WHY AUTOMATION IS NOT OPTIONAL

TARGET: BACK OFFICE
WEAPON: AUTOMATION
RESULT: SMOOTHER ROAD TO RECOVERY

SRM ACADEMY BRIEF
May 2020

THE SRM ROAD TO RECOVERY SERIES

THAT LOUD SUCKING SOUND

The back-office operations at financial institutions - from receivables to auditing to accounting and back- are dense with manual, repetitive operations. In the current climate, these labor-intensive, monotonous processes are low-hanging fruit representing uncovered cost savings that can make a material difference on the road to recovery.

The reason financial institutions have poor levels of efficiency in the back office is not due to ineptitude. Rather it is largely due to the many other critical responsibilities on which they must focus; those central to providing financial services to consumers and businesses. Given these demands, there is often an "if it is not broken, don't fix it" mindset present that – because of these many other priorities – remains unchallenged.

EVOLVE OR DIE

Long before the COVID-19 pandemic, the largest institutions had awakened to the fact that they must garner economies of scale and improved efficiencies wherever they can. Their application of various Artificial Intelligence (AI) tools signals one way they believe they can achieve their goals. Many of the other thousands of banks and credit unions have yet to do so. There is often a default in the thinking of community financial institutions that AI is not something they can afford and/or use effectively. However, it is important – even vital – that these organizations understand that the benefits of AI are not limited to the biggest financial institutions.

For community institutions, AI should be used to target low hanging fruit in the back office. Look for processes more fit for a machine than a person. Typically, several of these can be replaced with AI and yield a ROI in the near term that repeats annually. In addition to uncovering cost savings, the financial institution recoups the lost opportunity cost of having a talented human resource doing what can be done with software.

One area where AI can make a profound difference is in how banks and credit unions manage the multi-faceted relationships they have with their vendors. These relationships are not only complex, but the number of them that must be managed is growing. Certainly, there was a time when the goal of consolidating vendors in order to decrease the overhead associated with managing them seemed plausible. The digital age, with its ever increasing rate of innovation, has erased that hope and has caused just the opposite, a proliferation of new vendors with new technology that is vital to meeting the expectations of customers and members. Given the proliferation of vendors and the economic downturn, there has never been a better time for utilizing automation to improve efficiencies, lower costs, and prevent expensive errors within this area of an institution's operations. This brief will highlight areas with vendor relations where these benefits can be most readily accessed.

AUTOMATION IN THE VENDOR RELATIONSHIP ECOSYSTEM

There are several specific use cases where automation can be applied to optimize, simplify, and inform various areas that are part of an institution's vendor relationships. Considering the regulatory and compliance scrutiny that serves as the backdrop for all critical vendor relationships, these benefits carry with them not just operational upside but help institutions meet the obligations assigned to them by governmental agencies.

Below is a summary of how automation can reduce the overhead associated with manual processes and also improve quality in ways that lower risk.

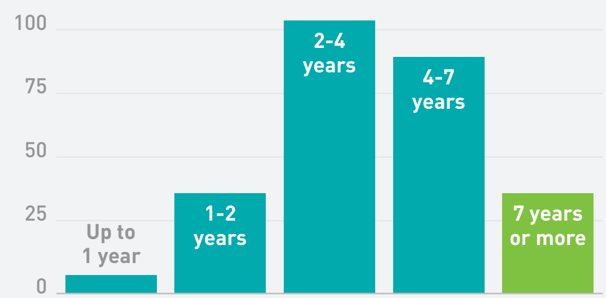
Parsing contracts and establishing alerts associated with mile-stones such as auto renewal, termination notification, and more.

Conducting vendor due diligence and risk assessments to identify high risk suppliers which require careful monitoring and oversight.

Tracking contract variables impacting costs to ensure vendor invoices represent them correctly.

Auditing vendor invoices to identify abnormalities using prior invoices and details within existing service contracts.

VALUE OF AUTOMATION



Source: IACCM, Benchmark Research, 2019

NOT FOR THE FAINT OF HEART, ESPECIALLY GIVEN REGULATORY FOCUS

The descriptions of these capabilities may sound rather simple, leaving some to think that automating these areas in the ways described could make them double down on their approach of using spreadsheets, formulas, and lower paid administrative personnel. This perception would be incorrect as well as costly to retain the expense and risk associated with the use of human resources.

The critical vendor contracts financial institutions rely on span several years and are very complex. They contain milestones in them – e.g., notification to terminate, autorenewal – which, if missed, can cost an institution hundreds of thousands of dollars. The FDIC stated long-term contacts and those which automatically renew "may be at higher risk" for coverage gaps and institutions should assess and manage them better than they are currently.

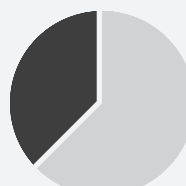
It is no longer possible to handle critical vendors using a "set and forget" mentality. The OCC noted that, "... the quality of risk management over third-party relationships may not be keeping pace with the level of risk and complexity of these relationships. There are instances in which management has failed to properly assess and understand the risks and direct and indirect costs involved in third-party relationships."

Let us discuss a specific example...properly auditing vendor invoices and tracking contracts is difficult for many financial institutions to accomplish with regularity and thoroughness. Contracts are signed, invoices paid, and the details concerning thresholds or other events which could trigger increases in cost are forgotten in favor of the day-to-day management of the vendor's services.

Because of the shear complexity of vendor invoices, many containing hundreds of line items, institutions do not perform a thorough audit them. This is understandable given auditing an invoice thoroughly can take hours, and any complete audit of a critical vendor invoice is typically done after the invoice has already been paid. This approach leaves money on the table at a time when such an approach is unsustainable. A study, conducted by SRM, Inc in 2019 involving the review of tens of thousands of vendor invoices from the banking industry, revealed an average vendor invoice error rate of 10 percent. The cost of these errors range between a few hundred dollars to several hundred thousand dollars.

According to regulators, many institutions have failed to perform adequate due diligence and ongoing monitoring of third-party relationships by entering into contracts without assessing the adequacy of a third party's risk management practices. FIs enter into contracts that motivate a third party to take risks that are often detrimental to the institution and consumer, in order to maximize the third party's revenues and engage in informal third-party relationships without contracts in place.

VALUE OF AUTOMATION



37% [1]
REDUCTION IN ERRORS

44% [2]
REDUCTION IN COST

82% [3]
REDUCTION IN TIME

1. Impact of Automation, JSTOR 2. Concur Solution Research 3. Institute of Financial Management

THOUGH IT MAY SEEM OTHERWISE – MANUAL PROCESSES ARE BROKEN AND NEED FIXING

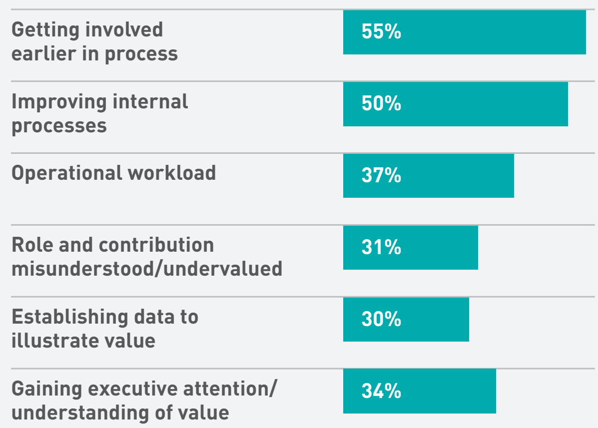
Perhaps the most dangerous perception associated with managing vendor relationships is that the current manual system works. This "If it isn't broken, don't fix it" mentality is as big a threat to organizations as undiagnosed internal bleeding is to human beings. In other words, the stark message to community financial institutions is, "It may not feel like you are dying, but you are." During this recovery, not addressing such "internal bleeding" could hasten your demise.

Utilizing this same technology to audit invoices means software algorithms can review every line, every invoice, every month, with accuracy and speed, before the invoices are paid. By utilizing automation in a focused way, key areas of risk and cost can be addressed by financial institutions without requiring a large investment or a long wait to gain enough benefit to cover the cost. Efficiencies gained from automation decrease the time spent on many of these activities at a range between 20 to 50 percent.

Community financial institutions' back offices processes are robbing stakeholders of millions of dollars even while the advancements in technology exist to return even more value to those same groups. As one banker said, "The failure to automate in these critical areas is akin to putting on metal cleats to walk on a metal grate during a lightning storm … and you'll never see the one that gets you, but, trust me, you will feel it."

This "If it isn't broken, don't fix it" mentality is as big a threat to organizations as undiagnosed internal bleeding is to human beings. It may not feel like you are dying, but you are.

MAJOR CHALLENGES IN CONTRACT AND VENDOR MANAGEMENT



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