CREDIT UNION JOURNAL

The Third Piece of Risk Management: Understanding 'Profit Risk'

By Frank J. Diekmann, Editor

LAS VEGAS-The next "big thing" for financial services will be "profitability risk," and it might apply to credit unions more than any other type of institution.

Several analysts at the Bank Administration Institute's (BAI) Retail Delivery Show here recently forecast that the inevitable fallout from larger "mega-trends," in particular the financial crisis, is an clear understanding of how specific customers and members are contributing to or detracting from the bottom line.

At least one credit union already has begun implementing a program examining its own profitability risk and is changing pricing and policies as a result (see related story).

For credit unions still putting in place strategies for more effectively dealing with concentration risk and enterprise risk management, adding what promises to be an even more demanding reexamination of their operating model may seem overwhelming. But analysts stressed credit unions that expect to survive and grow will have little choice.

"What's the next big thing in the industry? It's profit risk," said Rich Weissman, CEO of DMA, the Beaverton, Ore.- based company that provides measurement analytics and database management tools to financial institutions, among other tools. "It's the concentration of the income statement vs. distribution and diversification of profitability streams. We think this is the third piece of risk management. Just as ALM became big after the S&L crisis, this will become big after current crisis. When profit risk is minimized, income volatility is mitigated, income is sustained and grows, and the bank or credit union remains viable. The next big mega-trend is sustainability."

Weissman noted that a mega-trend is any general shift in thinking or an approach that affects countries, industries or organizations, and he believes "profit risk" clearly qualifies. While "hot" trends such as Gen X, Gen Y, use of social media or new products are important, none are as important as profit risk, he said. "They are not going to fundamentally change the paradigm. Something else is going on that is even bigger and far more profound."

Deregulation, said Weissman, whose career includes a stint as marketing director with Bank of America, "created something incredibly unhealthy that very few of us were prepared to look at, and that was we weren't keeping track of what this sales culture was doing to our income statement. Imagine taking every one of your members and creating a complete income statement for each member at the account level. Imagine a complete allocation of the G-L and all components. Imagine an income statement for each member relationship, and ranking each from most unprofitable to most profitable.

"If you do that, as we do with our clients, the typical statement shows that the top 10% generate nearly 500% of all earnings," continued Weissman. "That's what we call 'profit risk.' It's an unhealthy mix and a recipe for failure."

Compounding the problem, said Weissman, is that the bottom or least profitable members are typically cross-sold the highest number of products, most of which are unprofitable. "Right in front of everyone was a crisis waiting to happen," said Weissman. "The hard reality is that most of what we do is unprofitable. I used to be in packaged foods industry, and one thing I remember from the packaged goods industry is they understood costs. I went to work for a big bank on Wall Street and bottom line looked good. How we got there? Not so sure. And that is true of most of financial services industry."

Financial institutions have typically focused only on credit risk and asset-liability risk, with little attention to the profitability dynamics of the income statement, said Weissman. Addressing the problem, he said, will require going beyond grand marketing campaigns and products of the week. "You need to build a unique income statement for each account for every member account and relationship, for every product, for every market, for every branch, for every sales officer. This is the era of using the income statement for analytics. You need to understand what makes one member profitable, and another not. And you've got to do it at lots of different levels."

The top 1% of customers/members at the typical institution, said Weissman, generates 277% of profits. The risk lies in when those members leave, and the unprofitable remain. He cautioned that a profitability risk analysis may be the demand from regulators.