

# PROFITABILITY, CUSTOMER RELATIONSHIP MANAGEMENT AND CONVERGENCE IN THE FINANCIAL INVESTMENT ARENA - WHERE ARE WE REALLY?

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Convergence and Customer Relationship Management (CRM) are terms for the millenium. More significant than the rampant Y2K issues we heard so much about prior to 2000, these two concepts will have dramatic affects on a financial institution's ability to increase profits in the next decade. The drivers behind these concepts are customer demand as well as the pressure for institutions to find new growth opportunities and revenue streams. In the financial services industry there are many separate and diverse definitions for these two terms, however, all of them reference some dynamic of profitability and all embrace a sense of urgency. Most importantly, I would propose that they are not mutually exclusive concepts but rather inseparable.

Steve Landberg, a principal with Sibson & Co. summed up the challenge nicely in an April article for the American Banker when he identified seven issues that institutions struggle with when implementing a convergent CRM strategy:

- 1) Legal and regulatory issues: focusing on "how" to make it happen vs. "why" we can't,
- 2) Organizational structure: aligning the company's infrastructure to support meeting customer needs,
- 3) Performance measures: redefining them to support revised business models focused on relationship management,
- 4) Capturing customer information from banking, investment and insurance product groups: you can't effectively cross-sell if you don't know what your customers already have and what they need,
- 5) Solving the sales versus service arguments: understanding how they can be integrated, and
- 6) Skill set development: integrating sales, marketing, financial planning and customer service. Most institutions have only begun to understand the amount of change that is required to shift the paradigm and become true relationship managers.

Insurance companies and brokerage firms are looking for partners. Distribution rather than manufacture has been a major source of industry growth in the '90s. Meheriar Hasan at TransAmerica Financial Services provides a savvy assessment of the challenges facing the traditional insurance providers. In the life insurance arena demographics have shifted-longevity has increased. Consumers are focusing more today on retirement income streams than on traditional death benefits. Resultantly, companies design products like

universal life and annuities that provide retirement income as well as death benefits. Commission expenses increase as "agents" demand more for their services as financial planners. The very nature of the sales process changes as customers look for advise-some view their banker as a safer source of information. Other insurance firms struggle with being able to distinguish profit levels among producers and with properly addressing risk in their business.

The challenges are slightly different for brokerage firms and traditional banks. Brokerage firms have been better organized in their overall customer approach. Vince Errico, Director of Electronic Brokerage for Charles Schwab attributes their success to two key strategies: 1) believing in their mission that they are the custodians of their customers' financial dreams, and 2) having a very solid understanding of the profitability drivers of their business. Schwab values their customers, segments them, centralizes information for customer contact personnel and continues to provide a broad selection of products and access methods targeted to meet varying customer needs. Other brokerage firms have followed different strategies. Many felt the need for enhanced distribution channels, likewise financial institutions desired investment credibility-partnerships were formed. Relationships with banks can provide brokers access to customers they couldn't reach as easily before. Banks partnering with investment firms can bring products to market quickly while reducing training, administration, and servicing expenses. Additionally bank partners benefit from brokers' already established "brand awareness."

For banks in particular, the last 5-10 years have been fraught with increased competition from all arenas. As referenced in a Wall Street Journal article on January 7, 1999 "brokerage firms and mutual fund empires in particular are trying to grab traditional bank customers, and highly profitable ones are the most attractive." Not surprisingly , the role within commercial and retail institutions of the "off balance sheet products" is increasing in importance as these products contribute to the overall client relationship profit levels.

The GartnerGroup Mentis Financial Services cites a survey that indicates approximately 50% of the banks with more than \$1 billion in deposits are using some profit data to make customer decisions. Our research finds this statistic to be highly inflated if you hold the institution to a standard of incorporating the "key" components to any valuation Our studies indicate that the percentage of institutions currently possessing "moderately" sophisticated customer profitability valuations is probably less than 20%. The definition of moderate sophistication as we describe it includes the following characteristics:

- Funds Transfer Pricing rates assigned at the account level
- Account-level transaction data gathered for channel distinctions
- Marginal, fixed, activity-based, and origination costs assigned at the account level
- Reconciliation to the institution's financials
- Smoothed values over time

Our studies also show on average that a lack of appropriate account-level funds transfer pricing, account-level transaction data, and smoothed values over time will significantly shift the value of over 42% of a bank's customer base-a customer you thought was a "C"

is actually an "A" and visa versa. Furthermore, the percentage of those institutions who are incorporating the value of their brokerage, annuity, mutual fund and insurance accounts into their customer relationships is probably less than 7-8%. That is not to say that institutions do not understand the next steps.

Institutions today who are truly embracing the Customer Relationship Management (CRM) concept understand that the proper definition and valuation of any customer relationship must include the brokerage, annuity, mutual fund and insurance accounts. More importantly, future market leaders clearly understand the positioning for these products within the umbrella of their overall product offerings. They know that properly defined and managed, these ancillary products provide an offensive strategic opportunity for not only enhancing the profitability of their current business lines but also paving the way for growth opportunities . This is counter to many original defensive strategies where institutions sought to offer these products solely to stem potential deposit attrition.

There are several good reasons why the industry has not moved as quickly as once thought in incorporating non- traditional products into customer profitability valuations:

- Inability to function in an integrated fashion
- Unfamiliarity with how the non-traditional businesses make money
- Data gathering and monitoring difficulties
- Legal and regulatory constraints on data sharing among bank entities
- Turf issues regarding customer ownership
- Management commitment of appropriate resources

**Inability to function in an integrated fashion.** Historically, banks have not had a "uniform" approach to customer definition. The operations side of the business defined a customer in one manner, following strict procedural boundaries. The marketing side of the business sought to define a customer in terms of a relationship : household, business owner, affiliation, etc. This made it impossible for operations areas (Customer Service) and sales areas (Branches, Private Bankers and Call Centers) and marketing areas (Direct Marketing and Advertising) to define and execute consistent strategies.

Technology in this industry is way behind in providing timely information uniformly sourced, integrated and made readily accessible to divergent points of customer contact. Data warehousing projects continue to fail because they lack proper scoping, user orientation, and effective resourcing. Unfortunately, the merger and acquisition frenzy has only exacerbated the situation as institutions struggle to be the same entity across diverse and distant geographic markets.

**Unfamiliarity with how the nontraditional businesses make money.** In many organizations the people initially responsible for managing the nontraditional product lines came from other positions within the institution and didn't possess the skill sets that their broker/dealer competitors did. Additionally, they faced a number of imposing questions in order to launch these efforts: 1) Should the institution offer the products directly? 2) Does an alliance with a third-party provider make sense? 3) How much

should the initial investment be? 4) What sales levels represent critical mass for break-even? 5) What sales levels can be expected and how quickly? 6) How aggressively should existing customers be solicited? 7) Should sales compensation packages be brought into alignment with the rest of the organization?

**Data gathering and monitoring difficulties.** Institutions offering investment and insurance products are usually dealing with a variety of providers including some proprietary funds and instruments. Gathering the appropriate data elements for incorporation into a customer profitability valuation then becomes a production challenge. Streamlining the data manipulation from one source is difficult enough, multiple sources only compound the issues. Within the institution, someone must take responsibility for managing the data gathering function. Existing data elements must be identified, including their source and characteristics, selections of pertinent items must be made, data extracts must be requested for routine, monthly execution, costs must be determined, and formulas created.

Institutions dealing with third parties may not have negotiated these details up-front as part of their contracts. Data collection and manipulation is often neglected as it isn't a priority for the third-party.

That isn't to say that some institutions haven't been successful in making it happen. First Commerce Corporation in Louisiana (now part of BancOne) received a great deal of press by successfully incorporating their investment product set into their customer profitability valuation. Jeff Nathasingh, former SVP of Strategic Management Information, was instrumental in broadening their customer definitions and in integrating that information into analytic models.

In general, Customer Relationship Management in the financial services industry lags behind current perceptions. Account and customer profitability also lags and is key to the effort. Including investment and insurance accounts in relationship values is a must. Better information is also critical. But the biggest challenge in the next few years will be to better align the organizational infrastructures so that Customer Relationship Management strategies can be better executed. That includes redefining our business models, goals, performance measures and customer service definitions to support a broader, more sophisticated definition of relationship management.

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