

Take out your calculators

Most banks do not have an accurate measure of their product profitability. But this metric is critical when marketing for profitability. Why are banks so derelict? And how can the marketing department take the lead in turning this situation around?

By Rich Weissman

For years, banks have devoted little attention to truly understanding the details of product profitability.

With staffs of people who sell products, service products, manage products and promote products-and even more who manage credit risk and asset-liability risk relative to those products-one has to ask: Where are the people focused on detailed product profitability? Few banks, large or small, have such expertise. It might be listed as one of many duties in someone's job description in accounting, finance or product management, but certainly it does not have the resources to understand the unique profitability contribution of each and every account, in each and every product.

Why is that?

One would think that an industry so focused on the bottom line would understand the profitability components of each product. Right? Not exactly. Now there are very high-level profitability analyses that are done from time-to-time, perhaps as a special project or as a periodic product review. Or, some industrywide research is used as a proxy. We've all seen these and they are, at best, light-weight. They are typically top-down, where an average profitability per product is assessed on a generalized level.

Serious, day-in, day-out efforts to understand the detailed profitability for each account and each product-and providing specific profitability dynamics for each product-are performed only by a select few cutting-edge banks.

As an industry, banks have been able to historically generate sufficient earnings by managing the margin through asset-liability management (ALM), keeping costs reasonable by focusing on expense ratios and imposing fees whenever possible. As long as this equation worked and the earnings were sufficient to warrant acceptable return on earnings (ROE)/return on assets (ROA), the industry was content. The bank executive teams were able to meet the needs of the shareholders and boards, and earnings were within target. The regulators also accepted this approach, and as long as the capital ratios and credit risk parameters were in line, no one was demanding

sophisticated product profitability analytics. Let's face it, post savings-and-loan meltdown, the industry overall was doing well, with little impetus for change. And this kind of change is hard. It's complex. It requires a dedicated effort, and there hasn't been an outcry for it.

Moreover, this approach yields some unpleasant news: *Most accounts in most products are highly unprofitable*, and most of the product lines in most banks result in serious negative profitability! Only a handful of accounts in a handful of products provide profitability, and banks are dependent on those few accounts in those limited products to make enough to cover the losses in all other products-and provide a reasonable level of net income at the end of the day.

This is not healthy.

Enter the new world where product profitability is a topic worth pursuing. The recent financial crisis presents the industry with new challenges, including understanding the composition of the bank's income statement in altogether new ways. Banks can no longer rely on a simple income statement view. They need to know the details behind it to the n^{th} degree. Banks are only now beginning to understand that they can no longer view their income statement as *sustainable* if they don't know what makes it hum. Gotta look under the hood. The bottom line might look good, but if the details and dynamics behind it are poorly aligned, then that income statement is at risk.

Who will lead the bank on this journey?

Here's the surprise. *The marketing division will*. That is, the marketing division working closely with the accounting/finance and the sales divisions. Marketing? Aren't those the "creative" types? Most marketing folk do not see their job as product profitability experts. That's just not a traditional bank marketing role.

Well, in order for the bank to properly market itself for profitability-to run marketing programs, to promote products, to develop and price products, to incent the sales force to sell products-marketing has to step up to the plate and take the leadership role in developing the profitability foundation. *Product profitability will only become a focal point when it is owned by those who are focused on product results* (and that's where marketing comes in).

So where do you start?

You begin by acknowledging that most products are unprofitable and most product sales produce *negative* profitability. Embrace the concept that there needs to be an understanding of the composition of the income statement in a detailed way, creating highly analytic assessments of the unique contribution (or lack thereof) for each account within each product.

This is accomplished through a sophisticated profitability database approach, where an income statement is developed for each account that every customer has. The income statement needs to contain:

- All of the unique costs (noninterest expenses) associated with the specific account, based on all of the activities in the account, all of the costs associated with those activities (both direct and indirect costs), and risk ratings for loan accounts (so as to assess the provision costs).
- All of the unique fees (noninterest income) generated by the specific account (item-by-item).
- The value of the specific balance in the account as determined by funds transfer pricing, according to the unique balance/outstanding, rate and term of the account-specific to your cost of funds and yields as determined through funds transfer pricing (utilizing either internal or external curves to allocate net interest income).

The sum of the income statements have to balance back to the bank's income statement in your general ledger, and then you're ready to start to assess product profitability.

Product profitability becomes the creation of an income statement on a product level, where a unique income statement is produced for every product, usually defined as discreet product codes in your systems. These are produced by consolidating all account income statements for each unique product, resulting in a series of unique income statements by product. You can look at the bottom line of each product, see how profitable (or unprofitable) it is and go deeper by creating unique income statements within a product by balance-range, customer type, and according to any other factor within your database.

You'll start to see patterns where entire product lines are highly unprofitable. You'll see profitability stratifications within a product by balance ranges. You'll see the levels at which there may be break-even points. You'll start to understand which products are profitable or unprofitable because of the different components of their income statements. (Is the product's bottom line such because of costs, fees, balances, rates?) This is when marketing can start to restructure products and how they are marketed to improve profitability.

There are three specific "best practices" strategies that can be implemented by marketing under this new approach.

First, understand product profitability breakevens so as to price and promote products based on these points. Each product has unique break-even points, and that point will differ by institution. You need to:

- Create minimum deposit or loan balance requirements based on break-even points. These points need to be the target above which deposit and loan products are opened, or the target below which there are differential fees and rates. Create pricing tiers for fees and rates so that customers are incented to move up, or to provide greater profitability through fees and/or lower deposit or higher loan rates, or to leave.
- Promote and sell to the break-even point and above. These points can act as the basis for targeting new account acquisition and can be key criteria in determining targeting efforts. And, stop selling to those levels that are

unprofitable. Create internal incentive programs to sell only above break-even points and not below.

Second, understand which unique combination of products creates positive profitability and which ones don't. This is called the "McDonald's" approach, which focuses on those combinations of products that, when bundled, generate greater profitability than when offered unbundled. You need to:

- Bundle only those products that create positive profitability greater than the individual profitability of each product. Market those bundles differently from discreet product sales (the "Happy Meal" approach).
- Provide "rewards" only for those packages that result in optimal profitability when purchased as a bundle.

Third, understand the products that the more profitable customers purchase, and apply those dynamics to other customers who are not profitable-and assess those who have the potential to become profitable through additional profitable product up-selling. You need to:

- Up-sell specific products to those who have the potential to increase in profitability through the additional purchase of a specific product that will move the customer into a higher profitability contribution level.
- Seek those opportunities at all points of customer contact to up-sell the additional product that moves the customer into higher profitability contribution.

We know that product profitability measurement is a necessity in today's environment if we are to manage the income statement for sustainability. 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 encourage all banks to adopt this mantra as their own, so that they can start to understand product profitability in new ways. This understanding will serve as a foundation for the next generation of bank management and bank marketing.

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