

Profit in the Drink

In today's recessionary environment, more than ever, marketers need to understand the mechanics of managing profitability and mitigating profit risk.

by Rich Weissman

As we look back at how the financial services industry fell into the recession, we cannot help but wonder: How did so many banks miss the mark?

For an industry heavily steeped in managing risk, everyone seemed to have overlooked something important.

You may think that the crisis was all about credit risk, right? *But it wasn't.*

Huh? Isn't that why the industry cratered because of overextension of credit? In part, yes. But the mess cannot be fixed by simply improving credit risk. It requires an understanding of "risk" in a new light—something that we call "profit risk."

Research has been done on profit risk that can be used by financial institutions to mitigate the potential for future financial meltdowns.

Let's share our insights on what the industry can do differently.

How did it happen?

You can divide the history of the financial services industry during the last 80 years into three distinct cultural phases.

Phase 1 began with the Great Depression—we call it the "Pre-Deregulation Phase." The industry operated under strict regulations, and the notion of marketing or selling was not in the equation. Financial institutions did not compete with each other on products, price or the ability to sell more. The government determined, by and large, what institutions could offer, and the way in which institutions differentiated themselves was through branch networks and providing quality service to customers (and maybe a toaster or electric blanket every now and then!).

This phase ended, with the Depository Institution Deregulation Committee and an act of Congress (Banking Act of 1980, which rolled out in the early and mid-1980's). Enter Phase 2, where the industry quickly adopted the concept of marketing and selling as fundamental. We call Phase 2 the "Sales Culture Phase," where every institution got on the marketing and sales bandwagon big time. The goal was to aggressively market and sell products, compete on price, and focus on three key measures for assessing marketing and sales, and hence institutional success:

- Sales volumes.
- Cross-sell ratios.
- Deposit and loan growth.

It was a culture of “Just bring in more.” And as institutions got on board, they unknowingly were creating a bubble in their income statement that few understood until recently.

When an institution understands the income statement bubble that Phase 2 creates, it becomes clear that there is a need to rethink current practices. Enter Phase 3—we call it the “Profitability Phase”—where the focus is on the dynamics of the income statement and not on balance sheet production. Phase 3 is about understanding the income statement in the most microanalytic way, and correlating its components with future earnings growth or loss, and then managing to maximize future income growth and minimize future income losses.

What's new here?

Doesn't everyone know that profitability is important, and haven't institutions always had a keen eye on the bottom line?

Yes, but the issue is that very few know *how* they got to the bottom line. Very few have taken the steps to measure and manage profitability as a risk-management effort. Because of this, very few understand the potential for meltdown within their income statements.

Instead, most think about risk in two areas:

- Credit risk.
- Asset liability risk.

They manage the risk components of the balance sheet, ensuring that loans are properly made so that reserves (and capital) cover losses, and that the tenor of deposits is in line with loans so that mismatch and interest rate risk is minimized. There are entire risk management systems, processes and staff at most institutions for these. The regulators pay careful attention to how these are managed! Of course, there is also the area of operational risk. Got these covered? Then you're set, right?

Wrong! Because few are managing for *profit risk*. In its simplest form, profit risk measures the concentration of the income statement on a variety of levels. And, there are specific concentrations for each level that when reached, future profitability is at risk. Profit risk represents the tipping point at which further concentrations will translate into income volatility and a decline in earnings. An institution can watch its earnings grow, but if those earnings are heavily concentrated, then earnings can quickly head south before the institution sees it coming. The profit risk system and analytics act as measures that allow institutions to see future earnings growth or decline based on how the profit risk concentration measures behave month-to-month. It's the crystal ball for future earnings.

Most importantly, we know that Phase 2 activities result in greater concentrations of the income statement, and the more an institution “just sells,” the greater the risk and the greater the potential for a meltdown in earnings. Phase 3 is about turning this around.

What has the research shown?

Research has shown that there are direct correlations between concentrations of the income statement (“profit risk”) and future earnings, on five key levels:

- Across customer relationships.

- Across products and product lines.
- Across markets.
- Across branches.
- Across officers.

Research shows that for each of these levels, there are tipping points at which earnings will become volatile and decline over time as concentrations increase, even in a rising earnings environment. And these points can be quantified and measured monthly. Moreover, specific strategies and tactics can be taken to minimize profit risk and ensure long-term sustainability of the income statement.

What should you do differently?

As a start, you need to clearly understand that marketing and selling for production and the balance sheet won't work anymore. Phase 2 thinking has to go.

You need to create your own crystal ball. Do this by building a fully integrated database with all customer account data and all general ledger (G-L) data. The idea is to fully explode the income statement to create a unique income statement for every account that every customer has at the institution, complete with all noninterest expense, noninterest income and funds transfer pricing, so that each account is uniquely provided with its own income statement that represents its net contribution to the institution.

It's complicated, but the rewards are worth it.

Then, you need to adopt a Phase 3 strategy:

- Implement a profitability and profit risk measurement system so that, you can understand all of the details of profitability, down to the customer account-by-account level. Make the effort to get it right.
- Incorporate profit risk measurement and goals into your strategic planning, marketing/sales planning, and budgeting process. Make profit risk a critical part of your management objectives.
- Create a profit risk culture. Designate a profit risk officer responsible for managing the profit risk discipline. Give the officer the systems, tools and support to get the job done.
- Ensure your profit measurements are part of your monthly board and management reporting.
- Incorporate profitability in daily decision-making. By utilizing your profit risk system you can ensure that no critical decision is made without a full understanding of its impact, of profit risk.

Finally, you need to take action in marketing and sales:

- Create a profit risk marketing/ sales plan, where detailed steps for improving profit risk are noted and tracked.
- Redesign your incentive and sales programs so that they are not based on Phase 2 volume measures, but based on profitability contribution and impact on profit risk. Educate your frontline people on profitability dynamics and how to sell and up-sell for profitability.

- Reconfigure your marketing efforts so that they are in sync with marketing for profitability. Forget mass campaigns and focus on targeting profitable markets for profitable marketing results. Measure marketing programs on a detailed ROI (return on investment) basis to ensure each program is positively contributing to profitability.
- Price products for profitability and not just based on competitive pricing shops. Focus on product break evens as the minimum sales level.
- Focus on product sales that are both high in profitability (mitigate profit risk) and are sticky-so that retention is higher among those sales that support, rather than hurt profit risk.
- Evaluate product combinations based on profitability dynamics, so that packaging results in greater, and not less, profitability. Only market those packages that positively impact profit risk.
- Ensure that every one-off pricing is assessed for its impact on profitability, so that pricing modifications are only given when overall customer relationship profitability is fully understood and the pricing impact is assessed.

Of course, there are many more things you can do. These are just starting points.

What's next?

Let's get real, it's not about the hokey-pokey. It's about *sustainability* of the income statement, and at the center of it all is profit risk. We have a mantra at our office that we have plastered on our walls. It simply says; *"Only the most informed and profitable will survive and prosper ..."*

We say this because we know that managing profit risk is what makes the difference. 2009 was a horrible year, but one in which there are many lessons for 2010 and beyond. One critical lesson is that we not only experienced a credit crisis, we also experienced the bursting of the Phase 2 bubble. So let's regroup, learn, and move on by embracing profit risk.

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