined as numerical quantities that measure progress in achieving management targets aligned with the company’s strategic objectives. The general principle of KPIs is summarised below:

The main point about the design of KPIs is that they should be few in number and managers must be assured that the KPI for a selected target is appropriate and likely to produce the desired result. The trend in the values of the selected KPIs is important to determine progress in achieving management targets.

In addition, KPIs must evaluate both results and behaviour. As shown in Chapter 1, it is important to create positive bottom-line results such as long-term value creation. But it is also crucial to create the right employee behaviour so that the customer experience is positive, leading to customer satisfaction and eventually to customer loyalty. The module on Customer Care discusses this issue in detail and presents practical steps for creating a culture of customer care as well as the appropriate KPIs that will enhance this important objective of a retail bank.

Before we present some important KPIs for performance management, it is worth noting that in the design of KPIs, managers should heed the recommendations in the paper by Andrew Likierman (2009)*. He identified five common traps in performance measurement.

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Hidden Traps in Performance Measurement

**Trap #1:** Measure against yourself – using internal comparisons

**Solution:** Measure against the competition or some external benchmark.

Internal comparisons can be subjective and easy to manipulate.

**Trap #2:** Looking backward – the rear-view mirror fallacy

**Solution:** Use measures that are forward-looking.

KPIs must reflect an evaluation of performance that reflects the dynamics of evolving markets and customer preferences as well as the bank’s investment in innovation.

**Trap #3:** Putting your faith in numbers

**Solution:** KPIs must permit the evaluation of both results and behaviour. KPIs that are based solely on numbers (e.g., ROI) may encourage bad behaviour and destroy customer trust in the bank.

**Trap #4:** Gaming the numbers

**Solution:** Too many metrics will lead to ambiguity in evaluating employee performance. On the other hand, a single metric that is based solely on numbers is easy to manipulate. Care must be taken to create the right number of KPIs but they must be kept to a minimum to reduce ambiguity in evaluating performance.

Based on Trap #3 and Trap #4, it is advisable to keep KPIs to a minimum and evaluate a combination of results and behaviour.

**Trap #5:** Sticking to your numbers too long

**Solution:** Revise KPIs when necessary. Strategic objectives change and hence performance management and measurement (via KPIs) must be kept in alignment with these changes.

Coupled with these traps as identified by Likierman (2009), we add one more relating to the general issue of over-confidence in data accuracy and usefulness.

The Data and Measurement Trap

Organisations are experts at measuring information that is easily collectable, instead of carefully designing indicators that provide the information they really need. So, for example, branches tend to measure incoming deposit balances but don’t measure whether these are coming from new customers or from existing customers. This could lead to serious errors of interpretation, and managers could be victims of the so-called Simpson Paradox. This occurs where incorrect conclusions are reached when the decision-maker looks at data on a superficial basis. In other words, what is observed at the first analysis is misleading because common sense analysis was absent.

Worse, some managers measure so many things, they are overwhelmed by the data and unable to see the critical performance information it contains. Remember that most business decisions are based on some degree of information uncertainty. Do not be overcome by mathematical calculations. Use judgement and depend on acquired skills, expertise and experience. As stated in the Marketing module, data is not information and information is not insight.
Examples of KPIs for Retail Banking

Let us repeat for emphasis: retail banks must use a limited number of appropriate KPIs to permit effective and fair evaluation of performance at all levels – individual, team and divisional – and to provide organisational alignment. Furthermore, an evaluation of the values of the KPIs is necessary to assess progress towards the selected target. An analysis of budgeted versus actual values is required.

We now present common KPIs in retail banking for selected business units.

Sales Effectiveness

An important KPI is the level of sales revenue that can be further broken down into categories that vary by customer segment, product or region and by existing versus new customers.

Sales by Customer Segment

This provides data on which segments are generating the majority of sales, whether opportunities in other segments are being ignored, or if salespeople may require additional training to be more effective in a given segment. So, for example, a branch would have separate targets for the number of new Personal & Business Current Accounts per month.

If a bank is liability or deposit light, targets may be set for deposit gathering as against lending products. Alternatively, a typical branch salesperson will be required to sell current accounts, time deposits and credit cards. Let’s say their monthly goals are such that they need to sell 20 new current accounts, with a minimum incoming account balance of $200,000 so that the branch targets the right type of affluent customer, add $500,000 in time deposits and 15 new credit card accounts.

If this person is achieving 20 new current accounts but only getting an incoming balance of $75,000, clearly they are not targeting the right type of customers. This leads to a discussion around their prospecting list and how they should upgrade it. Alternatively, if they are achieving all their targets, except the one for credit cards, there may be a problem with product knowledge, and some training needs can be identified.

Sales by Product Type

This highlights the level of success of the product line, and potentially identifies opportunities for improvement. Further refinement and comparison can help determine where demand exists, and where effort is being applied.

Sales by Region

This metric profiles how sales are distributed by location. Analysis may suggest there is room for additional salespeople. Comparing sales by location may also highlight possible causes for variance. In most cases, organisations tend to underinvest in sales capacity. Setting a target for the sales team in a particular location becomes a key task. Take, for example, a branch footprint that has the potential for 100 current accounts per month. A single salesperson can at best do 10 per month, which suggests the branch should have a team of 10. However, if the branch has a team of just four, expecting those salespeople to deliver beyond their physical capacity and achieve 100 accounts per month is unrealistic.

Sales to New versus Existing Customers

This critical measure provides insight on where salespeople may be spending time, whether existing accounts are being developed, or if time is being devoted to prospecting for new customers. This is a very important KPI for a branch to focus on. Salespeople usually are of two types – ‘hunters’ who are good at finding new customers, or ‘farmers’ who are good at deepening existing relationships and increasing wallet share. A branch needs both on its sales team. Hence
the need to track performance of existing and new customer sales, and identify training or support needs to help salespeople achieve their targets on both counts.

**Average Revenue per Customer**

This provides a ‘big picture’ of effective sales. As this measure changes over time, one can assess the effectiveness and depth of market penetration. Typically, growth occurs with an increase in average revenue per customer and in the number of existing and new customers.

**Cross Sales ratio/number of products per customer**

This measures the number of products cross-sold to the customer. This is a critical ratio as it focuses on the quality of the relationship that the sales/relationship manager has established with the customer. The aim is to ensure that customers come to the firm for all their product needs and don’t open the door to competitive offerings. Typical branches have a ratio of 1.2 products per customer, but the more successful ones will have ratios that exceed two products per customer.

**Forecast Sales versus Actual Sales Results**

Almost all business performance is judged against forecasts. In fact, the stock market tends to judge overall business performance less by what has been achieved and more by what was forecast. Even at branch level this is critical. If the branch sales forecast is consistently within expected standards set by management, the branch can be said to know what is going on in the market.

**Loan to Deposit Ratio**

This measures the relationship of outstanding loans to deposits. Ideally, there is a balance between the two. If loans far exceed deposits it may be desirable to shift emphasis from loan generation to deposit gathering. It may also suggest that the bank is relying unduly on higher cost and more risky wholesale funding for loans.

**Tracking Expenses and Efficiency**

**Expenses – Actual versus Budget**

This KPI highlights performance against budgeted expenses. This is one of the most critical measures of a well-managed branch. It demonstrates that the branch manager and his/her team are able to deliver results while keeping the cost of delivery within specified cost income ratios. When done at the salesperson level, these measures can help the organisation contain costs and illustrate how well the salesperson manages budgets.

**Operating Expenses to Client Balance Ratio**

This ratio is a measure of operating efficiency and hence, all else being equal, a lower value will result in higher profitability. It is interesting to note that this ratio for the ING Direct banking model over the last several years has averaged about 45 basis points compared to traditional retail banking which typically has a ratio above 100 basis points.

**Cost Income Ratio (CIR)**

CIR is also called ‘efficiency ratio’ and it measures the proportion of each dollar of operating expense to income. The trend in CIR is important to assess efficiency in the bank. Evidence shows that the most robust way to lower the value of CIR is to increase the growth in top-line sales. Arbitrary cuts in cost may lead to the perverse effect of increasing CIR.
Measures of Profitability

Return on Equity (ROE)

ROE measures the profit of the bank as a percentage of shareholder equity. As usual the trend is important in assessing profit growth. This is appropriate at bank level. At branch level, it may be more important to consider return on regulatory capital required (RORC) or return on investment (ROI) whereby profit made by the bank branch is relative to the amount of money allocated to it over a time period.

Since ROE does not incorporate risk, it is preferable to also consider a risk-adjusted measure of profitability for the branch. As indicated in Chapter 1, RAROC is a suitable measure for this purpose.

Customer Measures

Customer Satisfaction Rating

Most organisations are unable to track this on a branch basis, as they don't get a large enough sample of customers to poll for each branch. Nevertheless, this is possibly one of the most important measures to consider. Customer satisfaction with a branch will directly affect new business from existing customers and referrals. It also affects the branch's ability to retain customers and revenues, and to ensure that the branch remains competitive.

Customer Attrition Rate

The cost of acquiring new customers is a multiple of that of retaining existing customers, estimated at anywhere between two and 10 times higher. Hence ensuring that customer churn is minimised is critical to the success of retail banking. When compared across branches in a territory, or even when comparing territories, this provides a critical insight into the ability of the branch team(s) to meet customer needs, keep acquisition costs low and maintain a strong market share.

Employee Measures

Employee Engagement Score

Probably the most important measure of people commitment to the bank's strategy is employee engagement. As shown in the People Management Module, employees who are engaged are more productive and are more likely to create a positive customer experience generating higher levels of customer satisfaction.

The application of this set of KPIs in retail banking is presented in a bank branch dashboard in Chapter 4.
Chapter 3:
Managing Divisional Performance: The Role of Transfer Pricing

At the next level of organisational complexity lies the division or business unit (BU) structure. For example, within a retail banking business there may be a Branch Network BU and a Direct Sales BU. It is critical that divisional or BU performance management be designed to ensure that not only does each BU achieve its goals, but that overall retail banking performance measures are met as well. Correct KPIs must be in place to measure divisional performance.

Divisional Performance Management and the Role of Transfer Pricing

Divisionalisation refers to the practice in an organisation where business managers are given autonomy to make decisions such as setting selling prices without referring to senior executive management. The biggest problem with divisionalisation lies in the fact that behaviour at divisional level may not be consistent with corporate goals. Think about your own organisation – how many times have you seen the corporate bank and retail bank at loggerheads about the cost of funds? The corporate bank or treasury wants to make a profit on funds given to the retail assets business – as the treasurer’s bonus is based on the profit that the treasury reports. The retail bank wants the lowest possible cost of funds so it can make a higher net interest margin on customer loans – as the retail bank head’s bonus is contingent upon the profits their SBU makes.

A measure of distrust inevitably creeps in because the objectives and behaviour of the two division heads are not congruent. In the case of a large bank, this is the equivalent of funds being sourced by the deposit gathering arms of the bank (retail bank) and being transferred to the lending arm of the bank (corporate bank). Increasingly, divisions perform services for others – for example, in many global financial service businesses, operational tasks such as call centres are outsourced by the country businesses to their divisions in low-cost geographies.

We now consider the role of transfer pricing in performance management in banks.

Funds Transfer Pricing

Funds Transfer Pricing (FTP) is a fundamental accounting practice in (retail) banking that affects RAROC through its impact on net interest margin, the largest component by far of total net income. The main point is described in the following two scenarios:
Consider a deposit-gathering business unit of a retail bank. In the normal course of business the bank staff of this business unit will gather deposits from savers at a known cost, the deposit interest rate. Bank staff can also estimate the employee costs and other operating expenses associated with IT, office space etc. The main problem is that the return on these deposits is unknown. The reason is that the deposits may be used to fund various types of assets on the balance sheet ranging from personal loans to small business loans, mortgages, and corporate bank lending.

**What is the return on deposit gathering?**

There is a similar problem when we consider a lending business unit in the retail bank. In the normal course of business the bank staff will know the price charged on a loan. But what is the funding cost? A (retail) bank typically raises funding from several sources that include personal deposits, corporate deposits, wholesale money markets, and interbank funding.

**What is the cost of funding for this loan?**

This is the role of funds transfer pricing in retail banking. The main point is as follows:

In principle, the treasury department of the bank is an intermediary in that it gathers the deposits from the deposit-gathering business unit and transfers them to the lending business unit. Take the example of a lending business unit:

**Important**

In a real sense, all interest risks in the banking book are centralised in the bank’s treasury. There is an internal market for interest-rate setting. The treasury is the internal market between two other sectors – the deposit-gathering business unit and the lending sector that underwrites credit risk. In this internal market, the deposit-gathering sector ‘sells’ deposits to the lending sector through the treasury.

The FTP accounting method calculates the price of the transferred funds which is usually market-based – the rate at which the bank borrows or lends funds in an open market.

Here is an example for a fixed-term deposit where the fund transfer price is based on an interbank yield curve related to Libor.

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**Graph:**

- **Interest Rate**
- **FTP for this Maturity**
- **Customer deposit rate**
- **Contribution Margin for this BU (eg Branch)**

*206.4: Fixed-term deposit where price relates to interbank yield curve*
The lending business unit will calculate its interest margin as the difference between the customer lending rate and the cost of funding represented by the FTP.

We present this ‘internal market’ mechanism in the diagram below:

206.5: Internal market mechanism

Normally the treasury is expected to make a profit = FTP selling – FTP buying rate. We shall see later that this spread is subject to expected future interest rate movements. Care should be taken that treasury does not inhibit the competitiveness of the core savings and lending business.

Most banks currently apply some variation of the matched maturity transfer pricing (MMFP), which is illustrated using a simple example:

The lending facility issued a two-year fixed-rate loan where the customer pays five percent annually. This loan is funded by a one-year time deposit where the customer is paid a 2.5 percent deposit rate. Treasury buys one-year money at the open-market rate represented by the one-year swap rate of 3.4 percent. It sells two-year money to the lending business unit at a funds transfer price of 3.7 percent.

Deposit-gathering Business Unit:
Contribution Margin = FTP (sell funds rate) – Customer deposit rate = 3.4 percent – 2.5 percent = 90 basis points.

Lending Business Unit:
Contribution Margin = Customer loan rate – FTP (buy funds rate) = 5 percent – 3.70 = 130 basis points

Treasury:
Contribution Margin = FTP (sell rate to lending business unit) – FTP (buy rate from deposit business unit) – cost of swapping funding from one to two years = 3.7 percent – 3.4 percent – 0.15 percent = 15 basis points.

So the total interest margin = contribution from each business unit (BU) = 90 basis points from deposit BU + 130 basis points from lending BU + 15 basis points from Treasury BU = 235 basis points.

Obviously the interest margin = customer loan rate (five percent) – customer deposit rate (2.5 percent) – cost of funding swap (0.15 percent) = 235 basis points.

Formally, we can write the net interest margin as follows:
Net interest margin =

\[(\text{Customer Loan Rate} - \text{FTP (funding cost from Treasury)}) \quad \text{Lending BU Contribution}\]

+ [ FTP (funding cost to Lending BU – FTP (Treasury yield on funding from Deposit BU) – cost of swap to match asset/liability duration] \quad \text{Treasury Contribution}

+ [(FTP (Treasury yield on funding from Deposit BU) – Customer Deposit Rate]

\text{Deposit BU Contribution}

**What has the funds transfer pricing process achieved?**

Significantly, since both the deposit-gathering BU and the lending BU have matched exposures, they are relieved of interest rate risk for the period. The contributions from the deposit-gathering BU and the lending BU are essentially locked in.

**Interest rate risk is transferred to the Treasury**

Now that we have looked at the role of FTP, we consider how it is calculated by the treasury.

**The Fundamental Components of FTP**

The FTP rate for selling funds to the lending facility is typically made up of different components – but the general rule is that it is a markup on a reference rate (e.g., appropriate swap curve rate).
The reference rate is the appropriate swap rate from a swap yield curve. The swap curve is normally upwardly sloping as duration increases. To match asset and liability duration, there is usually an associated cost. Simply put, the swap spread is the price of matching durations and eliminating interest rate risk.

Since the transfer pricing process eliminates interest rate risk for the lending BU, the starting reference rate is the swap rate for the duration of the loan.

There is also a markup for liquidity risk – mainly funding liquidity risk as well as contingency liquidity risk. Liquidity is the capacity of the bank to meet any short-term liabilities. Hence, liquidity risk may be viewed as arising from the bank taking on maturity mismatch risk between assets and liabilities. The fact that the Treasury (as in our example) is funding a two-year fixed rate loan with a one-year time deposit creates funding liquidity risk. This mismatch or structural liquidity risk arises from the maturity transformation of short-term deposits funding longer-term loans. The other type of liquidity risk called ‘contingent liquidity risk’ refers to the cost of maintaining high-quality assets to meet unexpected requirements. The Basel III liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) emphasise the requirement for liquid assets.

The credit spread is an estimate of the bank’s default risk (see below for an example of the use of credit default swaps to obtain a credit-enhanced FTP). Finally, loans may have embedded options such as the option to call or the option to prepay, which is common for residential mortgages. Indeed customers can generally withdraw funds any time they wish. Customers have a withdrawal option on their account. This further complicates the FTP process. This option is typically reflected in an adjustment of the duration, and the corresponding swap rate at that point is used.

FTP Rate = Reference Swap Rate [(includes markup for credit risk) + Liquidity Spread (markup for liquidity risk) + Optionality Spread (markup for optionality)]

From this formula for the FTP rate, we obtain the profit margin as follows:

Profit Margin =  Customer Rate – FTP rate – Operating Costs (Acquisition and Servicing Costs) – Expected Credit Loss

Here is an FTP example for mortgage pricing using actual data obtained from a large AA rated retail bank in Canada (13 February 2013). We see that the FTP rate = AA swap rate + (Liquidity Markup + Optionality Markup) = 1.7 percent +0.3 percent +0.3 percent = 2.3 percent

By accounting for operating and expected credit loss, we get that:

Profit Margin = Customer Rate (4 percent) – FTP rate (2.3 percent) – Operating costs (0.45 percent) – Expected Credit Loss (0.15 percent) = 1.1 percent

Finally, we consider the Role of FTP on RAROC. Four-year swap rate is used as the mortgage is paid off.
We now illustrate how the FTP takes into account credit risk. (We leave the other components out for this illustration). Again we use the interbank yield curve to derive the reference rate that corresponds to the maturity of a fixed rate loan (see below):

<table>
<thead>
<tr>
<th>5-year mortgage</th>
<th>4.00%</th>
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</thead>
<tbody>
<tr>
<td>AA Swap rate (incl AA credit risk markup)</td>
<td>1.70%</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td><strong>0.30%</strong></td>
</tr>
<tr>
<td><strong>Commitment (optionality)</strong></td>
<td><strong>0.05%</strong></td>
</tr>
<tr>
<td><strong>Pre-payment (optionality)</strong></td>
<td><strong>0.25%</strong></td>
</tr>
<tr>
<td><strong>FTP rate</strong></td>
<td><strong>2.30%</strong></td>
</tr>
<tr>
<td><strong>Acquisition cost</strong></td>
<td><strong>0.25%</strong></td>
</tr>
<tr>
<td><strong>Servicing cost</strong></td>
<td><strong>0.20%</strong></td>
</tr>
<tr>
<td><strong>Mortgage expected credit loss</strong></td>
<td><strong>0.15%</strong></td>
</tr>
<tr>
<td><strong>Profit margin</strong></td>
<td><strong>1.10%</strong></td>
</tr>
</tbody>
</table>

206: 7: FTP in relation to credit risk

In this example, the price of bank default – a measure of the market estimate of the appropriate credit spread – is added to the reference rate. This creates an upward shift in the reference interbank funding curve and the new FTP is obtained. It now includes the price to be paid in the market by the bank for its default risk.

Finally, we consider the Role of FTP on RAROC

**FTP and Performance Management**

As we have seen in the above analysis, the FTP process centralises risks (e.g., interest rate risk) in the treasury of the bank under the assumption that they are better managed centrally. As also seen above, the funds transfer price (FTP) is the matched maturity funding rate (the swap rate that serves as reference rate) plus a markup for other sources of risks that include liquidity, credit
and option risks and possibly a markup for profit.

Open Question #2

Does the addition of the bank default risk premium via the funds transfer pricing process reduce the incentive for branch staff to be more careful about credit risk management?

Discuss.

We have seen how the FTP process breaks down the net interest margin into three components of contribution margin. The bank branch may be seen as two profit centres – one that is a deposit-gathering business unit and the other is a lending business unit. Through the FTP process, each is treated as a creator of contribution margin. But since the FTP price is based on a market-determined reference rate plus a markup for additional risks, it may be viewed as a forward looking concept (i.e., ex-ante). The contribution margin is a measure of economic value.

As a result we can define the RAROC on a loan as follows:

RAROC = Contribution margin – Operational cost – Expected risk cost + Income on Economic Capital

Contribution Margin = R – FTP where R = customer loan rate; FTP = treasury transfer price reflecting bank credit risk and EC = economic capital. The business unit creates positive economic profit if the RAROC for this loan is higher than the cost of capital of the bank.

Open Question #3

How does the FTP process affect performance management in the bank branch?

Now that we have looked at issues related to individual, team and divisional performance management and measurement, the next step is to take an integrated view of retail banking performance. This brings us to the consideration of scorecards and dashboards. Simply put, a scorecard measures organisational performance against goals. The scorecard comprises a set of KPIs that provide a snapshot of organisational performance. Arguably, the most popular scorecard is the balanced scorecard by Kaplan and Norton.

The Balanced Scorecard

The Balanced Scorecard is a performance measurement model that comprises strategic non-financial performance measures and traditional financial metrics to give managers and executives a more ‘balanced’ view of organisational performance. Importantly, it considers performance across the two important dimensions of results and behaviours. There are four quadrants – Financial, Internal Business Processes, Customer and Learning and Growth. The focus is on customer and bank staff on one hand, and internal processes on the other. These culminate in the financial bottom line.
Summary of the Balanced Scorecard with Suggested Targets

The Balanced Scorecard is made up of four key elements. These elements are defined as:

FINANCIALS

For a retail bank, the KPIs can be created with the following targets:

a) Sales growth b) Cost income ratio c) Value Creation d) Profitability e) Risk management

CUSTOMER

KPIs can be created for the following targets:

a) Customer satisfaction b) Customer profitability c) Customer attrition rate d) New customer acquisition rate

INTERNAL PROCESSES

KPIs can be created for the following targets:

a) Cycle time b) Bottlenecks c) Service delivery time

LEARNING AND GROWTH

KPIs can be created for the following targets:

a) Staff performance b) Employee engagement c) Employee attrition d) Training and development

* Source: Balanced Scorecard Institute
A typical scorecard for a credit card company could therefore look like this:

<table>
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<tr>
<th>Organisational Strategic Objectives</th>
<th>Customer</th>
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<tbody>
<tr>
<td><strong>Financial</strong></td>
<td><strong>Customer</strong></td>
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<tr>
<td>• Revenues</td>
<td>• Customer Service score</td>
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<td>• Operating costs</td>
<td>• New products launched</td>
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<tr>
<td>• Credit &amp; Fraud Losses</td>
<td>• Market share</td>
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<tr>
<td>• Increase revenues</td>
<td>• Brand awareness</td>
</tr>
<tr>
<td>• Reduce cost</td>
<td>• Increase market share</td>
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<tr>
<td>• Increase shareholder value</td>
<td>• Improve brand image</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Business Process</strong></th>
<th><strong>People</strong></th>
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<tbody>
<tr>
<td>• Productivity at operations</td>
<td>• Staff training index</td>
</tr>
<tr>
<td>• Branch sales productivity</td>
<td>• Staff retention rate</td>
</tr>
<tr>
<td>• Customer onboarding time</td>
<td>• Staff satisfaction and engagement index</td>
</tr>
<tr>
<td>• Increase economies of scale</td>
<td>• Optimise workforce – costs and number</td>
</tr>
<tr>
<td>• Reduce defects</td>
<td>• Enhance workforce skills</td>
</tr>
</tbody>
</table>

The above example shows how the Balanced Scorecard can be used in a retail bank so as to translate strategy into an operational view of how the business is performing in terms of its ability to meet pre-set targets.

The Balanced Scorecard can be viewed as a strategic map of how a retail bank actually conducts its business. Here is an illustration of this:
206.9: Balanced Score Card as a Strategic Map

Finally, we end this module with a discussion of a bank (branch) dashboard.
Chapter 4:
Bank (Branch) Management Dashboard

A dashboard is a “visual display of the most important information needed to achieve one or more objectives; consolidated and arranged on a single screen so the information can be monitored at a glance” – Stephen Few, Information Dashboard Design (2006).

Specifically, let us consider a bank branch dashboard, an excel-spreadsheet that captures the full view of selected branch metrics.

This dashboard considers branch performance over several dimensions including:

a) Budget versus actual spend on a comparative basis. This shows the progress being made over time.

b) Related categories of KPIs include:
   - Financials such as income, staff cost and risk costs (profit and loss)
   - The scale of the business in terms of deposit balances, loan balances and mortgage balance
   - FTEs and client numbers
   - Efficiency of the business in terms of cost income ratio and risk costs
   - Profitability in terms of ROE
   - Employee engagement and customer satisfaction scores
## Performance Dashboard Branch

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<th>November 2012</th>
<th>Profit and Loss/KPIs</th>
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Importantly, the branch dashboard permits branch managers to visualise performance on a daily, monthly or quarterly basis and to discuss progress and share best practice with other branch managers.

The use of the branch dashboard can generate healthy competition among bank entities (e.g., between branches in a selected region to ensure proper comparison) by making periodic performance data available to all branch managers.

Summary

This module considered performance management and measurement in retail banks with special emphasis on the following topics:

a) Managing for Value – The Role of Economic Profit

b) People Performance Measurement. Key Performance Indicators (KPIs) or Value Drivers

c) Transfer Pricing and Divisional Performance

d) Bank Branch Management (Dashboard)

We demonstrated that transfer pricing has a direct bearing on the performance of divisions and business units. Performance measurement must be guided by a limited number of KPIs that are based on results and behaviours. The Balanced Scorecard summarises the four key areas of emphasis when it comes to organisational performance. Finally, we presented a branch dashboard for a retail bank that serves to monitor performance.
Multiple Choice Questions

1. Which of the following leads to positive economic profit for a bank?
   a) Return on Equity < Cost of Equity
   b) Net interest margins are positive, as would be the case for an upward sloping yield curve
   c) After-tax profit > the bank’s borrowing rate on long-term loans
   d) Return on Equity > Cost of Equity

2. What is the profit margin on a loan product where the FTP rate is 150 basis points, customer loan rate is 340 basis points, operating costs 30 basis points and expected credit loss 20 basis points?
   a) 150 basis points
   b) 100 basis points
   c) 120 basis points
   d) 140 basis points

3. All of the following will increase RAROC except:
   a) Higher growth in sales revenues
   b) Higher cost of capital
   c) Reduction of risk costs
   d) Reduction of expenses

4. Which is not one of the four quadrants of the Balanced Scorecard?
   a) Customer
   b) Financials
   c) Internal Processes
   d) Team Performance Measurement

5. Which of the following statements is incorrect?
   a) Performance measurement has a personal, team and company element.
   b) The higher in an organisation in which performance management is conducted, the heavier the weighting for team and company results.
   c) Personal targets weigh less heavily for staff in a department.
   d) Performance measurement is the basis for determining variable pay.

6. Which of the following is incorrect in relation to metrics for a bank branch dashboard?
   a) Customer balances measure the scale of the business.
   b) Net promoter score is a measure of customer satisfaction.
   c) Cost income ratio is a measure of operational efficiency.
   d) The number of full-time equivalent employees measure the net profitability of the business.

7. Which of the following KPIs is a direct measure of expense efficiency?
   a) Cost income ratio
   b) Return on equity
   c) Sales per customer
   d) Salespeople engagement score
8. The following information is obtained for a bank product: Interest Margin = 236 basis points; Direct Costs = 110 basis points; Risk Cost = 12 basis points; Cost of Capital = 10 basis points. The economic profit for this product is:

a) 114 basis points  
b) 132 basis points  
c) 104 basis points  
d) 98 basis points

9. Which statement is incorrect?

a) If RAROC for a business unit is higher than the bank’s cost of capital, then the business unit has created positive economic profit.  
b) The FTP process has transferred interest rate risk to the bank’s treasury.  
c) An appropriate KPI for the Learning and Development quadrant of the Balanced Scorecard is customer attrition.  
d) Performance management aligns and creates strategic clarity between high-level strategy in the bank and its desired objectives.

10. Which of the following attributes of KPIs can lead to a problem called ‘gaming the numbers’?

a) Backward-looking  
b) Based only on internal comparisons  
c) Based only on numerical outcomes  
d) Having too many KPIs

Answers

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