

# HOW TO USE YOUR DATABASE OR DATA WAREHOUSE OF PROFITABILITY INFORMATION TO MAKE BETTER MARKETING DECISIONS

by [Kim Sutherland](#), Director, Market Line Associates

Account and customer profitability can be very useful in helping a good marketer make better decisions. It becomes one more piece of information you can leverage in your day-to-day product, sales and pricing strategies. In this article I hope to illustrate how to integrate account and customer profitability into three common banking initiatives:

1. Improving a direct mail campaign
2. Setting sales goals for branches or trade areas
3. Evaluating the impact of a potential pricing decision

I am assuming for purposes of discussion that you have already calculated account and customer profitability. Once that has been done, you have several steps to complete in order to better use this information. By that I mean, we're going to create actionable information for strategic use. In order to get started, we have two decisions to make:

1. Choosing an appropriate profitability level, and
2. Selecting a scoring scheme and scoring the customers

## Choosing an Appropriate Profitability Level

First, you must decide what level of profitability you will use in your various projects. There are typically several different levels of account and customer profitability in your valuation. They include but are limited to the following:

- Net Contribution – this level of profitability includes Spread Income, Fee Income and Marginal Expenses. It may or may not include the cost of opening an account. Banks treat account opening differently – some exclude it, some amortize it, others front-load the expenses. You will also have to make this decision in keeping with your organization's philosophy.
- Net Income Before Taxes (NIBT) – this level of profitability is basically Net Contribution less Fixed Expenses.
- Net Income After Taxes (NIAT) – this level of profitability is basically NIBT less Taxes.

There are other levels of profitability that also subtract overhead expenses and/or capital allocations, but for the purpose of our discussions let's limit our choices to the three mentioned above.

Most banks today score their customers at a level that best meets the needs of the intended users. If you are going to send customer scores to sales people, calling centers, and relationship managers, most banks score the customer base at the Net Contribution level. This doesn't overburden the customers with fixed expenses or overhead. This does not prevent you from using NIBT or NIAT at a product level for product design and pricing decisions. This allows you to use different levels of profitability for different purposes.

So now, you have a profit value assigned to every account and customer and you have a score associated with every customer as well. Most banks in the U.S. are not passing actual dollars of profitability to their sales staff – but rather a score 1,2,3, etc. or A, B, C, etc. That means you have to decide how many customer groups you will divide your base into.

## **Selecting a Scoring Scheme and Scoring the Customers**

Although there are still more institutions talking about customer profitability than actually have it, more and more banks are attempting to have this information readily available. Unfortunately many have spent millions of dollars only to be very unsatisfied with the results.

In the past, many banks chose to divide their customer bases into deciles. Conventional thought now is that this distinction is not meaningful. It falls short for the following reasons:

- It's a mathematical distinction, nothing more.
- 10 levels of distinction imply that you're going to differentiate actions (pricing, sales contact, etc.) – 10 is too many
- 10 levels of distinction are difficult to communicate to a sales force i.e. what's the difference between a 6 and an 8 for example, and most importantly,
- Shifts in a customer score are not directly related to customer behavior.

For these reasons, most banks are now dividing their customer bases into 3-5 groups. For purposes of discussion let's evaluate a 5-group scenario with Group 1 being the most profitable and Group 5 being the least profitable. Once you know what your average relationship value is – you can arrange the groups. Group 3 is typically those customers whose profitability is above \$0 but less than average. Group 2 customers are above average but below some level you designate as “wildly” profitable. Group 4 and 5 are both unprofitable – with 5s being worse than 4s. It is not unusual for the Group 1 customers to be 4 or 5 times more profitable than average.

Once you've made these distinctions – the group scores can be added to your household information. Now you're ready to use the information

## **Improving a Direct Mail Campaign**

When you're mailing to a group of prospects, you attempt to mail efficiently. In the past, most bank marketers have used three dimensions to achieve this – the number of possible targets to mail to, the expected response rates, and the resultant cost of acquisition. Now you have an added dimension – profitability that can be very helpful in targeting new customers. In order to do this you will need to do the following:

1. Have defined customer segments. The method you choose isn't as important as making sure you understand the distinctions and believe in them. These segment codes need to be on your database. Then you will want to rollup account-level profitability by product within each segment.
2. Now look at what you know. You now know the average profitability of each segment by product. And, you know how much better or worse these customer segments are compared to the average relationship value (your Group 3s above) for your organization.
3. Understand, for the product you wish to promote, which customer segments make you the most money. The composition of desired customer segments will differ by product. That means your mailing strategy and your prospect lists should also vary by product.
4. Make sure that your prospects for your product mailing can also carry a segment code. This enables you to forecast the potential profitability of the acquired customers before you mail.
5. Add the element of profitability to your selection criteria for direct mail prospects. We marketers used to use expected response rate levels as our cut-off point for mailing to certain groups. Now you can afford to mail to groups with lower predicted response rates – if they are above average in profitability. And, because you know how much more profitable they are, you can develop models that can show you how much you can afford to spend to bring those customers into the bank.

You won't end up spending the same amounts of money on each campaign – but you will be spending each dollar wiser. And, if you tag customers that are attracted to the bank by your campaign, you can evaluate the relative profitability of the customers you brought in and further refine future strategies.

## **Setting Goals for Branches or Trade Areas**

All of us deal in a world of goals and budgets. In the past we have usually had volume goals for numbers of accounts and dollars of balances. In a perfect world, we would have increased profitability goals for books of business or customer groups instead of pure volume goals. However, that's not always possible. But, what you can do is vary the

goals by branch or other geographic area in keeping with two items: 1) each area's relative ability to attract new business and 2) the potential profitability of this new business. Let's use a region within a bank that needs to set goals for next year as our example. In order to use your profitability information, you will need to do the following:

1. Make sure that the branch distinctions – branch number, etc. are fields on your database so that you can aggregate information by branch. Rollup your account-level profitability data by product within branch.
2. Now look at what you know. You now know the average profitability of each branch and the profitability of its product composition. And, you know how much better or worse each branch is compared to the average branch for this region and for your organization. You can also compare them to each other. **Remember what you have is not true branch profitability, but rather the profitability of the customers who are attributed to these branches.**
3. Understand what the goals are for this banking region.
4. Understand certain basic information including demographics for each branch within the region. For example, you would want to know the following for each branch:
  - The current market share
  - The area's recent growth rates – last year – last 5 years
  - The area's potential growth rates – next 1-3 years (if possible)
  - The relative age of the branches in the region – new, fully established, etc.
  - The current product composition in each branch

Now you have the ability to understand each branch's potential for attracting new business as well as the current profitability of their business.

5. You will be able to see that certain products are more profitable in certain branches. This is a result of customer behavior. But it would make sense to ask branches with higher demand for certain products and higher potential profitability to attract more business than those who do not. In this manner you can combine profitability potential with each branch's ability to attract new business. And, you can begin to vary the goals set for each branch within the region in a manner that achieves the same overall volume goals of accounts and balances – but from sources that will improve the overall profitability of the bank as well.

## **Evaluating the Impact of a Potential Pricing Decision**

We all have to face periodic pricing reviews for our product sets. And, we have historically made these decisions based on what we felt the market would bear in light of

competitive pressures. Now you have the added ability to forecast the potential impact on profitability for the pricing decisions you are considering. For this example we will consider a bank deciding to raise the minimum balance level at which a service charge will be assessed on a Non-Interest Bearing Checking account and an increase in the service charge of \$2 from \$5 to \$7. The previous price point was at a \$500 average balance, the bank is now considering a \$750 average balance. This is how you can evaluate your options incorporating your profitability information.

1. Divide the customers who currently have this product into 3 groups: those that have an average balance below \$500, those that have an average balance between \$500 and \$750, and those that have an average balance above \$750.
2. Understand the average account profitability for each group as well as their average relationship profitability
3. Estimate how many customers in the first group will tolerate a \$2 increase in their service charge – and create some attrition expectations.
4. Estimate how many customers in the second group will tolerate receiving a \$7 dollar service charge – remember that this group is affected the most – and make some attrition estimates.
5. The last group is not affected – they didn't receive a service charge in the past, nor will they in the future.
6. Calculate the impact on profitability of the new fee income as well as the lost customers from groups 1 and 2.
7. You may want to evaluate several different strategies in this manner before selecting an optimal pricing change.
8. Once you've completed this exercise – look at the customers you expect to lose in this account – and look at the other accounts they have in their relationship with you. Decide if their other relationships are at risk as a result of this potential pricing decision. Then, reevaluate the profitability impact you calculated in step 6 above. You probably want to evaluate more than one scenario. I would suggest a best case, worst case and most likely case.

Now, you are prepared to make a pricing recommendation that not only “works” in your competitive environment, but also can contain expected impacts to the bottom line. And, most importantly – track your results. Each time you do this type of analysis – you become more comfortable with the exercise.

Hopefully these three examples demonstrate how each of you can incorporate account and customer profitability into your day-to-day decisions as a marketer.

(AMIFs - Journal of Bank Cost and Management Accounting)