

Profitability Information to Manage Commercial Relationships

By Kim Sutherland

Pricing, incentive compensation and marketing can be improved with more refined relationship profitability information.

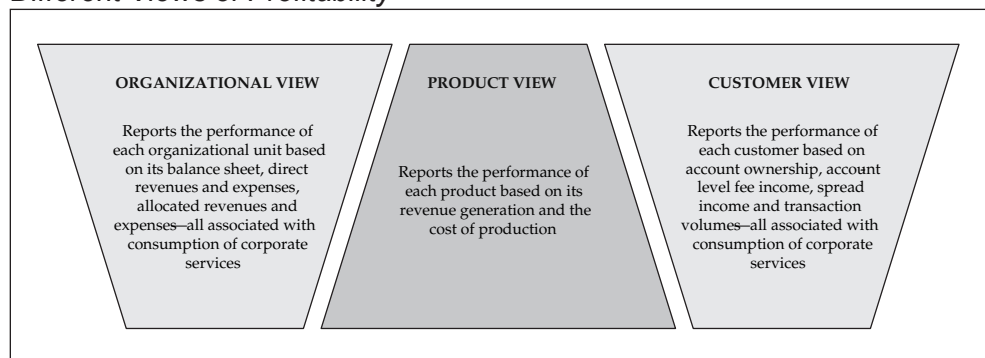
The topic of commercial profitability connotes different things to different audiences. Even within the banking community, there are a wide variety of definitions. This article will provide an overview of the topic, its evolution, its components and best practices for its uses.

Commercial profitability is at its core a performance measure, prospectively or historically, and includes a variety of viewpoints:

- Organizational profitability
- Product profitability
- Relationship profitability

Each evolved differently, each has different uses and answers different questions, and each has different metrics that are important. The key is understanding the differences (Exhibit 1). And it is essential to understand the relationship among the three basic viewpoints.

*Exhibit 1
Different Views of Profitability*



Performance measurement or profitability measurement within the financial services industry has evolved over the last 25 years for both the com-

mercial and the retail sectors. Before the advent of subset performance measurement, a bank's overall financial statement was the only view of profitability. The evolution of performance measurement began with organizational or line-of-business profitability and was followed by product and customer or relationship profitability.

Commercial Bank Profitability: Line-of-Business View

Early on (roughly 1980 or prior), many banks used reporting systems driven by the general ledger (GL) to generate their performance measures. Reporting was largely financial rather than managerial in nature. This provided views of fee income and operating expenses by line of business or individual organizational units. Generally, these units were identified by responsibility or cost centers and their aggregation.

This view used a top-down approach to fee income and operating expense assignment. Funds transfer pricing (FTP) rates

Kim Sutherland is Director and Chief Operating Officer at Market Line Associates, Atlanta, Georgia. Contact her

at ksutherland@market-line.com. The author would like to thank Anna-Fay Lohn, Director of Client Services, and Michael Kuehne, Director of Costing and Profitability, at Market Line Associates for their contributions to this article.

were assigned to loans and deposits in aggregations of balances. Initially, a single-pool or multiple-pool approach was used. A “pool” grouped together instruments with similar term characteristics (short term, intermediate term, long term, *etc.*). Expenses were assigned to individual responsibility or cost centers in the GL and usually included only direct expenses. While this view was more informative and actionable than the single bank financial statement, it left several gaps: inability to allocate indirect expenses; inability to drive expenses to units based on their use or activity instead of broad allocation methods; inability to assign FTP rates at the instrument level; no view other than “organizational”; and no ability to incorporate risk properly.

In the early to mid-1980s, organizational profitability continued to evolve as product was just developing. All of the enhancements that were implemented on the organizational view were also passed on to the product view.

The first enhancement to organizational views of profitability tackled the task of expense (cost) allocations. It was helpful to align indirect expenses (those more associated with support functions and with overhead) to the appropriate profit centers within the bank’s GL hierarchy. Attempts were made to allocate these costs based on suitable cost drivers: numbers of full-time-equivalent employees, square footage of departments, frequency of use, *etc.* In that sense, they were volume driven—but still with a top-down approach.

Performance reporting was now enhanced by the addition of indirect expense line items on the profit and loss (P&L) statement for various organizational groups. This generated a more “fully loaded” profitability subtotal (net income before taxes) for all reporting units: commercial banking, retail banking, trust, mortgage, *etc.*

The second gap to be addressed in commercial organizational profitability was the development of a rudimentary “product” view of profitability. This also occurred in the mid-1980s. Not surprisingly, the product categories were largely based on organizational cost centers and typically were only developed for assets. They were also very broad: real estate, lines and commitments, leasing, *etc.*

The next gap to be addressed in the more modern versions of organizational profitability was instrument-level FTP assignment. Technology came to the

rescue as assigning and maintaining instrument-level rates was a major undertaking.

Several providers surfaced in the late 1980s and the early 1990s who offered software that facilitated the automation of business rules and formulas and would assign funds transfer rates to individual deposit and loan accounts. This more detailed and sophisticated methodology improved the accuracy of the organizational view of profitability. The performance reports were enhanced by now having interest income, funds credit, interest expense, funds charge and the subtotal net interest income—or net spread—at any organizational level.

Next, the component of risk was assessed. The first manifestation was in allocating capital. Capital allocation, in theory, recognized that a dollar of profit from a loan account was not the same as a dollar of profit from a deposit account. In fact, there was significantly more risk associated with lending money than in gathering deposits.

In addition, one of the goals of capital allocation was to put all accounts (products) on a level playing field by allocating more capital to accounts with more inherent risk. The approaches used by banks to allocate capital varied by institution, but the goal remained the same.

Once capital had been allocated, new metrics were introduced to the P&L statement for overall as well as subset views of profitability. Now, it was possible to calculate a return on equity (ROE) or a risk-adjusted return on equity (RAROC).

In the commercial arena, the ability to assign expenses to units based on their activities or uses did not manifest itself until the mid-1990s at best. Up until that time, it remained lacking.

Commercial Bank Profitability: Product View

Elementary views of product profitability surfaced in 1979 and 1980. This was a concept that had long been embraced in packaged-goods marketing but was relatively new in service industries. Mellon Bank and Wachovia were the forerunners in the financial services industry. At this point, the categorization of “products” was transformed. While older product models used cost centers to define broad product categories, newer models used ac-

count types. These classifications were typically present on the application systems. This provided a wide variety of possibilities. Liabilities were included in the categorization along with assets. In the commercial arena, great focus was given to the services that comprised the cash management business. Sample product categories would include commercial checking accounts, commercial money market accounts, commercial lines of credit, account reconciliation, lockbox, *etc.*

Product profitability came into the forefront of performance measurement with the advent of “product management” as a marketing discipline within the financial services arena. Product managers were responsible for categories of products as described above including the improvement of their profitability. Measuring the profitability of these products became another “view” of traditional profitability measurement.

Product profitability benefited from the inclusion of indirect expense allocations, the improved account-level FTP assignments and the allocation of capital but faced new challenges on the expense absorption front. Expenses needed to be aligned more directly with products. While this method was still a top-down approach, it introduced new cost drivers. Costs were allocated based on the activities associated with the creation, management and maintenance of accounts within product categories. Product-specific costs included origination, maintenance and a variety of transaction types.

Banks embarked on large costing projects designed to create unit costs that could be tied more closely to specific activities than before. Initially, these efforts primarily benefited the retail side of the bank. Additionally, the projects had their problems. Many projects resulted in “costing” activities that could not be counted. Therefore, the unit costs could not be used properly. In addition, the projects were often so massive that only parts of an organization could be costed at any time. This created a shortfall in expense absorption and created noise in the resulting P&L statements and reconciliation difficulties.

In any event, P&L statements could now be generated for specific products. Comparisons could be made across product lines. The elements of origination and servicing could be isolated. Transaction details were visible. Most important, all of the components of profitability (net-interest income,

fee income, expenses, *etc.*) were visible by product. Product managers could better understand which products made money, which didn’t and why.

While this approach was helpful, it did have its limitations. Product profitability produced metrics for total portfolios. Average per-account statistics were also available, but dispersion surrounding the averages as well as high points and low points were obscured. While products could be compared to one another, individual accounts could not.

The desire to be able to compare and contrast individual accounts and customers gave birth to relationship profitability.

Commercial Bank Profitability: Relationship View

Relationship profitability was a different view, and it arose in the area more of management reporting than financial reporting. It’s important to understand its history, the components of a state-of-the-art valuation and the challenges banks face when they begin this effort.

History

Relationship profitability evolved very differently in commercial banking than it did in retail banking. Commercial bank officers had embraced the concept for years. They looked at clients as an aggregation of accounts and informally used the inferred value of a particular customer relationship to make pricing decisions. Retail banking was a more mass-market approach and didn’t realize the benefits in the same manner. Relationship profitability on the commercial side was used directly by the line functions. On the retail side, relationship profitability was used more by the staff functions.

The formal, more automated practice of calculating relationship profitability evolved when the technology was present to view a customer’s entire relationship within the bank. It began with marketing customer information systems (MCIFs). These databases, usually maintained in marketing arenas, were able to aggregate customers into “households” for a more complete picture. This facilitated customer contact and reinforced the notion that banks were truly aware of a customer’s overall relationship with the bank.

The necessity of knowing which customers make any financial institution money was founded in four basic dynamics:

- **The removal of bank regulation and the shifting interest rate environment.** For years the banking industry was regulated. When that changed, and the interest rate market shifted, margins narrowed. The need to focus on revenues and, more important, expenses, became urgent.
- **The limitations of a top-down approach to profitability measurement.** An organizational view of profit was not sufficient. More detailed profitability information for both portfolios of products and portfolios of customers became a necessity. Top-down approaches greatly limited the ability to slice and dice information. In truth, the egg is already scrambled. You can no longer isolate the individual components or drill down for analysis purposes. Accordingly, there is no ability to distinguish one account from another accurately. Allocations are too ordinal, blurring the necessary distinctions.
- **The volume of customers on whom banks lose money.** The majority of any bank's customers lose them money. That's a reality that the financial services industry lives with. And because of the service nature of the business and its roots as a regulated industry, that fact isn't going to change soon. It logically followed that knowing which customers make money and which don't—and, more important, why—became strategically essential.
- **The inability to set performance goals at the relationship level.** As a result of the first three items, banks wanted to understand their average customer value(s). They wanted to monitor those metrics. They wanted to implement strategies and tactics that would improve performance. Therefore, setting and monitoring performance goals for portfolios of relationships evolved as

an important metric to make smarter strategic decisions that could improve overall profits.

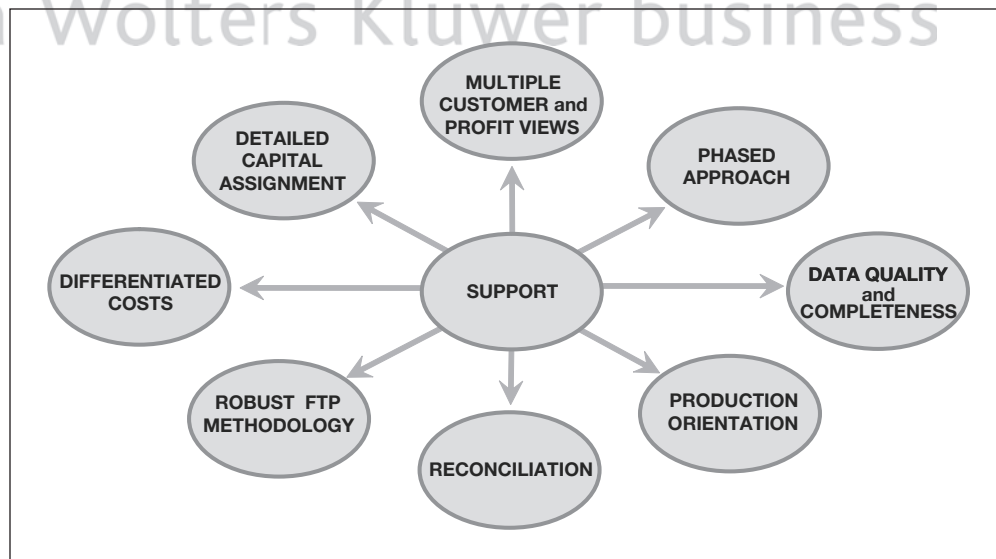
Definition

First and foremost, customer or relationship profitability views begin with account-level detail. Account-level information or data elements are captured and can then be aggregated to a variety of levels. This is a bottom-up approach. It is very sophisticated and nimble. As a by-product, it generates a wealth of behavioral information at the account and, ultimately, the customer level. In addition, it is a metric that must be refreshed if it is to be useful. That means that the processes must in fact be reasonable to execute and maintain. Most relationship profitability models are run monthly and shared with a variety of bank departments on either a monthly or a quarterly basis.

Components

There are nine basic components to a state-of-the-art relationship profitability calculation (Exhibit 2).

*Exhibit 2
Components of Relationship Profitability*



The foundation is **support**. That means support from executive management that relationship profitability is important to the institution and will be integrated into the bank's strategies and tactics. This support is needed to secure the resources and the prioritization for the work. Without it, many projects flounder or fail.

The second component is a **phased approach**. This acknowledges that successful implementations are conducted by subdividing the initiative into meaningful parts. This usually begins with the customers and accounts from the basic lines of business: commercial and retail banking, mortgage banking and credit card. It then branches out to trust, brokerage, insurance, *etc.* Often it depends on who is sponsoring the project within the bank. However, breaking a project into parts ensures that you will have working information ready for use quicker and the opportunity to demonstrate real value to the bank.

Data quality and completeness is the third component. Time spent to increase data specificity will provide the best output product. Having the appropriate data elements is paramount. This requires a sound knowledge of what's available and also of how the bank intends to use the information. Armed with that information, you are better prepared to make the inevitable compromises that will arise. Data quality cannot be taken lightly. Measures for evaluating the data—every time a valuation is produced—must be developed and automated.

The fourth component is having a **production orientation**. This acknowledges that the output of the relationship profitability calculation process is what is valuable—not the calculation itself. It means that all of the data elements that are chosen can be harvested in a timely fashion. It means that every decision made and process designed must be fluid enough to have a timely execution while not compromising the accuracy of the valuation output. It means that contingencies must be prepared. Bank application and transaction systems are the primary sources for the data used in most relationship profitability models. Approximately 15 percent of the data elements experience some abnormality that needs to be explained each month. What is more, the demand for information is so high that allowable processing cycles are shrinking.

Reconciliation is the fifth component. The model must be able to generate information in an aggregate sense that, in fact, reconciles to the bank's financials. Only then can the information at the account and/or relationship level be considered sound. There is a difference between reconciling relationship profitability outputs to the GL and balancing them.

One example is the dollar amount of expenses associated with transactions each month. Unit-cost assumptions are held constant (usually for a year)

in relationship profitability models. Their volume drivers, however, will vary from month to month. So each month there will be a varied amount of expense absorption based on the volumes for that period.

It should also be noted that within the past 12 months, there has been increased regulatory focus in the reconciliation area. Banks are being asked to demonstrate that they, in fact, do reconcile their models to known financial statements.

The sixth component of state-of-the-art valuations is having a robust **FTP methodology**. That means the valuation uses instrument-level FTP methods applied to each instrument. This instrument-level approach is designed to be part of the broader FTP program within the institution. In all cases, the commercial FTP assignments should be endorsed by the treasury or finance function. Having tested a variety of options, we know that having an accurate account-level assignment improves the accuracy of the output of the relationship values by 18 percent to 20 percent.

Differentiated costs are the seventh component of a sophisticated valuation. They are very important within the commercial context. This embraces the idea that each distinct customer activity and behavior carries a unit cost. Furthermore, these costs are differentiated by a variety of means: product ownership, customer type and channel.

While unit costs for profitability models have been differentiated by product and by activity, there are nuances to commercial accounts that need to be considered. Four key elements need to be addressed with regard to commercial cost differentiation:

- The management of commercial relationships
- The capture of pertinent transaction activities for commercial accounts
- The use of branch resources
- The custom nature of every commercial relationship

The eighth component of a state-of-the-art valuation is having a **detailed capital assignment** method. While this is an important component of all customer profitability systems, it takes on greater significance on the commercial side because of its relatively high use of capital. Commercial relationship values that are risk adjusted and scale adjusted allow for customer comparisons within and across segments, for example, small business, large corporate, *etc.*

Capital assignment in customer profitability models contains at least two components, credit risk and

operating risk. Interest rate risk and option risk are typically addressed through the FTP process. Other forms of business risk are less often associated with account and relationship profitability.

Credit risk assessments include unexpected losses, expected losses, total exposure assessments and charge-off and recovery information. Operating risk typically follows a corporate standard, most often based on net-interest expense (NIE) or some derivation of net revenue. More recently, account-level inputs have been used to enhance the operating risk assessment.

Multiple profit and customer views is the last component of a sophisticated relationship profitability model. Having multiple views of profit addresses the concept that different subtotals of profit in the P&L statement have different meanings and uses. A robust model would include at least the following:

- Net contribution before acquisition
- Net contribution after acquisition
- Net income before overhead
- Net income before taxes
- Net income after taxes
- Net income after capital charge

The desire is to be able to evaluate a relationship based on the expenses that are relevant to the question at hand. The fully loaded view is used to reconcile to the GL and prove the validity of the model. However, it is not very tactical. Net contribution before overhead and acquisition, for example, is often used as the measure that the sales force is made aware of. Product managers deal with many of the other subtotals as they work with product design and campaign evaluations. Being able to view profit at the account and relationship level with this granularity maximizes your ability to analyze the dynamics of the output.

Multiple customer views has been in the forefront for the past five or so years. Traditionally, a bank had two customer views. One was maintained by the operations area of the bank. It was usually created based on an account's legal title. This method aggregated accounts together and made them available to branch and call center personnel to facilitate customer service. The second view was maintained by the marketing department. It was created using an algorithm that was designed to make sure that people who resided at the same address were considered to be a "household." The purpose was largely for contacting the customers *via* mail for

either legal or sales reasons. Today, many institutions develop keys that allow for business owners' personal accounts to be viewed simultaneously with their business commercial accounts.

Commercial customers, as we've discussed, are more difficult to aggregate. Company names may be different, physical locations may be different, but they are all the same client. Small business customers sometimes have tax identification numbers, but sometimes they have Social Security numbers. How can you distinguish them from retail customers?

Some organizations want to allow for overlap of customer assignment. For example, a commercial customer may be assigned to a relationship manager but also does business with a branch manager. For incentive purposes, the bank may want to reward both managers for the improvement in this customer's profit. That means that the customer needs to show up both in the branch view and in the commercial view. That is much more complicated.

Other organizations want to be able to group accounts into what is called a "superhousehold." This would include but not be limited to the following:

- Being able to group the retail accounts of a business owner together with his or her business accounts, creating a pseudo-relationship for pricing and other decisions
- Being able to group customers who have something in common: all the doctors in a particular medical practice, board members who are associated with commercial relationships, for example

As the technology develops to manage these types of customer distinctions, we will continue to see different views of the customer.

Challenges

There are challenges within commercial relationship valuations that are relatively unique. These include assembling the data; distinguishing customer groups; differentiating and assigning costs; and assessing risk. The most important concept that overlays all of the challenges is knowing how to make compromises.

Data Assembly

With commercial accounts, as with others, the data assembly can be a daunting task. The required

account-level information is typically housed in multiple locations throughout an institution. The levels at which the information is presented also differ. For example, activity information is usually maintained at the transaction level, selected fee income information may appear at the instrument level, and other fee income information may be recorded at the GL level. Balance information is often maintained at the note level, while exposure information may be present at the commitment level. Moreover, not all commercial relationships have all parts.

This is where the compromises come into play. One of the hallmarks of a proper commercial customer profitability analysis is the comparability of the valuation across relationships. It is therefore incumbent upon the valuation to make the data comparable. From an industry best-practices view, the instrument- or account-level view contains the most strength, the fewest weaknesses and the best consistency.

Distinguishing Customer Groups

Another challenge associated with commercial relationship profitability models has to do with the variety of the types of customers that are considered to be commercial. In the retail sector, this problem does not exist. Aggregating the account-level information to the customer level is obviously a key issue. This is usually much more difficult in the commercial arena than in the retail arena.

At a minimum, the traditional commercial banking world includes large corporate customers, middle-market customers and small-business customers. From a technological viewpoint, this creates a huge challenge. In the retail world, automated models exist that combine a number of factors: last name, physical address, phone number, social security number, *etc.*, to create a unique identifier for each retail relationship.

This information does not work well for creating commercial customer identifiers. For the large, corporate clients, manual review is often important in associating subsidiary accounts with their appropriate parent account. Differentiating small-business owners from retail relationships is also problematic. Furthermore, keeping the information current is also a challenge. This requires a great deal of synchronization between commercial relationship managers, branch employees and the back office.

Differentiating and Assigning Costs

The assignment of costs in a commercial customer model is perhaps the most difficult challenge. Accordingly, it has taken the longest time to develop and has caused the most controversy. All of the nuances result from the more complex nature of the commercial relationship, its products and the levels of service that are required. While institutions approach the challenge differently, the best models try to incorporate as many of these specifics as possible. Major issues include the following:

- **Managing commercial relationships.** Unlike retail relationships, most commercial relationships are managed by dedicated banker(s). The dedicated bankers themselves vary in terms of experience and specialization and the degree of customization of services varies. However, these efforts are “more expensive” than their retail counterparts. Methods for addressing these more expensive, dedicated resources need to be included in the valuations. That typically includes some acknowledgment of the salaries of the relationship managers as well as some concept with regard to the time they spend managing individual clients.
- **Capturing pertinent transaction activities.** Transaction activities are also more complicated for commercial accounts, especially those associated with checking accounts and cash management services. Most commercial checking accounts are processed on “analysis” systems. These systems sit off to the side of traditional checking application systems. Sophisticated relationship profitability models must obtain information from these ancillary systems if they are to have a proper picture of the activities associated with commercial accounts. Likewise, the activities associated with cash management services may also reside on a different system. These activities must also be identified, captured and categorized.
- **Using branch resources.** While commercial relationships are traditionally managed by bank specialists, commercial clients also transact business in the retail branches. There are often specific tellers and branch functions—like coin and currency—that only affect the commercial customer. The nature of their deposit behavior and the manner in which debits are processed through their accounts are also very different than the re-

tail customer. Therefore, it becomes increasingly important to be able to identify these differences at an individual account level so that unit costs can be adjusted accordingly. In terms of adding value to the profitability calculation, having account-level volumes as drivers for transaction expense improves the accuracy of a relationship profitability calculation by almost 26 percent.

- **Customizing the commercial relationship.** Products and services that are delivered to retail bank customers are fairly uniform. The services provided to commercial customers, however, are more customized. The products, the dedicated relationship, the method(s) of customer contact are all very specific to each client's unique needs. This customization carries an added expense.

Risk Assessments

Within the commercial arena, the gradations of credit risk, the variability of total exposure and the range of size among relationships are so great that nominal results are substandard. The capital assignment is the lever used to help refine nominal results to risk-adjusted results. The challenge is to find the best drivers for assigning methodologies.

Historically, the valuation had to begin with aggregate institutional results and then separate them into elements that could be aligned with instruments. More recent evaluations either import account-level inputs from existing risk models or create account-level inputs through business rules. Most institutions weigh the relative ease of execution against the degree of compromise associated with either approach in determining which method they prefer.

Another challenge with risk assignments has to do with information being present at different levels, again requiring some transformation. For example, while credit risk is generally available at the instrument level, operating risk is traditionally available at the line-of-business or organizational level. Therefore, in relationship models, operating risk needs to be appropriately classified or broken down to be assigned at the instrument level.

Uses

There are five primary uses of the output of commercial profitability models: pricing, product design, goal setting, target marketing and incentive compensation.

- **Pricing.** Pricing continues to be the most prevalent use. Most institutions set hurdle rates for profit for commercial relationships. When notes come due, or other accounts are being cross-sold, relationship managers "model" the profitability of those relationships. They solve for the hurdle rates and attempt to negotiate a suitable solution that both makes money for the bank and meets the customer's needs.
- **Product design.** Product managers also use both the product and the relationship output when designing or enhancing commercial products. They use the behavioral information that is gleaned from the relationship information to better understand activity thresholds and customer preferences. These preferences can be translated into product features. The expenses associated with each feature can be calculated and evaluated. If feasible, these features become product enhancements. In this manner, the product manager has used the data both to assess a behavior or need and to determine if it makes financial sense for the bank to design something to fulfill that need.
- **Goal setting.** One of the metrics that becomes noteworthy once a bank has a working relationship profitability model is the average customer value for the bank. In organizations that have integrated profit improvement strategies, identifying this value and tracking it over time becomes paramount. Goals are set for each area of the bank. And each area, for example, retail banking, commercial banking, commercial real estate, would have goals based upon the average profit values for its customers.

Organizations that focus on these metrics have seen remarkable improvement: 15 percent to 20 percent in their average relationship values. That translates into a true bottom-line impact.

- **Target marketing.** Marketing can also use the concept of average relationship value. Most of us agree that a bank has to serve its customers, all of them, regardless of their profitability value. As banking professionals, we try to provide channels that are less expensive for customers to use. We try to design products that make economic sense as well as meet customer needs.

However, we might also argue that one of marketing's functions is to drive targets into the bank. Relationship profitability information can be used in conjunction with segmentation schemes. This marriage allows marketing to drive

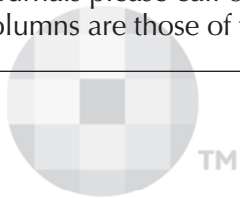
a better target into the bank; better meaning a customer whose profit potential is above average.

- **Incentive compensation.** Perhaps the most dramatic use of the relationship profitability information for the commercial line of business has been in incentive compensation plans. Many large banks now value portfolios that are managed by relationship managers. They track the performance of these portfolios both in terms of total profit and in terms of increased average-per-relationship values. Those improvements tie directly to bonus plans. That

has increased the scrutiny on the valuations and the underlying assumptions.

In summary, commercial profitability has changed quite a bit over the last 25 years. The dynamics of organizational, product and relationship profitability continue. However, the importance of all three as performance measurement metrics is solidly in place. Institutions that can successfully marry the concepts and actively use them in their day-to-day tactics see true bottom line results. Integration is the key, synergy is the advantage, and improved profits are the result.

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