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For the approximately 14,000 community banks and credit unions struggling with increased regulation in the current economy, there's bad news and good news.

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Community financial institutions are significantly overpaying for one of their largest categories of non-interest expense — outsourced core processing and IT services — according to a new report from the Business Performance Innovation (BPI) Network. The good news is that institutions are reducing these costs by as much as 43 percent, and by an average of 24 percent, by restructuring their vendor contracts based on national pricing data.

The BPI Network report, entitled "Less Burn. More Return," also reveals that bank and credit union executives believe their top two priorities for the coming 12 months are increasing the size of their loan portfolios and cutting non-interest expense. In addition, 68 percent of executives surveyed said they expected mergers and acquisitions to increase significantly over the next 24 months. However, only three percent said they expected to participate as sellers, while 42 percent said they were likely buyers, and 18 percent indicated they would be either as buyers or sellers depending on the opportunity.

To develop the study, the BPI Network surveyed bank and credit union executives,

services contract restructuring appears to be one those opportunities. These contracts now represent the second or third highest non-interest expense category for most community financial institutions. We highly recommend that bankers look at our findings and take appropriate action."

The study found that financial institutions with $500 million to $1 billion in assets saved an average of about $1 million over a five-year period when they restructured existing contracts based on national pricing data. Based on an average net interest margin for community banks of 3.6 percent in the fourth quarter of 2012, a financial institution would have to make $5.6 million in new loans, on day one, to generate an equivalent $1 million in net interest revenue. Of course, this does not consider the capital reserve requirements, customer acquisition costs, loan risks and regulatory issues associated with maintaining such loans.

Restructuring Contracts Prior to M&A Deals

The "Less Burn. More Return" report also demonstrates that community financial institutions can significantly increase shareholder value for buyers or sellers in a merger or acquisition by restructuring core service contracts in advance. The improved value comes from the combination of increasing franchise profitability prior to an acquisition, plus the inclusion of terms and conditions that will further improve efficiencies and reduce service cost after the merger. Including terms that reduce cost per transaction when a franchise reaches a certain transactional volume or capping conversion costs in the case of a merger are two examples. One bank in the study estimated that it increased its acquisition price by seven percent due to contract restructuring.

"The secret to restructuring a contract with an incumbent vendor is having the right pricing data in advance of negotiations, getting started well before the current contract expires, and negotiating a win-win agreement with the vendor," according to Aaron Silva, President and CEO of Paladin. “Many financial institutions may

margins (79 percent), increased government regulation (72 percent), sluggish economic growth (54 percent) and greater competition from larger institutions (33 percent).

- *The top management priorities for the next year include growing loan portfolios (82 percent), reducing non-interest expense (63 percent), managing new regulatory requirements (50 percent), increasing net interest margins (37 percent), and adding new technologies and bank processes (34 percent).*
- *Community financial institutions continue to add new customer-facing technologies and processes. Ninety percent reported having added new technologies and services in the past three years, and 74 percent plan to add additional services in the next three years.*

“Many community banks and credit unions feel they are playing catch-up with larger institutions when it comes to technology-enabled services for customers. Mobile banking is an area of particular interest,” said Silva. “We believe contract restructuring can play a significant role here, as well. By restructuring existing core processing and IT service costs, community financial institutions can effectively pay for these new service offerings.”

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