Relationship Profitability: A Strategic Priority

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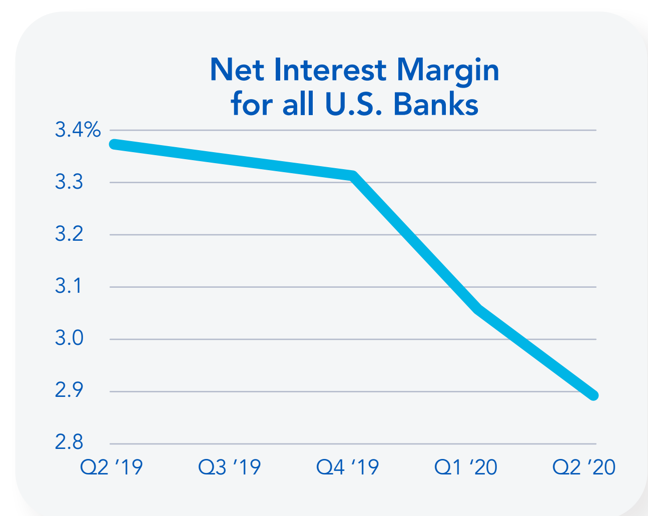
It is well understood by banks and credit unions that approximately 20% of their relationship base generates most of the profitability. However, our experience working with clients has indicated that many do not feel confident in their understanding of which relationships make up the most profitable or unprofitable segments, and it has often been perceived as a "back-burner" project for consideration.

However, if there has ever been a time to make this an urgent strategic initiative, now is that time for building a high-performing profitability culture that can thrive in these difficult times.

With the Federal Reserve sharply lowering interest rates and the concurrent challenge of lagging deposit rate reduction, Net Interest Margin (NIM) has plummeted since January 2020 with a 30-year low of 2.80% at the end of the third quarter. Most economists are predicting this low rate environment to persist through 2021 as the Fed's primary means to combat high unemployment and stimulate spending.

Preparing for Unknowns

There are many unknown outcomes over the next two years that will require agile data analytics to empower responsive and informed decision-making. Banks and credit unions that don't evolve and continue with the status quo of asset volume growth and an arbitrary pricing strategy will be blind to the financial impact and slow to react to the ever-changing pandemic and recessionary environment.



Source: Federal Reserve Bank of St. Louis

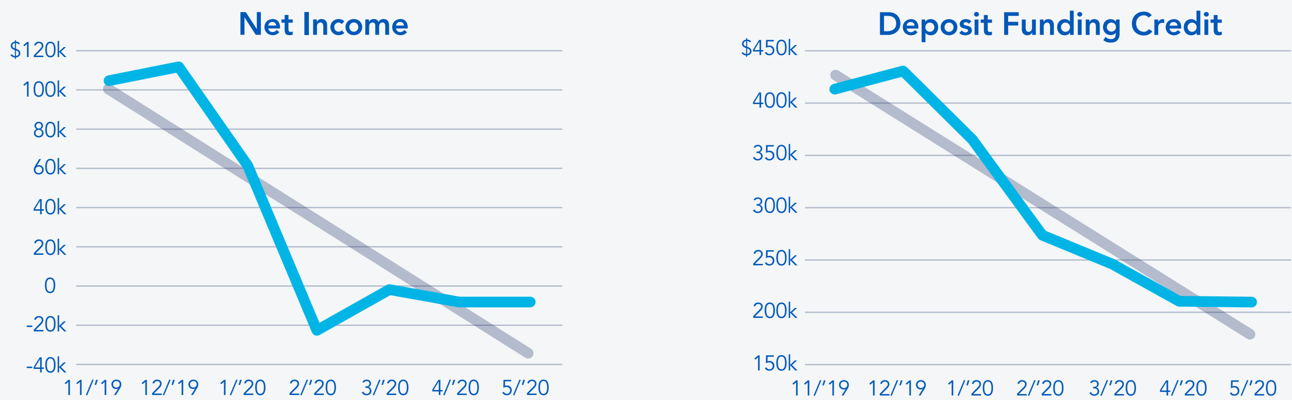
Post-COVID expense structures will change dramatically due to an accelerated digital transformation. There will be less need for in-person visits, travel, and more technical improvements needed to compete with the increasing competition with digital-only institutions. Are you able to measure this impact at the account level?

Long term low interest rates and higher competition for loans may induce a greater appetite for various risk attributes. Are you currently pricing commercial and consumer loans for the appropriate risk-adjusted cost? There is an adverse impact to credit quality looming with the unknown effects of the Paycheck Protection Program (PPP). It's also important to understand how the PPP loans are impacting the financials at the loan account level. That will help you understand:

- The initial fee amounts relative to the balance
- The future impact of loans not forgiven
- The potential impact to employee incentives – determining if PPP loans should be included
- The disclosure of net income (including expenses) based on total fees earned to justify the profit in lieu of some localities calling for the donation of revenue
- The strategic relationship value when evaluating future relationship pricing opportunities

Developing Proactive Strategies

The break-even cost on deposit accounts has increased significantly with lagging deposit rate reduction and low deposit funding credit (funds transfer pricing). For example, Jack Henry recently reviewed profitability trend data with a client and saw a sharp decline in relationship net income over time due to the negative effect of rates on their deposit base.



Source: Jack Henry Client

A decreasing rate environment devalues internal deposits and causes a drag on relationship profitability. High-performing banks and credit unions understand this impact and are proactive in developing strategies in advance to mitigate the higher cost of funds. They execute pricing strategies through good organizational communication and incentivize the right profit behaviors to reinforce it.

It is common for the lending team to regularly monitor a list of maturing loans, but is your ALCO committee monitoring a 90-day maturity list of high balance CDs? That will help determine an effective pricing strategy relative to the historical price sensitivity of the relationships. Are you matching competitor rates to retain high balance CDs and unknowingly maintaining unprofitable relationships? Depending on liquidity needs, it may be a worthy strategy for ALCO to use relationship profitability analytics to blend lower cost borrowed funds as a replacement for segments of high balance CDs owned by unprofitable customers or members who will find higher deposit rates elsewhere.

Getting a Comprehensive Relationship Picture

It is critical to understand the entire relationship story – the combined loan and deposit mix – in making informed decisions. Remaining siloed and stagnant in the status quo of uninformed decisions is not positioning for long term success. You need to know where you stand in answering these questions:

- Does our ALCO committee have the analytics to determine a pricing strategy for the lending team to execute based on a targeted portfolio mix?
- In a competitive loan deal, do we understand the full relationship value and long-term impact to the portfolio when considering a rate match?
- Do we know which relationships are driving the majority of our profit that we need to protect?
- Which relationships are significant "profit-drainers" that we need to lose less on?
- What contributions are lenders proactively making to improve portfolio profitability?

It is not uncommon to make relationship decisions that lose money – perhaps as a loss-leader or protection strategy. But high-performing banks and credit unions make data-driven decisions in this unstable environment. They are agile in their strategic relationship, marketing, and pricing objectives to achieve incremental gains in profitability and offset margin compression.

Looking for ways to drive profits and improve strategy? ***The Financial Performance Suite*** *from Jack Henry offers tools for pricing, profitability, forecasting, and CECL compliance.*

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