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White Paper

Driving Profitability Through Relationships

How to Effectively Identify, Measure and Manage Relationships

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With tight margins and continued pressure on earnings, many financial institutions want to better understand what drives their profitability and where opportunities exist for enhancing it. That means analyzing and understanding profitability drivers across a range of dimensions, including business lines, products, accountholders, channels and relationships.

Relationships Redefined

When ranking traditional profitability dimensions in order of importance, finance professionals in banks and credit unions widely recognize individual accountholders as the foundation for profitability measurement.

An even more powerful area – and one that now can be identified, measured and managed effectively – is the full relationship an account brings to the financial institution. Full-relationship management is typically related to commercial accounts, in which accountholders' business networks are included in their scope of influence.

All business silos – such as retail banking, commercial lending, investment banking and wealth management – contribute to the overall profitability of a relationship, which is administered by a manager with authority for pricing and other interactions that affect accountholders. The people or companies in a relationship have ties to one another that might magnify the results of any interaction.

A limited number of relationships often generate a disproportionate amount of net income in financial institutions. That creates risk and opportunity:

- If the institution loses a consumer or business in a top relationship and others in that relationship follow suit, the effect on the institution's performance will be material
- If the institution fosters additional referrals from existing relationships, growth can ensue

Knowing where profit is made enables effective pursuit of strategies to grow a particular base. Enhanced consumer and business experience, the right pricing decisions and growth of profitable relationships are interdependent. High-quality relationship management and relationship-informed pricing drive improved experiences, retention, referrals and profitability.

How Ready Is Your Institution?

The following questions can help executives and managers assess readiness to boost the profitability of relationships:

Relationship Management
Can your customer-facing personnel identify relationships in their portfolios? Can they manage, in an interconnected way, the accounts and customers in a relationship?

Relationship Profitability
Does your institution have the means to measure the profitability of each relationship? If so, how difficult is it and what metrics and calculations are used?

Relationship-Informed Pricing
How do relationship managers handle pricing conversations in a relationship? Can they quickly understand the effect of pricing decisions on key metrics and overall relationship profitability? Can they put tailored offers in front of every current or prospective person or business in that relationship?

Relationship Management, Profitability and Pricing

Relationship Management

Relationship management focuses on each person or business in a relationship and the network of connections that affect satisfaction and profitability. Each member of a relationship may influence the retention of others in the same relationship and affect profitability.

Relationship managers want to know the value of each account and relationship in their portfolio for two reasons:

1. All relationships are potentially "terminal." Loans mature and might not be renewed. Deposits wax and wane based on seasonality, business performance, service levels, fees and rates. An at-a-glance understanding of which relationships are driving profitability enables front-line staff to refine their focus.

2. Pricing decisions should be relationship-focused. Such decisions are based on empirical profitability instead of transaction volume or account balance, which often do not equate with profitability. With insight into the value of each member of a relationship, managers can make high-quality pricing decisions.

Financial institutions can achieve significant benefits from a system that offers a thorough view of relationship connections and enables portfolio management.

Still, identifying the full scope of relationships can be difficult. Financial institutions often duplicate identification of individual commercial and retail customers due to siloed databases, business requirements or data entry error. IT systems might have been assembled through dozens of decisions, reflecting different leadership teams, acquisitions and mergers over time.

The mechanism to connect those relationships is a unique identifier for each group of accounts comprising a total relationship. The identifier applies to immediate and obvious relationships, such as spouse and children, but also to extended relationships, such as business partners, their families and others. Relationship identifiers can be stored in a financial institution's core system, in a customer information file or with relationship managers.

Those managers can find benefits with a system that enables them to easily pull account data from numerous core systems and automatically combine records with the same identifier into one relationship. A flexible software system lets relationship managers build complex relationships with a high level of accuracy, making visible the network of connections.

A reliable system with accurate relationship information can offer a major competitive advantage. Knowing the value of a relationship facilitates high-quality pricing decisions, enhanced portfolio management and cross-sell and upsell opportunities.

Relationship Profitability

Traditionally, profitability analysis has been a back-office function. But the profitability of relationships deserves much greater focus. Relationship profitability analysis can move to management offices to inform policies, processes and decisions that enhance experiences.

Relationship profitability analysis begins with calculating the profitability of each account held by each retail or commercial customer or member and then aggregating that data. Numerous data points are required to quantify individual profitability. Source data, assumptions and any derived profitability results must be available for past, current and future.

Profitability calculations, which should be accomplished programmatically, provide at the account level five categories of important information:

Net interest margin – This is typically the largest component of profitability, so getting it right is critical. Net interest margin at the account level includes interest income or interest expense. It also includes the corresponding funds-transfer pricing (FTP) charge or credit.

A matched-term transfer-pricing methodology enables accurate calculation of FTP at the individual account level. The key driver in determining profitability, it enables accurate calculation of assets, liabilities and funding center.

In this analysis, each FTP rate is based on the cash flows of the underlying instrument and then applied based on those cash flows at its origination date (or last repricing date for an adjustable-rate account). This ensures the charge or credit calculated matches the term of the instrument. It removes all interest rate risk at the customer level and gives "control" of that spread to the funding center to manage the financial institution's interest rate risk.

Noninterest income – This includes fee income collected directly from retail and commercial customers and is supported by statements generated by core operating and ancillary operational systems. Some types of fee income directly related to customer or member activity can be allocated to each of them based on such things as debit card interchange income.

Noninterest expense – This includes direct-support costs, such as teller or operations transaction processing and indirect revenues and costs, such as salaries in human resources. Several approaches can be used to attribute costs at an account level, including an allocation process, unit-cost calculations or activity-based cost calculations. Many financial institutions use a combination based on the materiality of each item.

Provision for loan loss – This typically is determined as a percentage of the loan or lease amount based on the type and the retail or business customer's risk rating. It can have a significant effect on the profitability of each account and is crucial to the profitability measurement for each loan account. For the loan or lease product's attribute profile, the provision represents an "insurance cost" against the risk of expected losses.

Capital – This enables the financial institution to apply a capital charge or credit or determine a return on capital based on the amount assigned to each account. A best-practice approach uses an economic capital framework to allocate capital based on the risk profile of each product in the bank or credit union. The resulting

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risk-adjusted return on capital is a better indicator of each account's performance than a pure profitability measure because it adjusts for the level of risk incurred by the financial institution.

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A robust profitability tool can identify and quantify all profitability metrics at the individual level and then aggregate those metrics at the relationship level to help inform specific interactions. With aggregated information, the relationship manager can use a profitability-management system to access a detailed view of each relationship, including all the components of the profitability calculation for each account cycle on a rolling 12-month basis. Timely data analytics and aggregation:

- Determine which relationships bring the most value
- Limit the risk of underserving the most profitable retail and commercial customers and relationships
- Identify areas that might need attention

Relationship Pricing

Calculating accountholder profitability and determining the full scope of relationship profitability are only part of the equation for optimizing interactions and relationship potential. The information must be available to customer-facing personnel, so they can make relationship-based pricing decisions that maintain or enhance profitability.

This insight can play out in numerous interactions, such as with retail customers who visit a branch office to borrow money for their business. While the person might have only one account, branch personnel can see beyond to the larger relationship. That enables them to employ strategies, such as aggressive pricing, to ensure the person doesn't go elsewhere for the loan. In all scenarios, personnel can make informed, data-driven decisions at the point of contact.

Relationship-informed pricing optimizes the interaction to increase satisfaction and financial institution performance. Decisions related to service levels, fee waivers and pricing that are made with an accurate measure of relationship profitability maximize the ability to appropriately service retail and commercial customers and retain the most valuable relationships.

A high-quality pricing tool has two primary functions: pricing new business for existing relationships and pricing new business for prospective relationships.

Loan officers and other external-facing personnel must be equipped to make pricing decisions based on the current and forecasted value of the relationship and any new loans and deposits. Ignoring the value of a relationship when pricing new business creates pricing and fee risk that could result in either driving someone away or unnecessarily diminishing the revenue through insufficient pricing. A pricing tool that includes the forecasted profitability from current relationships is a powerful means for developing new and creative ways to capture and retain high-value relationships.

Comprehensive reporting capabilities also are key. Through timely and accurate reporting, relationship managers can obtain details on the profitability of their portfolio, share trends and provide upsell opportunities. Managers and executives can provide profitability and incentive compensation insights to upper management.

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Requirements of Actionable Profitability

The ability to boost institutional profitability depends on three elements:

Single Repository – The foundation of actionable profitability improvement is good data. Both sourced and derived data must be available for historical, current and future periods, and be accurate, consistent and available at the correct level.

Data can be stored in a secure, scalable, auditable and manageable database. To foster acceptance of results, users can drill down into the drivers of information as calculated in the database. Auditability around the entire process helps to ensure all changes are logged and can be flagged or reported if issues arise.

A robust calculation and modeling engine – This enables users to understand how decisions affect profitability. For acceptance, end users must have visibility into and comprehend the significant number of calculations and drivers, such as interest rates and transaction costs. Drivers are critical to performing simulations or what-if scenarios.

As additional data sets become available, it might be necessary to create new drivers. The calculation engine also should support creating new scenarios and enabling the end user to track them. The technology also should permit users to trace results back to their original source data and drivers.

Insightful analytics – Analytical capabilities are perhaps the most critical factor in successfully leveraging profitability information to understand and improve financial performance. Leadership can get a more accurate gauge of current and future performance and can look at how individual relationship managers perform to guide incentive compensation, inform any coaching needed and identify best practices used by top performers.

Today, financial institutions that invest in knowing the full scope of their relationships and their contributions to the bottom line are strongly positioned to:

- Quickly identify trends, opportunities and challenges
- Accurately identify which retail and commercial customers contribute to profitability
- Price new business based on accurate knowledge of current performance
- Manage margins more effectively with accurate pricing information
- Manage risk-adjusted contribution more effectively
- Quickly identify upsell opportunities
- Create targeted marketing campaigns
- Create a basis for a profitability-driven incentive compensation management program

Those activities will engage people in ways that promote satisfaction and optimize profitability.

Connect With Us

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