Commercial and Small Business Relationship-Based Profitability and Pricing: Putting It All Together

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TowerGroup Take-Aways

- Relationship-based profitability measurement and the pricing it mandates requires enhancement to customer relationship management (CRM), product and customer costing, risk assessment, data timeliness, and pricing models.
- As banks overcome challenges to implementing relationship-based profitability and pricing (RBPP), best practices emerge.
- Banks are turning to third-party RBPP solutions that combine deposit, credit, and fee-based products to evaluate pricing scenarios that meet their risk and profitability goals.
- Banks that involve wholesale banking customers in pricing decisions benefit from greater loyalty and improved customer satisfaction.
- Banks combining commercial and small business RBPP with robust CRM have the tools necessary to implement one-to-one marketing for their business customers.

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Report Coverage

As a result of the 2007–08 subprime mortgage crisis, banks are facing substantial declines in profitability. US commercial bank net income fell almost 40% from the first quarter of 2007 to the first quarter of 2008. These financial results highlight the importance of setting prices for new and renewing business (individual product purchases by business customers) that provide the bank sufficient profit while sustaining the customer relationship. Often, pricing in wholesale banking is negotiated or market driven, with little attention paid to profitability. Relationship-based profitability and pricing (RBPP) solutions ensure that pricing meets profitability goals.

This TowerGroup Research Note discusses implementation challenges, emerging best practices, and third-party solutions for commercial and small business customer RBPP. This Research Note is a companion to TowerGroup Research Note V55:13W, *Commercial and Small Business Banking in Troubled Times: Using Relationship-Based Pricing for Growth*, which discusses the business issues driving improvements in commercial relationship-based profitability and pricing along with historical pricing approaches, profitability components, and pricing attributes.

Introduction

TowerGroup defines relationship-based profitability as the overall economic return (or loss) arising from a customer's use of various bank products or services. Relationship-based pricing involves calculating the profitability of a particular customer's relationship and using that information to set the price of a specific bank product or service. Application of RBPP ensures a bank that its pricing adequately compensates it for supplying products and services and rewards customers for their relationship with the bank.

In the mid-1990s, Don Peppers and Martha Rogers, PhD, authors of several best-selling books on customer-focused relationship management (CRM), introduced the concept of one-to-one marketing, a strategy emphasizing personalized customer interactions and customized products. Together, commercial and small business RBPP and robust CRM serve as the tools banks need to implement one-to-one marketing for their business customers. Using RBPP and CRM, banks can identify target customers, determine their banking needs, assess the lifetime value of the relationship, and customize product and service bundles. The result is improved customer satisfaction, increased retention, and higher cross-sell rates.

Implementing of commercial and small business RBPP presents a number of challenges, but best practices are emerging. Comprehensive solutions from some third-party software providers have incorporated these practices to enable banks to calculate relationship profitability and establish pricing across product silos.

Challenges of Implementing RBPP

Wholesale banking is a relationship-based business. As discussed in TowerGroup Research Note V53:23W, *360-Degree Small Business Customer Profiles: Around the World of Entrepreneurs*, a 360-degree view of the business customer is critical if banks are to fully understand a customer's relationship with the bank. A comprehensive business customer profile is the linchpin of relationship profitability and pricing. It is challenging to construct because of the complexities of a business's relationship with the bank, as illustrated by the schematic profile in Exhibit 1. The exhibit shows an example of a 360-degree customer profile for a complex small business customer, but similar complexities exist for larger business customers.

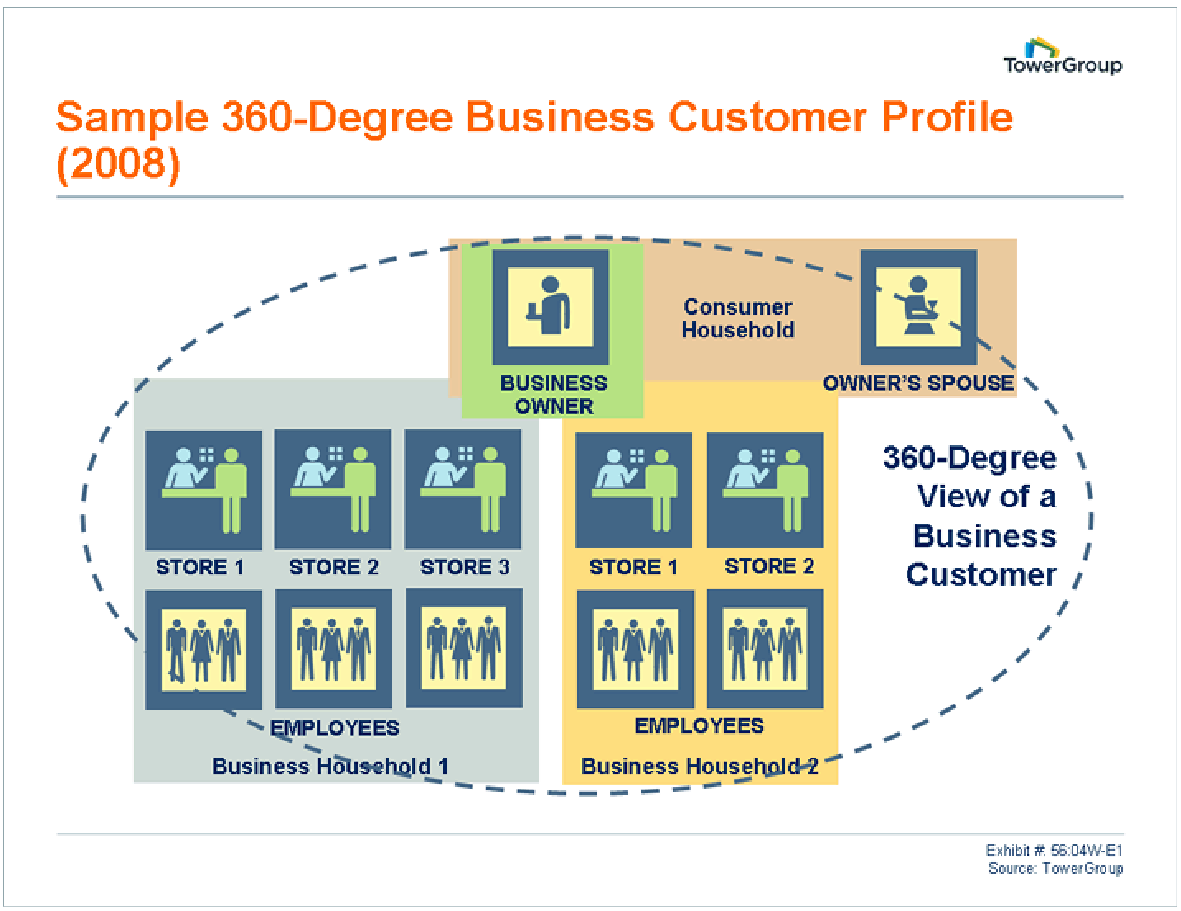

Exhibit 1
Sample 360-Degree Business Customer Profile (2008)
Source: TowerGroup

Defining a Business Relationship

The first challenge in creating a comprehensive customer profile is to define what constitutes a relationship for the purposes of relationship profitability and pricing. There are multiple ways of looking at a business relationship. The relationship is likely to encompass business subsidiaries across geographic locations. For a small business, the bank may incorporate the owner's personal accounts and balances into a relationship view. Financial institutions offering workplace banking or other types of discount programs to a business's employees may include the value of those employees' accounts in the overall banking relationship.

For bank marketers, retail householding is the process of linking individual consumers who reside at the same address and are part of an economic unit. The term "householding" is also used to denote linking related business entities, accounts, and individuals to create "business households" and customer profiles. Software exists to automate linking of retail households based on Social Security number (SSN) or home address. To create business households, banks often use the business entity's employer identification number (EIN), also known as a federal tax identification number (TIN), to match account records and create a customer profile. This method identifies only a single business entity, however, and cannot link related individuals, subsidiaries, or corporate parents. Because of the limitations of automated business householding, commercial relationship managers, and business bankers must manually identify links between business entities.

The Building Blocks of RBPP: Gathering Data

Commercial and small business RBPP builds on the 360-degree profile of a business. The building blocks of RBPP are product and customer costing, credit quality and risk profile, loyalty assessment, and profitability and pricing calculations. Unfortunately, banks face challenges in gathering the data to support these building blocks. These difficulties are outlined in Exhibit 2 and described in the following text.

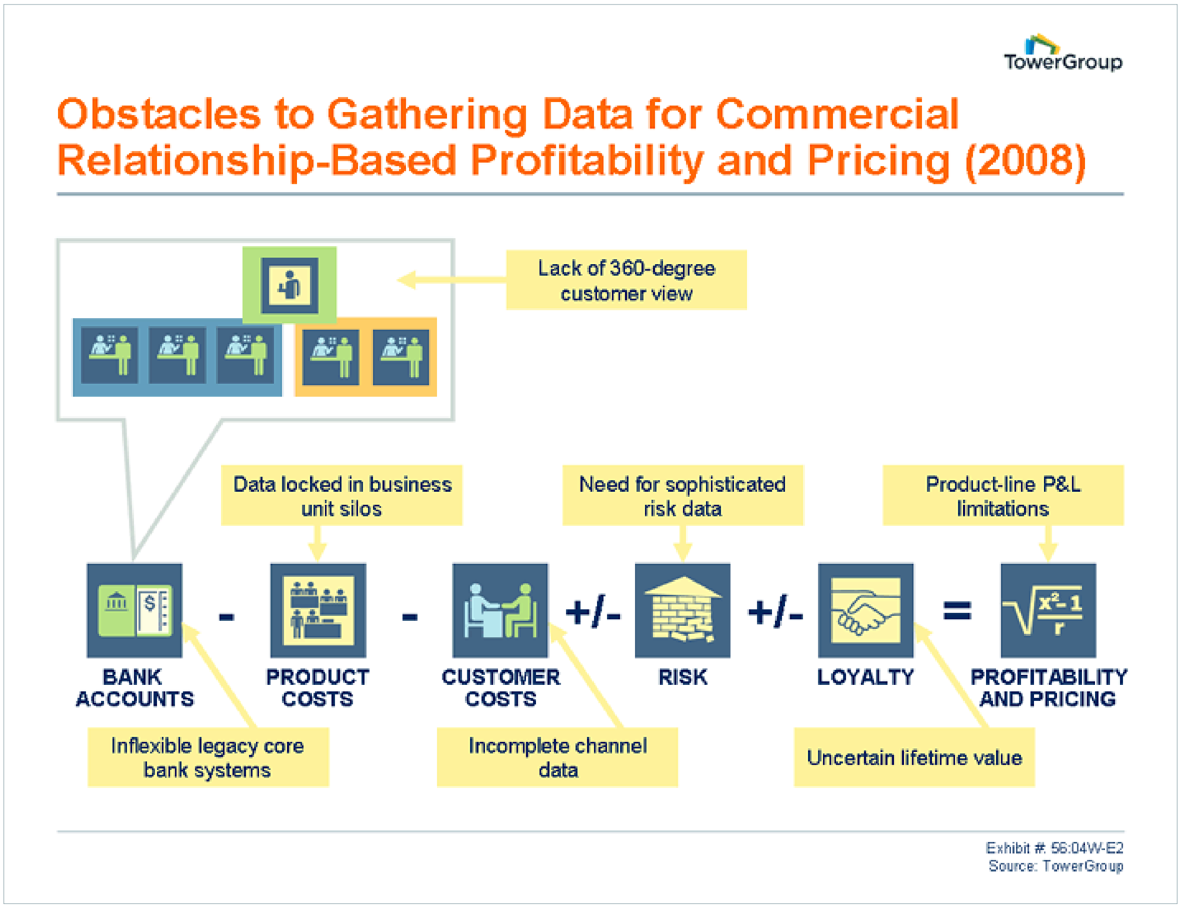

Exhibit 2
Obstacles to Gathering Data for Commercial Relationship-Based Profitability and Pricing (2008)
Source: TowerGroup

Disparate legacy systems hamper implementation of RBPP because vital information is typically scattered among operational customer information file (CIF), sales and service, marketing CRM, and credit risk systems. The disparate systems cannot store complex business profiles or relationship keys. Specialized wholesale banking applications such as account analysis and portfolio management house a portion of a customer's relationship profile. Account analysis systems, used for cash management billing, store business hierarchies associated with noncredit services. Commercial loan servicing and portfolio management systems store credit exposure and guarantor information for related business entities. But the challenge is three-dimensional: Besides collecting data from disparate systems in order to calculate profitability at the relationship level, banks need to aggregate customer information across product silos. These silos include cash management, commercial lending, investment management, foreign exchange, trade services, business credit card, and merchant services.

Bank Accounts. Although legacy CIFs, deposit servicing, and loan accounting systems provide account, balance, transaction, and fee income data for core commercial products, profitability calculations require additional account information from ancillary product silos. Banks must integrate data from investment management, foreign exchange, trade services, business credit card, and merchant services systems.

Product Costs. Unless a bank has implemented enterprise-wide activity-based costing (ABC), it is difficult to determine product costs accurately. ABC identifies the cost drivers of producing a bank product or service. A significant product cost component is net interest margin. Banks use funds transfer pricing (FTP) to allocate net interest margin. FTP is a process that assigns interest expense to loans and interest income to deposits for each customer's account.

Customer Costs. Although wholesale banking is a major contributor to bank revenues, it is also a major contributor to noninterest expense (NIE). In general, business customers are more expensive to support than retail customers, with significant differences across business customer segments. Middle-market commercial and large corporate customers require much more attention than small business customers, particularly in cash management and lending. Servicing costs vary greatly by customer segment because some customers prefer low-cost transaction channels (e.g., online banking, automated teller machines) while others use higher-cost channels (e.g., branch, relationship manager). Because of differences in channel costs, banks must identify transactions by channel. TowerGroup recommends that, to maximize accuracy, banks track customer interactions not captured in traditional transaction counts. These "invisible" transactions include relationship manager visits, business banker telephone calls, and customer service e-mails.

Risk. Historically, banks based commercial loan interest rates on collateral. Commercial real estate loans, with the underlying property as collateral, had a lower interest rate than unsecured working capital lines. Now experiencing dramatic increases in charge-offs for commercial real estate loans, banks realize that they should have charged a higher premium for risk. A higher risk premium compensates the bank for increased charge-off and collection expense. Incorporating risk into pricing decisions requires sophisticated statistical analysis to assign risk ratings. Many banks use third-party credit risk rating and risk-based pricing systems to manage the risk models and predictive analytics necessary to support credit risk assessment.

Loyalty. The subjectiveness of loyalty makes it difficult to assess in profitability calculations. Banks look backward at the economic benefit derived from their relationship with current customers, but there is no guarantee that the economic benefit will continue in the future. For new customers, banks may estimate the "lifetime" value of the products they are pricing. However, with the high customer attrition rates in banking, it is tricky to predict beyond a two- to three-year horizon.

Profitability and Pricing Calculations. The goal of RBPP is to evaluate pricing scenarios for deposit, credit, and fee-based products and services that meet the bank's risk and profitability goals. The customer may prefer to increase checking account balances in exchange for reduced credit line fees. However, implementing dynamic pricing for product bundles that cross line-of-business (LOB) silos requires a nontraditional approach to product profitability. Banks judge product managers on the financial performance of the products they manage. Product managers are unwilling to sacrifice profitability and support a "loss leader" approach without changes to the incentive structure. Relationship pricing is an opportunity for banks to move away from focusing incentives on products toward focusing incentives on expanding customer relationships.

Best Practices in Commercial RBPP

Overcoming the challenges identified above is not easy, but best practices are emerging in data management, model development, customer management, and information management that address many of the implementation issues.

Building Customer Profiles

Because automated business householding tools are limited, relationship managers and business bankers need to create customer and account linkages manually within the RBPP system. RBPP applications house complex organizational hierarchies and relationship profiles.

Integrating Account and Transaction Data

It is critical to have real-time or near real-time account and transaction data to ensure profitability and pricing calculations reflect the latest information about the customer's banking relationship. Various RBPP systems handle account and transaction data in different ways. Some vendors use periodic (weekly or monthly) batch data loads to populate a central database, while others access data from accounting and servicing systems in real time. Because it is important to aggregate product data across lines of business, it may be necessary to use different data integration methods, depending on the source system.

Determining Product Costs

Banks that have implemented activity-based costing often tie product financials to the general ledger. This ensures that all costs have been accounted for, especially fixed costs such as overhead and depreciation. For banks that have not implemented ABC, many RBPP vendors provide benchmark product cost data as a starting point. Banks can then refine cost data as profitability analysis matures.

Examining Customer Costs

When customers request frequent relationship manager visits and make daily deposits at the branch, their high servicing costs stand out when analyzing profitability. However, business customers are not created equal. Banks must look at the relationship profitability profile for each customer. For customers that are profitable to the bank, relationship manager and branch interactions provide cross-sell and up-sell opportunities. Those that are unprofitable to the bank can be moved to lower-cost delivery channels.

Measuring Customer Loyalty

Although it is subjective, banks should project the "lifetime" value of the customer's banking relationship. The time horizon differs by customer segment based on attrition patterns. For example, the high failure rate of small businesses translates into a shorter lifetime for small business relationships than the time horizon for large corporate customers that have been in business for many years.

Calculating RBPP

Because banks look at profitability from different angles, RBPP must calculate multiple profitability measures such as risk-adjusted return on capital (RAROC), shareholder value added (SVA), economic value added (EVA), return on assets (ROA), and return on equity (ROE). The profitability engine looks at the economic contribution from each product in the customer's relationship.

Revenue from wholesale banking products and services varies by product type. For small business and commercial checking accounts, cash management fees include monthly maintenance and per-transaction charges. Banks provide an earnings credit based on a customer's deposit account balances that offsets or reduces these fees. The credit may be large enough to eliminate the monthly charges. For lines of credit and loans, the borrowing rate translates into interest income. Banks also earn fee income on the granting of credit to business customers. Banks charge fees for origination, annual commitment, and unused commitment. RBPP also applies a risk-based pricing component for lines of credit and loans. Loans secured by collateral generally carry a lower risk premium than do unsecured lines of credit.

For commercial customers with a broad array of products, banks can adjust pricing across products. RBPP tools provide banks with the ability to create "what if" pricing scenarios that solve for target profitability measures by creating various combinations of deposit balances, borrowing rates, loan collateral, and fees.

Besides assessing customer profitability, RBPP provides valuable information on internal profitability. RBPP measures profitability by product, line of business, industry, customer segment, and geographic region. Product profitability highlights opportunities to increase efficiencies or cut costs. Measuring profitability by salesperson (relationship manager, business banker, or cash management specialist) ensures a focus on revenue rather than volume.

As with all statistical models, banks should measure the accuracy of profitability projections against actual results and refine RBPP profitability and pricing models as needed.

Customer Management

To be truly customer-centric, banks should involve customers in pricing decisions. Relationship managers that make customers aware of pricing options (e.g., higher balances, decreased channel activity, increased collateral) have an opportunity to move customers from unprofitable to profitable status on their books. Customers appreciate being involved in decisions that affect the financial condition of their business, and relationship managers have an opportunity to cross-sell additional services. Banks must adjust sales incentives to reflect the move toward customer relationship profitability and retention.

In the final analysis, bankers must consider the "business at risk" when negotiating pricing. It may be worthwhile to discount new products in order to retain a customer's relationship. At the same time, a bank should not be reluctant to encourage a customer to move its bank accounts elsewhere if there are no short-term opportunities to make the relationship profitable.

Sharing Information

To maximize customer interactions, the same lines of business feeding relationship data to RBPP need access to profitability and pricing calculations. RBPP systems must export profitability data into both upstream and downstream applications. Upstream platforms such as origination platforms for deposit products, loans, and cash management need pricing calculations as relationship managers and cash management specialists negotiate new deals. Similarly, downstream accounting, servicing, and portfolio management applications use profitability to track relationship performance and support pricing of renewing business.

Banks have not yet integrated the RBPP application with origination and servicing systems. Information sharing is limited to placing profitability indicators on customer profile screens and providing customer-facing personnel with lists of their most profitable customers.

Commercial RBPP Providers

Flexible, comprehensive RBPP systems overcome many of the challenges of implementing RBPP. The providers of RBPP solutions to the banking industry have different historical perspectives and competencies. Exhibit 3 lists a representative sample, which are discussed below. Some of these providers have worked almost exclusively in financial services; others have taken a more horizontal approach, serving the needs of many industries.

TowerGroup

Representative Sample of Providers of Commercial Relationship-Based Pricing and Profitability (2008)

Product/ Company	Parent Company	Headquarters	Public vs. Private Ownership	2007 Fiscal Year Revenue (USD)	Background
Baker Hill OnePoint PRICE	Experian Group Limited	Dublin, Ireland	Publicly traded (LSE: EXPN)	$3.5 billion	Relationship management
Touché Analyzer Harland Financial Solutions	M & F Worldwide Corp.	New York, New York	Publicly traded (NYSE: MFW)	$1.7 billion	CIF/CRM
IBM Cognos Relationship Pricing for Commercial Banking Blueprint	International Business Machines Corporation	Armonk, New York	Publicly traded (NYSE: IBM)	$98.8 billion	Business intelligence
IPS-Sendero Relationship Profitability Manager (RPM)	Fiserv, Inc.	Brookfield, Wisconsin	Publicly traded (NASDAQ: FISV)	$1.1 billion	Financial management
SunGard Ambit Relationship Manager	SunGard Data Systems Inc.	Wayne, Pennsylvania	Privately held	$4.9 billion	Risk and performance measurement
SunTec TBMS-F (Transaction Business Management System for Finance)	SunTec Business Solutions Pvt. Ltd.	Trivandrum, India	Privately held	Not provided	Transaction pricing and billing

Exhibit #: 56:04W-E3
Source: Company Information, TowerGroup

Exhibit 3
Representative Sample of Providers of Commercial Relationship-Based Pricing and Profitability (2008)
Source: Company Information, TowerGroup

Baker Hill OnePoint PRICE

In 2005, Experian Group Limited acquired Baker Hill and its OnePoint commercial lending management system, which was first implemented in 1989 and which is targeted at US financial institutions up to $50 billion in assets. The system's RBPP module is called PRICE; its other modules are sales automation (SALES), credit risk management (STAN), and collateral and exception management (REACT).

Touche Analyzer/Harland Financial Solutions

M & F Worldwide Corp. acquired Harland Financial Solutions (as part of John H. Harland Company) in mid-2007. Harland created the Touche Analyzer product in the late 1980s and now has approximately 600 US clients. In addition to profitability calculation, Touche Analyzer features include segmentation, third-party data, prospects, and campaign management. Harland Financial Solutions markets Touche Analyzer primarily to US financial institutions with assets from $100 million to $5 billion but has customers with assets from $30 million to $50 billion.

IBM Cognos Relationship Pricing for Commercial Banking Blueprint

International Business Machines Corp. (IBM) acquired Cognos Corp. in January 2008. IBM Cognos announced its Relationship Pricing for Commercial Banking Blueprint solution in April 2008. The relationship-based profitability and pricing solution is built on top of IBM Cognos 8 Planning and Business Intelligence (BI) software, which provides dashboards, analytical reports, and a preconfigured data model. The target market for IBM Cognos Relationship Pricing for Commercial

Banking Blueprint is banks with $5 billion or more in assets.

IPS-Sendero Relationship Profitability Manager (RPM)

IPS-Sendero, based in Norcross, Georgia, is a business unit of Fiserv, Inc. RPM is the next generation product to the legacy Customer Profitability System (CPS), which is still in production. The first implementation of CPS was in 1995, and the first implementation of RPM in 2005. In addition to customer relationship profitability calculation, IPS-Sendero provides asset/liability management, budgeting and planning, enterprise risk management, and financial accounting solutions to financial institutions. Banks can use the basic FTP capabilities contained within RPM or integrate RPM with IPS-Sendero's more robust FTP solution. IPS-Sendero's target market is North American banks ranging from de novos to $10 billion in assets.

SunGard Ambit Relationship Manager

SunGard Data Systems Inc. announced its Ambit (formerly BancWare) Relationship Manager in December 2007. The Ambit product suite provides a broad array of commercial banking solutions, including back-office transaction processing, multichannel delivery, trade finance, treasury, card management and payments. Ambit Relationship Manager is a component of SunGard's financial institution risk and performance measurement solutions. SunGard's core target financial institution customers have assets in the $2–50 billion range, but SunGard also targets institutions with up to $300 billion in assets.

SunTec TBMS-F (Transaction Business Management System for Finance)

SunTec provides relationship-based pricing and centralized billing solutions for financial institutions, communications, media and entertainment companies, as well as utilities service providers. SunTec's first installation of TBMS-F was in 2002. SunTec targets banks and other financial institutions in North America, Latin America, Europe, Middle East, Africa, and the Asia-Pacific region.

Related Systems

A number of applications integrate and interrelate with commercial and small business RBPP systems.

Corporate Performance Management

Corporate performance management (CPM) systems provide enterprise-wide financial metrics and key performance indicators (KPIs) such as revenue, return on investment, and operating expense. CPM systems accelerate data gathering and analysis, enabling bank managers to monitor bank performance more closely.

Account Analysis

US financial institutions use account analysis systems to calculate cash management service fees based on deposit balances, earnings credits, services used, and negotiated pricing. Although some account analysis systems support profitability analysis, the focus is on calculating monthly service charges and enabling consolidated billing for cash management product and transaction bundles.

Centralized Billing

TowerGroup Research Note V53:09E, *Relationship-Based Dynamic Pricing: The European Ecosystem of 2017*, discusses the contribution of dynamic product bundling in relationship-based banking. Centralized billing systems enable product bundling by consolidating charges across a bank's customer, line-of-business, and geographic silos. Banks use centralized billing systems to implement the customized pricing scenarios calculated through RBPP.

Funds Transfer Pricing

FTP systems interface to financial accounting systems to capture net interest margin contribution from banks assets and liabilities. FTP software provides flexible transfer pricing methodologies and rate tables.

Activity-Based Costing

ABC systems interface to financial accounting systems to capture data on direct revenue and expense associated with a product. They also enable automatic assignment of indirect costs to derive fully allocated costing across products and customer segments. Accurate product costs based on ABC help banks identify money-losing products along with opportunities for product development and delivery improvements. Some RBPP vendors offer ABC in their base pricing engine or as a separate module.

Risk Rating

Risk rating systems assign ratings based on the estimated expected loss (EL) from a particular lending transaction. Risk rating systems aggregate the data necessary to calculate the components of expected loss: probability of default (PD), exposure at default (EAD), and loss given default (LGD). These are the same data elements that banks are required to calculate in order to determine capital requirements under the Basel II Internal Ratings Based (IRB) approach.

Summary

Without being able to calculate the profitability of business customer relationships, banks cannot be certain they are being adequately compensated for products and services. Banks face a number of challenges in gathering the information that forms the building blocks of relationship-based profitability and pricing (RBPP) — account and transaction data, product and customer costs, credit quality and risk profiles, loyalty assessments, and profitability and pricing calculations. As banks overcome these challenges, best practices are emerging in the areas of model development, customer management, and information management. Third-party RBPP systems are available that incorporate many of these best practices and provide banks with the tools to ensure relationship profitability while evaluating pricing scenarios. Banks implementing RBPP have the foundation to implement one-to-one marketing for their business customers to improve customer satisfaction, increase retention, and deepen product cross-sell.