Perspectives

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STRATEGIC USES FOR CUSTOMER PROFITABILITY RESULTS

By Brad Dahlman, Sr. Product and Consulting Services Manager, ProfitStars

As accounting/finance professionals, we spend the majority of our time focused on delivering accurate financial reporting, but less time determining how the information will be used by the business units tasked with driving the institution's success.

As a result, accounting/finance managers often want to have deep conversations about Funds Transfer Pricing (FTP) methodologies or the benefits of full absorption costing rules. While having good business rules is key to providing accurate results, it is equally important to focus on how front-line employees should be using customer profitability data to effectively drive business decisions.

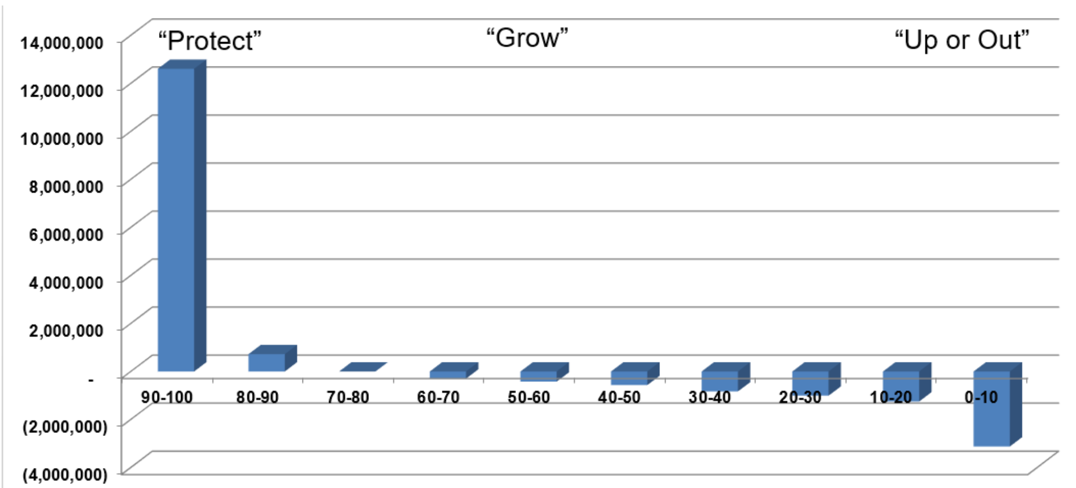
Identification and Protection of Key Clients

In the more than 100 customer profitability installations I have overseen, it has been universally true that over 180% of a financial institution's profitability comes from the top 20% of clients. This dramatic concentration of profit among relatively few clients demonstrates the importance of identifying these key clients and putting in place strategies to ensure they never leave your institution. While most well-run institutions have a good idea of who many of their top clients are, there are always some surprises – especially with deposit/service clients that don't go through credit underwriting processes.

In Figure 1, a well-performing $800-million bank shows average profitability for each client in the top 10% as $4,623 annually. Losing any of these clients will certainly hurt, so the organization must:

1. Identify them
2. Assign relationship officers to these key accounts
3. Put in place programs or rewards to ensure the client is satisfied, including providing key profit information to tellers and personal bankers so they can properly address fee waiver requests
4. Track lost "key" clients

FIGURE 1: PROFIT IS HIGHLY CONCENTRATED



Decile	90-100	80-90	70-80	60-70	50-60	40-50	30-40	20-30	10-20	0-10
Annual Profit	$12,606,960	$720,461	($2,636)	($294,663)	($420,957)	($565,610)	($829,480)	($1,006,724)	($1,247,660)	($3,124,221)
% of Total Profit	216%	12%	0%	-5%	-7%	-10%	-14%	-17%	-21%	-54%
Ave Profit/Cust.	$4,623	$264	($1)	($108)	($154)	($207)	($304)	($369)	($457)	($1,146)

Effectively Pricing New Transactions

The second use for customer profitability data is in pricing new transactions. As new business requests (loan or deposit) are considered, institutions with a customer profitability system should:

1. Understand current profitability (i.e. "before")
2. Price the new transaction, considering various pricing scenarios and terms
3. Assess the "after" – or post-approval profitability – to ensure an adequate return (profit/ROE)
4. Provide only those options to the client that meet targeted profitability thresholds

Segmentation and Marketing Strategies

The third major use for customer profitability data is by the marketing department. Accurate customer profitability data is often loaded into CRM/MCIF systems, as opposed to using rudimentary CRM/MCIF tools to determine profitability. With this accurate data imported into the application, the data is then used to segment clients and develop marketing campaigns targeted around both product usage and profitability data.

While many CRM/MCIF systems have basic profitability analysis included, it is essential to have one consistent view of profitability for use by finance/business leaders, tellers or other front-line personnel, as well as marketing. As such, data from a sophisticated profitability system should ideally be fed into the CRM/MCIF system.

Evaluation of Relationship Managers' Performance

The fourth major use for customer profitability data is evaluation of relationship managers' performance. The concept here is to determine the value of a relationship manager's portfolio at the beginning and end of the year to assess profit improvement.

In most institutions today, relationship manager goals often revolve around production goals like growing loans and/or deposits. While growth is indeed a positive measure, we also want to make sure these goals align with profitability goals. Without profitability targets, relationship managers will be incentivized to simply "price down" transactions to win business that could negatively affect the institution's overall financial performance. In other words, not all deals are profitable!

When a relationship manager has profitability growth goals, he or she is encouraged to find ways to make transactions profitable. Access to customer profitability data and effective pricing tools are key elements in this process.

Summary

Customer profitability systems have been available in the market for many years. However, the number of financial institutions that have accurate, sophisticated customer profitability systems and use them in the manners described above are few.

In my experience, community bank clients who actively use their customer profitability systems have experienced between 8-10 basis points of additional profitability over their peers. As your institution considers future growth and profit objectives, it is therefore worth asking this basic question: "Do we provide our front-line staff with the information to effectively engage with clients to grow profitability?"

If the answer to this question is "no," perhaps 2019 should be the year your organization explores customer profitability and pricing solutions.

ABOUT THE AUTHOR

Brad Dahlman is a Senior Product and Consulting Services Manager for ProfitStars focusing on the importance and uses for relationship profitability. In addition to developing a customer profitability system in the late 1990s, Brad has personally led the installation of customer profitability solutions at over 100 financial institutions over the past two decades. He has a broad background in banking and has held various positions in finance, audit, operations and technology with several mid-sized community banks.

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