Value of Customer Profitability

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Decile	Contribution %	Cumulative %
10%	35%	35%
20%	27%	62%
30%	24%	86%
40%	18%	104%
50%	11%	115%
60%	7%	122%
70%	2%	124%
80%	-4%	120%
90%	-8%	112%
100%	-12%	100%

Many organizations are unaware that the secret to improving profitability is to measure and manage **customer** profitability. Through the implementation of a customer profitability analysis system managers are able to see which customers contribute to profits, which customers are neutral, and which customers eat into profits.

Customer profitability analysis provides insights into the profitability of individual accounts, individual customers, customer relationships, and segments of customers. Using these insights management can devise strategies that add value to the most profitable customers, make less profitable customers more profitable, and stop or reduce the erosion of profit from unprofitable customers.

Studies have shown when organizations rank their customers based on profit contribution and split them into 10 equal subsections (deciles), the top 20% of customers generate anywhere between 50-80% of the organization's profits, with the next 60% only generating 40-60% of the profits. **On average the bottom 20% of customers reduces or destroys 10-40% of the profit.** Identifying and understanding these segments provides the **knowledge** to significantly increase revenue and net income at the customer level.

How Customer Profitability is Calculated

The foundation of customer profitability analysis starts with acquiring income and expense data for the individual customer accounts (instruments) from multiple sources. Income and expense measures along with statistical measures used for cost allocations are sourced from an organization's core banking systems.

Once the customer and instrument data has been translated and loaded to **profitlens**, a Funds Transfer Pricing module looks up rates based on the type of product and calculates the Cost of Fund or Credit for Funds at the instrument level.

After the FTP Charge or FTP Credit has been applied to the instruments, our Allocation Engine performs cost and capital allocations.

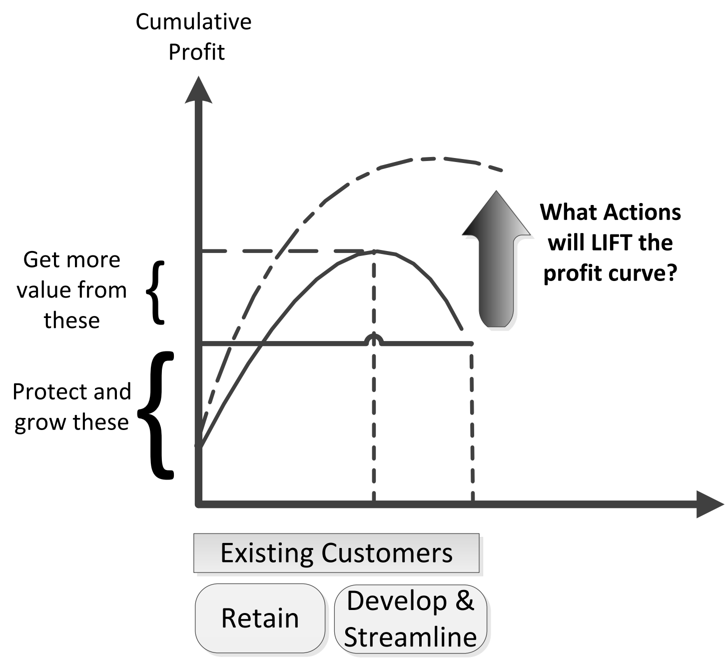
The Allocation Engine supports two main types of allocations. The first is a Unit Cost type to support Activity Based Costing and the second is a Prorated Type to allocate expense pools for defined proportion and specified.

When income and costs are applied at the instrument level it creates a consistent and integrated way to measure profitability across customers, officers, products and organizations. Management can use this data to understand the actual performance of each dimension.

Identify Opportunities

Customer profitability information provides customer-level insights into opportunities to increase the bottom line. Who are the most profitable customers to focus retention efforts? Who are the unprofitable customers, and what can be done to make them profitable? What are the similarities between the most profitable and least profitable customers? What are the differences?

Customer profitability information presents common characteristics or behaviors to understand what makes customers profitable. Management can use this information to continue to optimize their sales process, protect their best customers and develop actionable plans to deal with unprofitable customers.



Retention and Attraction Strategies

Management can use customer profitability information to implement tactical plans to promote retention of profitable customers. Some examples of these plans include:

- Provide personal attention from salespeople, relationship managers, or senior bank leadership
- Make price or service concessions to ensure the company remains competitive for these customers
- Determine what profitable customers like about the company and promote those features to attract new customers with similar profiles
- Develop a partnership with profitable customers by assigning them a high priority in serving or pricing

Management can also leverage customer profitability information to implement plans for bringing less profitable customer up in profitability. Some examples of these plans include:

- Add a surcharge for product or service features
- Provide fewer free services for this customer segment
- Increase prices
- Improve cost management and efficiencies
- Reward customer behavior changes

"Who are the most profitable customers to focus retention efforts?"

Benefits of Customer Profitability Systems

Customer Profitability System implementation and profitability reporting should not be seen as a one-off system. Information should flow on a regular basis, triggering a process of customer profitability assessment, feedback, analysis, decisions, and implementation. Profitability Analysis systems process vast amounts of data from multiple sources, which appears to be a huge undertaking. **profitlens** has a simplified implementation model that quickly delivers valuable actionable information at your fingertips.

The process enables management to tap the potential for increasing profitability by devising different customer targeting strategies, implementing differentiated services or service levels to customers, and making operating, marketing, or pricing adjustments in its attempt to make all customers profitable and manage overall customer profitability.

The potential benefits result from identifying customer or customer-segment profitability and then developing appropriate differential strategies for different customers. Held opinions and preferences in an organization may be crushed in light of facts and analysis. Armed with new information about customer profits, managers can focus on appropriate actions related to profitable customer retention and acquisition, making unprofitable customers profitable and reducing or eliminating profit erosion resulting from customers who destroy shareholder value.

** Source: "Customer Profitability Management", Institute of Management Accountants 2010*