Banking Industry Myths, Part 5 (altavia.com, 2016)

In the first four parts of this series we showed that two popular banker's Rules of Thumb are myths that will misinform and mislead management's decision making. We tested these Rules of Thumb using data from the sophisticated customer profitability management system this author installed at one mid-sized Credit Union, which used advanced ABC costing techniques and monthly transactions by customer.

Parts One and Two of the series shattered the banker's Rule of Thumb that cross-selling more financial products (accounts) to an existing customer will increase that customer's profitability. We concluded that the number of financial products (accounts) a customer owns is not a reliable indicator of a customer's potential profitability.

Parts Three and Four shot down the banker's Rule of Thumb that the more loan balances a customer has the more profitable is that customer. This proved to be false for the bulk of the credit union's customers, where factors other than loan balances can dramatically impact a customer's profitability.

We conclude from these analyses that the profitability of each customer is driven by that customer's behavior, and how he or she uses the financial accounts they have purchased from the institution. There is no universal metric or demographic measure or profitable product that applies across a bank's entire customer base. Customers are people and they act differently, not the same, and a customer's individual behavior has a huge impact on that customer's profitability.

Profitability at the product level may indicate an institution's non-interest bearing checking product is profitable, but a customer who visits a branch several times during the month to cash checks can easily move that product's profitability for that customer into negative territory. As can a customer who calls customer service every day to check his or her balances. A product can be profitable in one customer's hands, and unprofitable in another's. In this regard, the profitability of a product is actually the *average* profitability of that product across all customers who utilize the product. Thus, to understand product profitability one must first understand customer profitability.

So the key to increasing bank profitability, or return on invested funds, is not in using the banker's Rules of Thumb, but in cross-selling additional accounts to *profitable* customers, and in designing new products for unprofitable customers to steer them toward break-even or better. The ability of the credit union to see this insight, and implement the resulting strategy, rested on understanding each customer's profitability. An understanding made possible by their customer profitability management system based on an advanced costing approach.