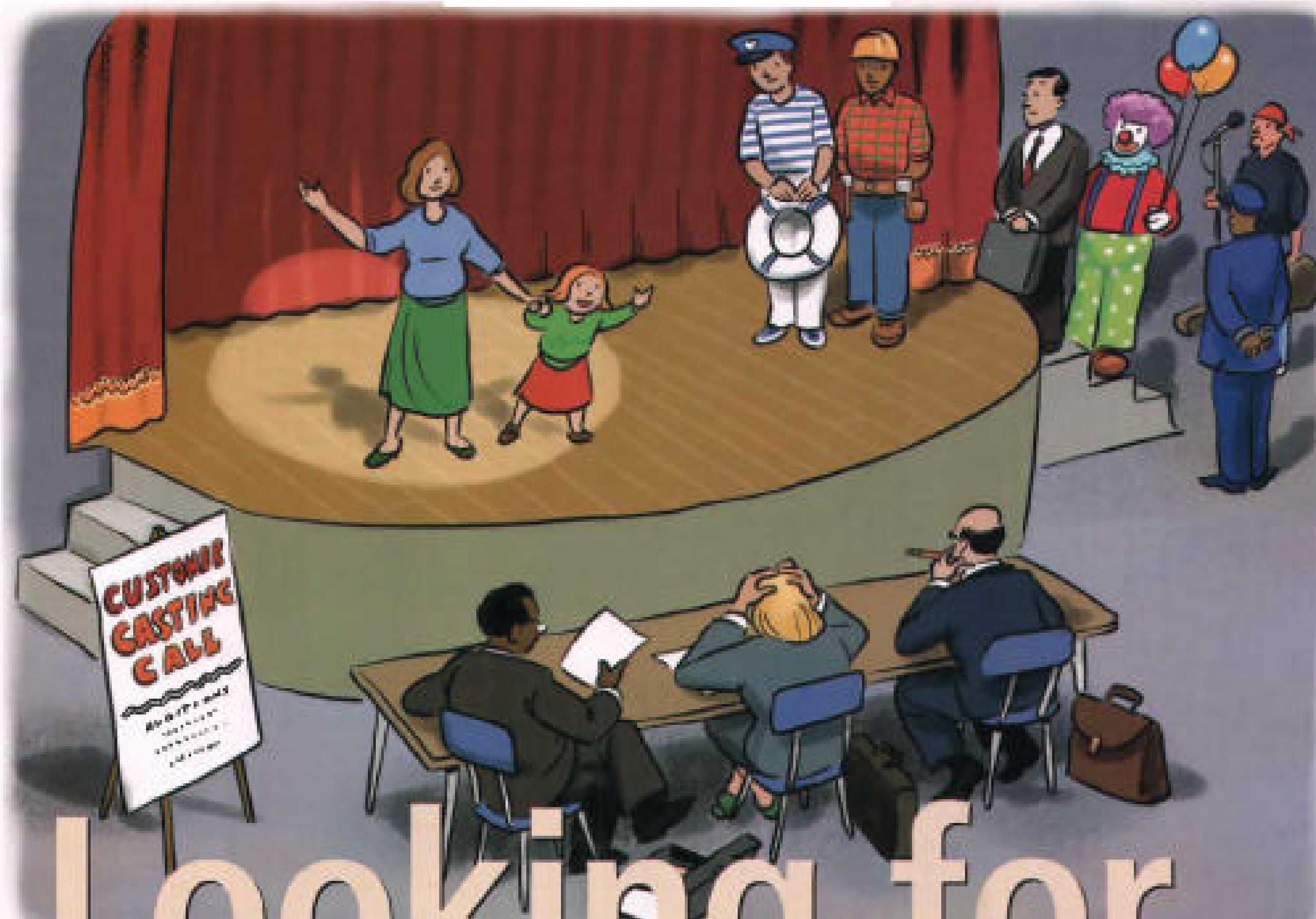

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Looking for Ms./Mr. Right

Could your marketing and branch managers pick out your most profitable customers? And if they could, then what?

How banks answer the above questions varies widely, but thanks to increasingly sophisticated technology and a rekindled interest in customer profitability measurement, a respectable number of banks would be able to answer "yes" to the first question. However, if you asked those same banks whether or not they have programs in place to hold onto those profitable customers, find more customers like them, and increase the profitability of their less-than-stellar contributors, very few could answer "yes."

By Lisa Valentine, a freelance business writer based in Middle Grove, N.Y.

Customer profitability has been bandied about for more than a decade as a way for banks to increase revenues, and although many banks have gotten pretty good at measuring customer profitability, they often fall short on effectively managing what they've measured.

"The lion's share of banks have the *ability* to know who their profitable customers are, but they don't always go through the exercise of identifying them by name because they are not sure what they would do with the data once they got it," explains consultant Margaret Kane, president and CEO of Kane Bank Services, Sacramento, Calif., and a former Wells Fargo retail banking executive.

"The profitability IQ of banks has risen significantly in the last five years," adds Robert Hall, EnAct group executive at Carreker Corp., Dallas. "The remaining challenge is to translate that into effort at the front line in an informed way."

But not everyone agrees that banks should get an "A" for customer profitability measurement. There is a right way and a wrong way to measure, and many banks are not looking at customer profitability in the right way, contends Phil Hudson, president and CEO, Aspen Consulting Group, Salt Lake City. Instead, they measure customer profitability by looking at fee income, deposits, and loan balances instead of at a holistic picture of the customer.

Customer profitability is not any more complex than measuring product profitability, contends Hudson, although it does require more effort as you gather data from multiple systems housing siloed products such as deposits and loans. But the effort is worth it, he believes, because unlike product profitability, customer profitability measurement provides "intelligently actionable information."

For example, although product profitability data can inform you that a product is marginally profitable and spur you to raise fees, he explains, it does not calculate the ripple effect of a profitable customer leaving the bank because she won't pay $12 per year for a previously free debit card. Armed with customer profitability data, you know not to charge those types of fees to valuable customers.

How important is perfection?

Measuring customer profitability is not an exact science and the results tend to be a "constant moving target," says Kane, driven by a large number of diverse and ever-changing factors such as how and where customers perform transactions.

Transaction data is critical to measuring customer profitability, agrees Christopher "Kip" Fowler, president of the Easton, Penn.-based consultancy Blue Mountain Group. "If you are not capturing raw transaction data, then you don't have a full picture of customer profitability. For example, if you lump all your fee income together, you will negatively impact the effectiveness of your profit model."

From a technology standpoint, systems are available that allocate costs for each transaction and then map every customer account and its profitability back to the general ledger. Integrating the G/L with customer data allows the bank to accurately assess how well each account contributes to the G/L, explains Rich Weissman, president and CEO of Database Marketing Agency, Portland, Ore., whose Integrated Database Marketing System does just that.

Weissman believes this level of detail makes a huge difference in customer profitability measurement, and is easily doable by most institutions.

But do you need to get customer profitability measurement down to the penny? You should try to come close, but this is not an area where perfection will reap huge rewards. And it is that desire for perfection that makes some banks abandon their customer profitability measurements. "A perfect measurement [of each customer] is not that important," says Hudson, and it's unwise to spend too much time trying to determine whether a teller transaction "costs $2.00 or $2.08."

And even if you could get to a perfect number, you would not want to use that number as the sole basis for decision-making, advises Fowler, because customer profitability numbers are—at best—directionally accurate. A customer who makes you a profit of $300 year, for example, is not four times as profitable as a customer who loses you $100 a year.

Chico, Calif.-based Tri Counties Bank ($1.46 billion) focuses less on the perfection of the customer profitability numbers and more on how to use relative profitability numbers to drive results. "You're better off investing money in training your employees to do the fundamentals correctly, armed with basic information," says Andrew Mastorakis, executive vice-president, sales and service. "You will always do better than if you have costly technology programs that front line people have a hard time using."

Broadway National Bank, San Antonio, is another institution that agrees with that approach. "You don't have to buy something that is going to take you to the moon and back to measure relative profitability," says James C. Allen, executive vice-president and director of the retail banking division. The key is that you need to include all products and services that a customer has with your bank into a customer profitability calculation. Armed with those less-than-perfect figures, "it's the strategy, the understanding, the communication and the activities," says Allen, which are most important to achieving results.

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>
> ***— James Allen, Broadway National Bank***

Manage, not measure

Because technology for measuring customer profitability has become readily available, banks began measuring without understanding the business problem they wanted to solve and how they would manage this newly-found information, suggests Kane.

Broadway Bank has carefully considered how to best use customer profitability data based on its growth strategies and bank culture. Allen explains, for example, how Broadway segments its customer base into five tiers, with tier one being the most profitable and tier five the least profitable—information the bank used when they decided how to communicate a systems change to customers. Understanding that the overhaul would have some impact on customers, such as changing the menu options on the telephone banking system, Broadway determined the most cost effective method of communicating the changes by tier—notifying tier 3, 4 and 5 customers by mail and assigning a personal banker to tier 1 and 2 customers to help them through the change.

Another example of proactively using customer profitability information is during an acquisition. By determining the most profitable customers of the bank you are acquiring, says Allen, you can put on kid gloves and create a game plan of how to introduce your bank to these customers prior to the acquisition being completed.

Don't throw out the baby

Once you find your most profitable customers, "do everything you can to keep them," says Aspen's Phil Hudson. That can be as simple as "preventing them from stepping on all the landmines that a product management mentality creates."

But while it's obvious that banks should work hard to keep the profitable customers, what about those unprofitable customers? Shouldn't you try to get rid of them? Or at least make it less pleasant to do business with your bank in the hopes that they will jump ship and become a drain on your competitor's balance sheet?

In addition to creating bad will that can have a ripple effect throughout the community, moving unprofitable customers out of your bank only distributes your fixed costs over a smaller group of customers, says Weissman. The key, he believes, is to spread profitability over a greater number of customers by working on making unprofitable and marginally profitable customers more profitable and thereby reducing "profit risk"—the risk of profitable customers leaving your bank. He cites one financial institution that increased earnings by 40% by decreasing their profit risk by 19%. He suggests taking baby steps such as focusing on moving 5% of your customers from slightly unprofitable to profitable each year. "That can be a significant impact to the bottom line," Weissman believes.

Another reason to focus on unprofitable customers and try to move them up the profitability food chain, is that your profitable customers are extremely vulnerable to competing offers from other institutions, says Alan Grant, CEO, Exchange Solutions, Waltham, Mass. Yes, you want to protect your valuable customers, but the reason they are so valuable is probably because you are not giving them any deals.

Exchange provides outsourced customer profitability data based on the value of an individual's total financial holdings.

Out to the front line

For many banks, part of the challenge of how to use customer profitability data is whether to provide that information to their front-line, customer-facing employees.

Broadway Bank has so far chosen not to provide profitability data to its tellers, says Allen, adding that a robust training and education program needs to be in place first. The question then arises, would you train your employees to treat less profitable customers differently? "We try to treat everyone with excellent service, believing that it causes people to want to bank with you," says Allen.

Grant also believes that the front line is ill-equipped to wisely use customer profitability information. "An employee may make a decision that may seem like the right decision given the information in front of them, but may not be the right decision over the long run," he says. "Without an incredible amount of training, I'd rather treat every customer the right way than try to treat customers differently."

Developing appropriate programs for using customer profitability at the front line can be very difficult, agrees Kane, and often the information is better used for centralized marketing programs such as direct mail to persuade less profitable customers to use lower cost transaction channels.

But while you may not want to provide individual profitability data to the front line, you can use such data to identify your most profitable customers and define rules around how those customers should be treated. For example, you may train employees to provide problem follow-up for "MVPs."

Less is more

Since the 1990s, banks have worked hard to develop a sales culture where cross-selling was seen as a panacea to all ills. The assumption was that the more products and services a customer has with your bank, the more profitable they are. While that may be true in some cases, more often than not banks were surprised at the results of their customer profitability calculations. "Smart cross-selling increases customer profitability but stupid cross-selling decreases customer profit," says Kane.

Weissman likens cross-selling to cholesterol—there is good cross-selling and there is bad cross-selling.

In fact, some of the most unprofitable customers at a bank can have the most number of products. When Tri Counties looked closely at customer profitability, it found that its most profitable customers tended to have home equity loans or lines of credit—as did their most unprofitable customers. The difference in profitability wasn't in the product per se, but in the *use* of the products.

Based on this information, Tri Counties has "been able to tactically change what we do to become more profitable," says Mastorakis, including training employees not to indiscriminately sell home equity products, as well as educating customers how to benefit from using them.

The rule of thumb, says Hudson, is that cross-selling profitable or marginally profitable customers will probably make them more profitable, but cross-selling unprofitable customers typically makes them more unprofitable. It's not that you don't want to sell unprofitable customers products, but you want to focus on selling them the right products that will *increase* their profitability, he adds.

Unfortunately, banks often load their customers up on products such as a free checking account, free savings account, a credit card with a $500 credit limit, and an ATM card, each of which is unprofitable by itself, and become even more unprofitable as a combination. However, toss in a home equity line with a drawn-down balance and a mortgage and an automobile loan, and the profitability of the customer changes dramatically.

Even as banks refine how they manage customer profitability and what they do with that information, they are realizing that this data is just one ingredient in the recipe for a successful institution.

"If you take profitability as gospel, no one would ever sell a DDA because you inherently lose money on it," says Fowler, warning: "You're in danger of losing sight of what you are in the business of doing—providing financial services." *BJ*