Banking perspectives

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What's top of mind for retail banks? More often than not, the focus is on customer profitability and risk management.

Customers are key to higher branch profits. So it's no surprise that more financial institutions are looking to improve the client experience. But success depends on gaining customer insight. If banks truly understand what clients want, it's much easier to tailor products and services in ways that are meaningful to them.

This from The McKinsey Quarterly: "Few banks have more than a rudimentary knowledge of what customers want from a branch and how they currently use it…so bank executives should use data analysis and direct observation to track the flow of customers and their behavior."[1]

On the other side, institutions have to contend with growing credit, market, regulatory, and operational risk. They're increasingly under the gun to improve their control and management practices.

What banks don't want is to be blindsided by process failures or operational errors. To reduce risk, they have to keep a tight grasp on business practices. That means gaining better insight into the organization, and measuring and analyzing risk events.

In this paper, we offer three perspectives on financial services. First, we suggest why banks have to invest in every aspect of the consumer experience and offer relevant products to drive up profits.

We also look at one IBM Cognos solution for managing risk: the *IBM Cognos® Risk-Adjusted Profitability Blueprint*. Finally, we provide a review of the issues impacting banking today and why performance management is gaining prominence.

In Europe and the U.S., retail banks are re-thinking the way they generate profits. Instead of focusing on fees and lending, banks are now turning their attention to customer service. According to a study by Financial Insights magazine, customer service dominates the CEO agenda in Europe. And U.S. banks point to customer loyalty as their top concern because of the "long-term impact on expanding the business."[2]

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[1] Nick Bidmead, Georges Massoud, and Piotr Romanowski. Bank branches that meet customer needs. The McKinsey Quarterly. August 2007.

[2] Bill Bradway. *Performance Management Drives Improvement at European Banks*. Financial Insights. June 2005; *Performance Management Drives Improvement at U.S. Banks*. Financial Insights. December 2005.

Better customer service presents a strategic opportunity to improve the bottom line. But it means more than providing longer banking hours and incentives to get people in the door. Retail banks have to invest in every aspect of the consumer experience and offer relevant products, says The McKinsey Quarterly.[3]

Branches still important

Throughout the 90s, banks invested heavily in ATMs, telephone, and Internet banking: technologies that let customers conduct everyday transactions almost anywhere except their branch. But 90 percent of customer relationships are still won and lost at the branch level,[4] where people can secure mortgages, mutual funds, and perform other complex transactions in person.

"For today's consumer banks, reinventing local branches as a hub to attract and retain customers is essential to profit and growth," says research firm Booz Allen Hamilton. To do that, they have to deliver what consumers want: choice, convenience, and customization.[5]

Banks can potentially deliver better customer value and make branch banking more profitable. The question is: How do they determine what consumers want? Many are turning to business intelligence for the answers.

The value of customer information

CRM, ERP, and other transaction systems present a goldmine of customer data – buying patterns, purchase history, satisfaction levels, demographics. BI leverages this information to help banks better understand their customers and tailor services to their individual needs.

For example: detailed customer profiles identify who is most likely to buy which products and why. Banks can then slice and dice this information to offer customized packages and services targeted to different customers. Whether it's an education loan for a student, or a mortgage and investment plan for a high-income earner.

And instead of seeing so many meaningless products, customers perceive the services as being relevant to them.

[3] Marc Beaujean, Dirk Reiche, and Charles Roxburgh. *How Europe's Banks Can Win in Tougher Times.* The McKinsey Quarterly. June 2005.

[4] Paul Kocourek, Aditya Bhasin, Paul Hyde. *A Better Way to Make Branch Banking Pay.* strategy + business eNews. Booz Allen Hamilton. February 2004.

[5] Ibid.

Customer retention and marketing

Identifying profitable new customers is important. But existing clients also offer long-term value. Analysis can uncover the most profitable customers or an individual's history, including purchases and changes in buying patterns. Armed with the information, staff can respond accordingly, by waiving a customer fee or cross-selling additional products.

"If any customer's rate of purchasing declines, we can rapidly approach them with targeted offers," says Johan Nordin, Head of IT at Volvofinans. The company uses IBM Cognos BI to leverage customer data to better target sales.[6]

Across branches, banks can identify where sales are highest and where they're flat. This may inspire additional product offerings, services, or marketing campaigns.

Loyalty programs

Profiles can provide the baseline for incentives or loyalty programs to keep long-term customers on board.

"Retail bankers need to be more creative if loyalty between the customer and the bank is to be a cornerstone of a strong, profitable relationship," says Kathleen Khirallah of the Tower Group.[7]

She suggests focusing loyalty programs on the total client relationship, rather than a single product or service. And a broad array of rewards is needed to ensure each customer perceives value. Leverage information, know your customers.

"It's only by taking advantage of business intelligence technologies that you can differentiate your bank by sincerely knowing your customers and appropriately responding to their needs," says Jill Barnes at IndyMac Bank.[8]

The customer relationship may be the key that drives up profitability. But to ensure positive outcomes, banks have to know and respond to what consumers want. Deeper customer insight is the touchstone that can benefit both sides.

The bank effectively targets and sells more products with less effort. The customer feels the bank is looking out for his or her interests. And over the long term, satisfied customers will likely invest more of their assets as their needs evolve.

> *"For today's consumer banks, reinventing local branches as a hub to attract and retain customers is essential to profit and growth."*
>
> ***– Research firm Booz Allen Hamilton***

6 *Volvofinans Uses IBM Cognos BI to Drive Sales Operations.* Cognos News Release. September 20, 2005.

7 Kathleen Khirallah. *Customer Loyalty in Retail Banks: Time to Move Beyond Simple Programs or a Product Orientation.* ViewPoint Issue 127. TowerGroup. February 2005.

8 Peggy Bresnick Kendler. *Bank Systems & Technology Online.* January 3, 2006.

Bringing risk and profitability together with IBM Cognos Performance Blueprints

The past several years have been a period of major technology investment for financial institutions. Sarbanes Oxley, Basel II, the Patriot Act, and other mandated federal initiatives have forced many firms into a perpetual spending mode to keep up with compliance requirements.

As a result, most financial institutions now have huge data warehouses for risk and compliance information, new risk modeling technologies, and dashboards and reporting to make sense of it all.

Investing heavily in technology

Internal initiatives have also spurred banks to invest in technology. Perhaps the strongest of these has been around profitability management and measurement to improve customer, business line and product, and channel profitability.

The result? Investments in budgeting and consolidation software, activity-based costing, customer relationship management, and profitability modeling systems have pushed the sophistication of profitability management to a new level.

But a major issue remains

Despite the strides made in profitability management and risk management, there remains a major issue. The two capabilities have not been integrated effectively. As a result, planning and forecasting don't incorporate risk management to the extent that they should.

At best, this leads to insufficient financial planning and forecasts that aren't entirely aligned with risk management. At worst, plans misrepresent the level of credit and operational risk–leading to major discrepancies between projected and actual financial results.

The *IBM Cognos Risk-Adjusted Profitability Blueprint* addresses these challenges by integrating risk management and financial planning.

"It's only by taking advantage of business intelligence technologies that you can differentiate your bank by sincerely knowing your customers and appropriately responding to their needs."

– Jill Barnes, IndyMac Bank

Blueprints for core functions and key industries

Blueprints are pre-defined data, process, and policy models that help organizations speed their software deployments and drive faster return on investment.

The *Blueprints* address many essential functional process areas as well as the unique needs of specific industries. In addition, *Blueprints* can be linked together. This allows companies to establish dynamic connections that keep strategic objectives, operational plans, people, and activities aligned as business conditions change.

The *IBM Cognos Risk-Adjusted Profitability Blueprint* allows financial institutions to integrate risk information with an enterprise-wide, distributed profitability management process that provides:

- Integrated risk-adjusted planning and forecasting at the product level, across multiple dimensions with risk measures that include Risk Adjusted Return on Capital (RAROC), Economic Capital, Probability of Default, and more.

- Activity-based management and costing capabilities for key customer, product, and business segments, providing the most accurate, reliable profitability planning and reporting data.

- Compatibility with any ABC/M system, due to joint development efforts with partners such as Acorn Systems.

- Multidimensional risk management and profitability reporting and analysis, combining the power of the IBM Banking Data Warehouse with IBM Cognos 8 Business Intelligence.

- Unparalleled financial services domain expertise provided by IBM Global Business Services.

An integrated solution

By using the *IBM Cognos Risk-Adjusted Profitability Blueprint*, banks can plan and forecast at the product level, ensure unmatched accuracy with activity-based cost information, and incorporate risk calculations.

"Most financial institutions now have huge data warehouses for risk and compliance information, new risk modeling technologies, and dashboards and reporting to make sense of it all."

This way, they boost profitability through more precise planning and leverage existing technology investments, improving technology return on investment and overall return on assets.

U.S. banks: spreadsheet warriors or scorecard wizards?

Editor's note: The following is an excerpt from Performance Management Drives Improvement at U.S. Banks, written by Bill Bradway, Group Vice President, Banking Practice, IDC, and published in December 2005. The research was sponsored by Cognos, before IBM acquired it, to gather perceptions and opinions about the banking industry's need for performance management solutions and how these might develop over the next few years.

Less loyalty, increased demands

The regulatory environment and competition among banks have intensified to new levels, raising the stakes to even higher levels among U.S. banks. Customers are less loyal and more demanding. While banking products continue to evolve, margins have narrowed and merger and acquisition consolidation continues to challenge banks to improve their business results. Many banks see improved customer loyalty and improved risk management as the way forward.

Key drivers: customer loyalty & risk management

We asked 15 large U.S. banks with assets of $10 billion or more to rank the importance of 10 business drivers. Two drivers tied for the top with unanimity: customer loyalty and risk management. Comments indicated that these drivers have risen to the top of mind because of their long-term impact on expanding the business (keeping customers and cross selling) while avoiding mistakes or making bad decisions (mostly credit/loan related). All banks talked about regulatory compliance; it was a significant issue for 60 percent of respondents.

Financial metrics focus on costs, losses, and risk-based returns

Most banks are still driven by financial measurement systems tied to their annual profit plans and budgets. Respondents all had a well-established, integrated general ledger with profit and cost centers used to measure and control the business. As expected, about 70 percent of respondents cited the profit-and-cost center capabilities as having a high impact on their bank's performance management. However, what took top position was the impact of performance management on non-performing loans and loss ratios – a unanimous point of view.

"Banks can plan and forecast at the product level, ensure unmatched accuracy with activity-based cost information, and incorporate risk calculations."

Customer metrics focus on relationship and value

A high percentage of respondents cited customer profitability, share of wallet, and revenue by customer as important elements of their performance management system for both line management and top management. Banks that are investing heavily in performance management technology also include customer metrics in their plans. At several banks, these investments reflect the CxO's priorities.

Potential profitability, stage of life-cycle metrics, and lifetime value are used by only 20 percent of the banks. But each of these metrics is included in future plans at 60 to 70 percent of the banks. These results are indicative of where the advancement in customer metrics will occur over the next five years.

Leveraging technology for performance execution

Respondents are using a mix of online access to retrieve and use performance metrics and batch reports. About 33 percent have either daily or real-time performance management capabilities enabled by distributing information to line managers. And 63 percent still rely on monthly batch reports.

About 75 percent provide online access to a data warehouse (or data mart). Almost all the banks had enabled their Intranets to support online access. The differentiation between the more advanced banks and the rest is the amount of accessible performance data. Slice-and-dice analytical tools are becoming more widely adopted. 60 percent have enabled these tools online, while another 20 percent also deploy these tools for use with batch report-based data.

Dashboards were used for batch reports, and one-third of the respondents are now them in an online environment. These dashboards stop short of true enterprise balanced scorecard objectives. Managers at these banks are using dashboards to make tactical decisions in daily operations with more rigorous analysis on a more timely basis.

Spreadsheet warrior or scorecard wizard?

Based on the research results, Financial Insights developed a Performance Management Leadership Grid, which classified respondents into four categories:

- Spreadsheet Warriors struggle with inefficiencies and measure business strategies with whatever tools are available.

> *"Many banks see improved customer loyalty and improved risk management as the way forward."*
>
> *– Sam Israelit*

- Enterprise Performance Kings have a less than optimal execution effectiveness rating but are investing heavily with a view to improving.

- Technology Engineers have good tools but little alignment with strategy. They tend not to spend on performance management, yet perceive few shortfalls.

- Scorecard Wizards have developed advanced analytical scorecards but are currently distributing only monthly reports.

Recommendations

There are many ways for banks to address performance management. The most successful, however, will develop performance management metrics that blend financial results, "customer delight" metrics, and operational excellence. To build solutions that fulfill this triangle of demands, U.S. banks should consider the following:

- The foundation of all good performance management is a reliable set of financial information that is generated automatically, on a timely basis, and reconciles with operational transaction systems – providing clear accountabilities for profit and cost centers.

- Planning tools and processes should enable effective linkages between departments, lines of business, and the enterprise to eliminate dysfunctional or manual steps for drill-down and roll-up views.

- An online environment with appropriate access for all levels of management and staff will enable better and faster decision making, as well as timely and consistent measurement of results.

- Banks need to develop the analytical processes and tools to explain variance against plans, to test "what-if" hypotheses, and create recovery scenarios to improve decision making.

Over 1,000 retail, corporate, and investment banking institutions trust IBM Cognos software to increase customer, product, and channel profitability, manage and reduce risk, address compliance issues, and improve the predictability of financial performance. For information on IBM Cognos solutions for banking please visit www.cognos.com/banking.

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"The most successful banks will develop performance management metrics that blend financial results, "customer delight" metrics, and operational excellence."

About IBM Cognos BI and Performance Management

IBM Cognos business intelligence (BI) and performance management solutions deliver world-leading enterprise planning, consolidation and BI software, support and services to help companies plan, understand and manage financial and operational performance. IBM Cognos solutions bring together technology, analytical applications, best practices, and a broad network of partners to give customers an open, adaptive and complete performance solution. Over 23,000 customers in more than 135 countries around the world choose IBM Cognos solutions.

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