To identify customer segments that offer good returns, marketers have to measure profitability. But there are a lot of conflicting approaches for doing this. Which works best?

The Profit Pursuit

We asked three 'profit prophets' for their perspectives on this and related issues.

by Janet Bigham Bernstal

Measuring customer profitability for marketing purposes has long been problematic. Is one system better than the others?

ABA Bank Marketing magazine spoke with experts who offered slightly different perspectives on three issues related to profitability and profit measurement. The profit issues include concentrating on (1) wallet share, (2) customer relationships and (3) marketing return on investment (ROI). Most profit approaches are built around the core belief that banks must establish a system that marries marketing to finance and targets the *truly* profitable customer.

I. Focus on Market Share

Most marketing campaigns are volume driven, and that very practice puts the bank at profit risk. Profit risk is a term coined by Rich Weissman, president and CEO of the Portland, Oregon-based Database Marketing Agency Inc. to describe the degree to which net income is concentrated in a very small portion of a banks' relationship base.

Basically, this small group "owns" the bank's profits. If this group is not retained, and retained at current profitability levels, then the overall net income of the bank is at serious risk.

"Most clients guess it's the 80/20 rule, where 80 percent of their earnings are coming from the top 20 percent of their base, "says Weissman. "It's not an 80/20 rule. It can be 150 percent and we've seen it as high as 300 percent."

How do banks get into this position? Dangerous concentrations of profit risk are a result of traditional marketing and sales efforts.

"They prayed to the cross-sell ratio, they believed the higher the cross sell, the more money they would make, but it turned out to be highly unprofitable," claims Weissman. "We tell sales and marketing, think beyond just 'sell lots of things.' Focus on *share of wallet* and *profit dynamics*, because profitability is dynamic."

To grasp "share of wallet," Weissman's firm does a full customer profitability assessment that balances back to the general ledger. They look at each customer on a relationship basis, to see what true *relationship profitability* is, as well as by officer basis to see what contribution officers are making, and on down to the branch and region level.

"There could be a branch with high volume, but it's not profitable," explains Weissman. "They could have a low-volume branch, or an officer with low volume, but they're bringing in profitability and they're impacting bottom line. Suddenly marketers see it's not just generating volume, but doing things well."

Doing things well means:

1) Understanding profit risk concentrations. "Folks at the top have truly made this their primary financial institution," says Weissman. "The share of that customer's wallet is high."

Those at the bottom are bringing down profits, and their share of wallet is with the competition.

An interesting note: Weissman frequently finds the most profitable and most unprofitable are demographically similar. So forget marketing to demographics and *focus on wallet share.*

Once the bank understands its profit risk, the goal becomes to move the number down and spread the profitability over greater numbers of relationships, thereby increasing earnings through decreasing profit risk. This comes about through *matrix marketing.*

2) Matrix marketing. To get a complete picture of the customer relationship, Weissman's team fully appends the customer database with demographics, business-graphics and geographics, and other external databases like the census database.

"Now we know who they are from an activity perspective, in terms how they manage their account," says Weissman. "We take it all and create a multidimensional matrix, or whole series of dimensions such as demographic variables, profit variables, usage and longevity."

They then define customer groups, or cells, based on those that have the potential to move up in profitability. "What-if" activity follows to determine what relationship sold what particular product would result in a profitability increase.

"We develop programs to go after those optimal cells, like direct mail or a sales call program, and lay it out month by month and manage the database throughout the year," says Weissman.

So each month, marketing and sales are doing the right kinds of activity for the right kinds of groups that will minimize profit risk and spread out profitability.

II. Target Customer Relationships

The bank marketing committee at People's Bank, a Cuba, Missouri-based community bank with assets of $120 million, had a big surprise once they switched from an MCIF to IPS-Sendero's Customer Profitability System (CPS). They had been using the MCIF to calculate profits, but found they were getting exaggerated profitability results.

"The MCIF results were skewed, and that was the issue," explains Kurt Guenther, senior vice president and
director of sales in the United States and Canada for IPS-Sendero, Atlanta, Ga. "An MCIF doesn't have a profit calculator in it."

MCIFs came into vogue to mine customer information and to help manage campaigns. Their major shortcoming, according to some experts, is that they're not profitability based.

"There is a realm of customer profitability that MCIFs do," says Guenther. "But our system is devoted to helping financial institutions understand the customer relationship profitability—which customer relationships are truly making money and which aren't."

"We've been getting good numbers out of CPS for four or five months," says Angie Medwick, Peoples Bank chief financial officer.

Taking a fully loaded look at profit per household relationship is critical for banks to understand where to spend marketing dollars. This would have saved one particular bank from marketing the wrong product. Once they calculated that HELOCs were a profitable line of business for the institution, the bank put on a marketing push. Not intelligently, though, claims Guenther.

"They got a huge amount of clients, but got them in South Florida," he explains. "They were mostly retirees who took them more for an insurance policy, but HELOCs don't pay unless the customers used their line of credit."

Moral of the story is "All growth is not good." How you actually calculate profitability is the key. A bank must interpret the information to go after the most profitable opportunities as opposed to offering products that won't necessarily pay back to the bank.

Waiving fees and service charges may make a bank popular with its customers, but if the customers are less than profitable, the action can lead to a significant loss in revenue.

The Bank of Tampa, a commercial bank with assets of more than $575 million in Hillsborough County, Fla., knows that principle well. The bank was sometimes lending at low rates, dropping account fees and granting other "freebies," based largely on intuition. Individuals whose firms had large account balances were getting "sweet" deals that weren't always in the bank's best interests.

"We just hoped we were making a good decision based upon an return on expense (ROE)," said Bill West, executive vice president. "Once we linked all of the relationships together, we started looking at them in the aggregate to see if they made sense. Sometimes they did, but sometimes they didn't."

West said that his organization now prices at the *relationship level* rather than the transaction level, which is more consistent with the bank's strategy.

The results speak for themselves— in two years, income from deposit account service charges rose from $1.4 million to $2 million.

III. Marketing ROI

Many marketers are turning to return-on-investment, or ROI-based marketing, a system of processes that leads to consistent approaches and reduces second-guessing. With the proper strategic planning and support prioritization of marketing investments, an institution can move toward better ROI and profits.

"Everything about marketing ROI is common sense with a financial discipline," says Jim Lenskold, president of the Morristown, N.J.-based Lenskold Group, and author of "Marketing ROI: The Path to Campaign, Customer and Corporate Profitability." "But it's bringing that discipline into an area where it wasn't, an area that was labeled creative."

Right now, Lenskold claims, marketing is being measured through traditional methods like response rates, costs per sale or costs per lead. But those metrics don't take into consideration both the cost side, i.e., the investment, and all the different aspects of the return, such as how the money is coming back. He believes that marketing ROI can help banks manage the marketing budget as an *investment* instead of an expense.

"Because so much in marketing has already been trimmed, there is no more room to look at the cost-cutting side," says Lenskold. "For profitability to grow, they have to spend smarter and look more closely at revenue and the profit side."

In his book, Lenskold maintains that there are significant profits to be gained through better management of marketing investments and practical application of marketing ROI processes. For example, applying these principles to retention marketing helps in strategic planning. As more vulnerable and valuable customers are targeted, more can be invested to keep customers and build loyalty.

"The challenge with a customer base is how do I find the vulnerable ones, the customers at risk?" says Lenskold. "Because that's where I have to put my marketing dollars to change their behaviors and protect them from the competition. Spending money to change behavior I'm expecting to happen—that's where I'll get return."

For maximum customer profitability, though, you have to implement marketing ROI in the early planning stages.

"When you're spending X amount of dollars you can run an ROI in the beginning and say 'We have to get this much back in profits to make it worthwhile,'" says Lenskold, "But also ask, 'Where are we getting profits from? What are our expectations?"

Marketing ROI has been often misused and miscalculated, according to Lenskold. It is essential when the marketing ROI processes are put in place that they:

- Align with the strategic marketing decisions that are being made.
- Maintain financial integrity that is free from subjectivity.
- Reflect the dynamics of customer behavior.

Much of the success of ROI-based marketing depends on internal culture. According to the best practices report "Maximizing Marketing ROI," published by the American Productivity and Quality Center (APQC), if the management team fully embraces ROI-based marketing then consensus is reached more readily. This leads to faster marketplace reactions.

"Even the gaps between marketing and sales, this is cultural," says Lenskold. "They work so independently, but with marketing ROI, they start to recognize that the more they align the goals, they more they sell, and the two sides start working together."

More than just a suite of tools, a ROI-based approach to marketing means an institution changes the way it plans, implements, and assesses its marketing programs. In turn, the APQC report findings revealed that learning processes hasten because there is a common framework for sharing. Not only does this shorten the decision-making cycle, it increases the confidence in decisions, which moves downstream to customers who react more positively to the offers extended to them.

Janet Bigham Bernstel specializes in writing about marketing and financial services industry issues. She works in Jupiter, Fla.