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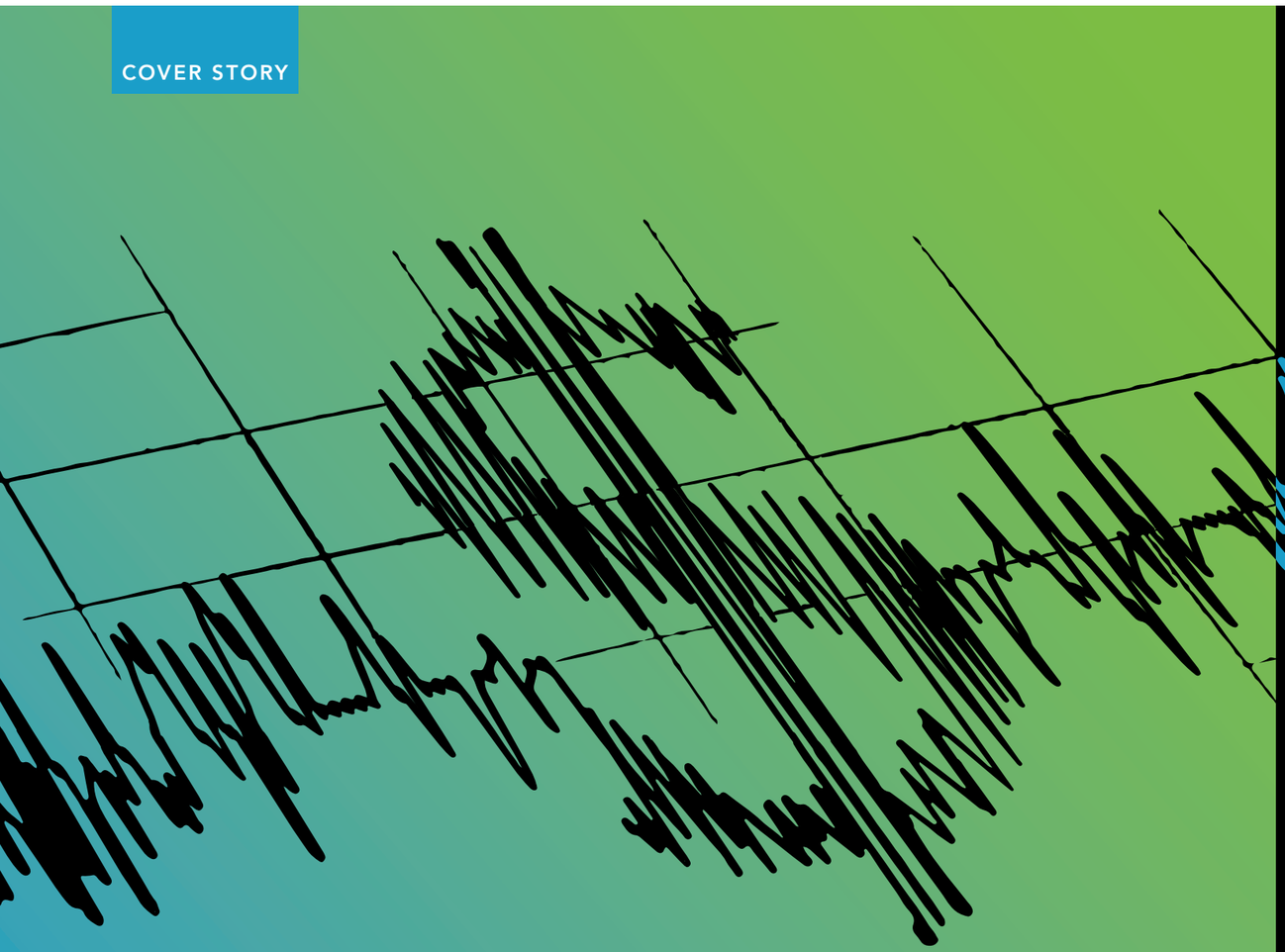
COVER STORY



The Pulse of Profitability

A TRIO OF INDUSTRY VETERANS WEIGHS IN ON THE ART AND SCIENCE OF PROFITABILITY MANAGEMENT

Recent FMS research confirms what appears to be a growing trend in the industry – more and more community banks and credit unions are not only performing some form of profitability analysis, but are significantly relying upon that information to make strategic decisions (see callout box on page 11). While the greater emphasis on profitability management can certainly be seen as a positive for these institutions, as they start to make a more pronounced effort to better understand and benefit from their abundance of data, the question remains as to whether they're really scrutinizing the most significant dimensions of their business in this regard.

Any discussion of profitability analysis will, of course, involve a wide range of opinions concerning the most important numbers and/or factors upon which to focus. From business lines to customers to products to officers to channels to some grand combination of all of these, there are a number of different facets to consider when trying to assess the full profit picture of an institution.

But is there more to profitability management than simply trying to pump up the average profitability of the money under management for each customer? How does the **scope** of a customer's influence – that is, both the customer's relationship to the institution and his or her network of connections to other customers – impact the bottom line, and what can banks and credit unions do to maximize this side of the profitability equation?

To tackle these burning questions, we called on **BRAD DAHLMAN** of ProfitStars, **KEN LEVEY** of Kaufman, Hall and Associates and **GREGG WAGNER** of The Kafafian Group for a closer look at how institutions can best attempt to balance both the art and the science of profitability management.

Do you consider profitability improvement to be more of an art or a science?

BRAD DAHLMAN: It's an interesting question. There are definitely some components of each in profitability, but I view it primarily as a science.

When thinking about profitability there are really three major components to consider. First are the data elements required to determine profitability (science). Second is the database/engine needed to perform calculations on the data and store the results in a manner that can be easily retrieved (science). And third are the business rules that drive profitability calculations, such as funds transfer pricing, credit cost, expense and capital allocations (both science and art). There are industry standards for these methodologies, but there certainly is an element of art to this component.

Each organization can and should discuss various approaches to these methodologies to determine which approach is most appropriate for their institution.

KEN LEVEY: It's definitely a little of both. The art is to consider the full scope of a customer's influence on overall institution profitability, but there is solid science behind the ability to make data-driven decisions based on the profitability and risk associated with that customer's business.

The optimal approach analyzes a variety of profitability drivers – for example, the allocation of net interest income, non-interest income/expense, loan loss provision and capital.

GREGG WAGNER: Of course you need a little of both – you need the science to ensure you have the right data as the basis for your decisions, and you need the art to be creative in developing solutions to the problems.

Take for instance a bank that has seen its cost to originate commercial loans increase. You need the profitability data (science) to determine why the costs are increasing. The data should provide the source of the increase, such as increases in loan underwriting or loan processing. The art comes in then determining the best solution to reduce costs, such as using technology to drive more efficiency into the origination of a loan.

What dimensions or profitability drivers are most institutions tracking? What should they be tracking?

DAHLMAN: When it comes to dimensions of profitability, I like to think about 'layers,' starting at the highest level and moving down to the lowest level from institution-wide profitability to department profitability to product profitability to customer profitability.

We find that over 180% of an institution's profit comes from the top 20% of clients. Understanding where your clients fall on the profitability spectrum is essential for segmentation and effective customer engagement.

Brad Dahlman, Sr. Product Manager – ProfitStars

All institutions track institution-wide profitability and its various components (margin, fees, expenses). However, as you move down from institution-wide, the level of adoption diminishes with each level seeing lower adoption (customer profitably being the lowest).

The other interesting challenge with profitability is that as you start to examine profit at levels below the institution level, you need to start to consider funds transfer pricing, credit risk and expense allocation rules, since they are not 'balanced.' These are essential to properly allocate margin, credit risk and expenses to departments, products and customers.

LEVEY: According to our 2019 Profitability Perspectives survey jointly conducted with FMS, over 93% of institutions say it is *important* to monitor the profitability of organizational / business lines, customers, products and relationships, and nearly three quarters say you should track officer profitability. However, the percentage of institutions that actually track those dimensions is far fewer: 83% track organizational / business line profitability; 54% track product profitability; and fewer than 40% track customer, officer or relationship profitability.

We feel it is important to track profitability across all of these dimensions to get an accurate picture of institution health and to drive appropriate business decisions. Each institution needs to evaluate the importance of each dimension relative to its own business model.

WAGNER: The profitability drivers most institutions are focused on today are the net spreads for both loans and deposits. Our data shows that during the past three years of Fed tightening, the net spread on loans is coming off its high but has recently found a resting point. On the other hand, the spread on deposits has benefited from the Fed tightening. Banks may have lost that benefit since the Fed is currently holding rates in place, and at the same time institutions are seeing more demand for deposits which is causing deposit rates to rise.

If deposit rates continue to increase, those banks with a stronger core deposit base will certainly be the winners through this latest interest rate cycle.

How do customer relationships impact profitability?

DAHLMAN: Customers are the reason we exist and the source of our revenues! The most important thing for institutions to understand is that profit varies dramatically by customer. We find that over 180% of an institution's profit comes from the top 20% of clients. Understanding where your clients fall on the profitability spectrum is essential for segmentation and effective customer engagement.

LEVEY: A very small percentage of relationships – typically about 1% – generally adds the most value to an institution's profitability. The loss of any of these relationships can have a significant impact on institution health.

Full relationship management or 'super-householding' is typically related to commercial accounts where an individual's business and personal network are included in his or her scope of influence. These ties can magnify the results of any front-line interaction. Understanding the relationships and where the value comes from is imperative to managing a profitable portfolio.

WAGNER: The impact is enormous. For example, let's say Bank A's commercial lenders are rewarded on growing their loan portfolio and are not necessarily focused on deposit growth. These are normally the institutions we see with higher borrowing levels to fill their funding gap, which impacts earnings through a higher cost of funds. Bank B, meanwhile, has commercial 'relationship' employees who are incented to grow 'relationships' through both loans and deposits. These are the types of institutions we find that tend to have lower funding costs and higher overall profitability.

What profitability benefits can financial institutions achieve through more effective management of their relationships? What are some of the requirements and challenges of doing this?

DAHLMAN: When an organization installs a customer profitability system, it will immediately gain insights into the 'profitability distribution.' This distribution is essential in segmenting clients and providing direction to employees about how to engage with clients. We often see three segments.

The **protect** segment includes your highly profitable clients, which are in the top 10% of your organization. Because they deliver substantial profit, these relationships demand extensive efforts to protect them from leaving, such as assigning a designated officer and making regular outbound calling efforts. The **grow** segment represents the 'middle 80%' of clients. These relationships are 'incrementally' profitable, but when loading fixed costs are often unprofitable. For clients in this segment, the institution will want to try to market products and services that either improve profit or decrease costs, such as increased debit card usage or e-statements. Finally, customers in the **up or out** segment are in the bottom 10% of profitability. They tend to be either problem credits or accounts that have been inappropriately priced. For these clients, the institution needs to work to shore up credit issues and re-price transactions when they renew.

A TRENDING MARKET – THE STATE OF PROFITABILITY ANALYSIS

If the responses in a recent FMS survey are any indication, profitability analysis is playing a bigger role in the plans of financial institutions in 2019. When asked about the priority of profitability analysis in their institutions, 42% of the 400 bank and credit union executives surveyed said it is "significantly relied on for strategic decisions," an increase of **9%** compared to 2018. A corresponding decrease was noted among those respondents who perform some type of profitability analysis, but do not closely scrutinize the results – down to 14% in 2019, compared to 22% in 2018.

Source: Community Mindset: Bank and Credit Union Leadership Viewpoints 2019 – FMS Research

The key steps in this process include defining how you will use profitability data, installing a customer profitability system, educating staff on profit drivers and specific actions around use and monitoring use and establishing accountability. While there are often challenges associated with installing and educating (steps 2 and 3), most often tend to fall down on steps 1 and 4 – defining how the data will be used and creating accountability for use usually pose the biggest challenges.

LEVEY: Correctly defining relationships and accurately analyzing their profitability provides a number of benefits, including identifying trends, opportunities and challenges; limiting the risk of underserving the best customers (and overserving less profitable ones); accurately pricing new business to optimize key profitability metrics; and more effectively managing risk-adjusted contribution over time.

Providing a robust calculation and modeling engine that accurately evaluates profitability and generates acceptable pricing scenarios provides relationship managers with further tools for success. Keys to making this work are defining each calculation needed (examples include funds transfer pricing (FTP), risk-adjusted return on capital (RAROC), provision expense and cost allocations) and agreeing on methodologies for calculation and how to access the source data.

In other words, it starts with making the data transparent. Each institution must establish methodologies, hurdle rates and other thresholds that are easily understood. Making the data transparent also allows institutions to hold relationship managers accountable.

A very small percentage of relationships – typically about 1% – generally adds the most value to an institution's profitability. The loss of any of these relationships can have a significant impact on institution health.

Ken Levey, VP of Financial Institutions – Kaufman, Hall and Associates

WAGNER: The most meaningful benefit of building an institution focused on strong customer relationships is a more stable and lower-cost funding base. The more 'full-relationship' customers the institution has, the less volatile and less expensive its funding base should be.

The challenge in fostering a relationship banking culture is centered on ensuring products are developed to enhance relationships and, most importantly, ensuring your employees have the proper training and incentive plans to motivate them to build those strong customer relationships.

What kinds of decisions might institutions be able to improve through better relationship management?

DAHLMAN: For organizations that have a customer profitability system installed and are actively using, it really transforms the way they manage their business, by establishing pricing guidance for new transactions, creating accountability around 'key client retention' for the most valued customers and evaluating officer performance partly on the profitability of their portfolio over time.

The challenge in fostering a relationship banking culture is centered on ensuring products are developed to enhance relationships and, most importantly, ensuring your employees have the proper training and incentive plans to motivate them to build those strong customer relationships.

Gregg Wagner, Managing Director – The Kafafian Group

LEVEY: By accurately defining the full scope of each relationship in the institution (including all related customers and accounts), then quantifying and comparing their profitability, relationship managers can identify and expand their most profitable relationships and provide needed focus on relationships that pose a drain on earnings. These insights can guide several decisions:

- Individual relationship managers can better manage the relationships within their own portfolio, informing pricing on new business, and appropriately prioritizing their business development and account management efforts.
- Their managers can identify what top performing relationship managers do differently to coach others, as well as tying incentive compensation to relationship profitability (vs. production volume).
- Institution leadership can get a more accurate gauge of current performance and better predict future performance based on factors such as relationship profitability of the portfolio as existing loans and deposits mature, and the effect of new business on future profitability.

WAGNER: To help strengthen the relationship with current customers, provide additional incentives rewarding your loyal customers with more competitive pricing to further deepen their relationship with your institution. Since customers who use you as their primary institution are normally your most profitable customers, you can provide incentive pricing to maintain and build your relationship with them. In the long run, this should build overall banking relationships and reduce the need to only build your balance sheet through significant incentive-type pricing that usually only attracts non-core relationships.

What steps can an institution take to cultivate the kind of relationships that can lead to better profitability?

DAHLMAN: Improving profitability is first about understanding current profitability, then segmenting clients and developing plans for each of those segments. There are specific strategies associated with each of the customer segments I mentioned earlier.

For clients in the **protect** segment, it's all about retention. Keeping this business is the first priority, so institutions need to assign account officers and make regular outreach efforts to stay close to these clients. It's also beneficial to seek referrals in this segment, as these clients often have contact with similarly valuable prospects for the institution. The **grow** segment comprises the vast majority of an institution's client base (the 'middle 80%'). Because there are so many of these clients, regular contact/outreach simply isn't possible. So the goal here is to use profitability data to target market to clients based on product use and profitability. For these clients, it's all about incremental profitability and getting an additional $3-$5 per month in additional revenues or lower costs, which can have a big impact on profits. In the **up or out** segment, meanwhile, it's all about trying to find ways to diminish the loss by working to improve credit (or find an alternative lender) and employing effective pricing as transactions re-price.

LEVEY: Pricing correctly is probably the most critical element. Institutions need to provide the best financial products for their customers at a price point that makes sense to the customer, but do so in a way that is financially prudent for both the institution and its investors. This can be accomplished by pricing new business based on the entire relationship, comparing different scenarios such as changes in interest rates and/or fees that both meet customer needs and meet or exceed established profitability metrics.

WAGNER: Our experience has shown that institutions that do not feed their customer profitability systems with their own cost accounting system data most likely are using flawed data to make decisions. Many customer profitability systems use pool transfer pricing and 'industry' product cost data to determine the profitability of their customers, which may not provide accurate customer profitability information.

Institutions with a cost accounting system can upload transfer pricing data based on the characteristics of each loan and deposit and their actual cost data for each of their products into a customer profitability system. Which information would you rather use as the basis for your customer decisions? ▪

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