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Commercial and Small Business Banking in Troubled Times: Using Relationship-Based Pricing for Growth

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TowerGroup Take-Aways

- Banks are turning to relationship-based profitability and pricing solutions that combine deposit, credit, and fee-based products to evaluate pricing scenarios for new wholesale banking deals.
- Relationship-based pricing enables banks to shift from a product-based approach to a customer -centric strategy, rewarding business customers for total relationship value and loyalty.
- Traditional wholesale banking market-based pricing fails to incorporate the overall value (or cost) of a customer's relationship across the banking enterprise.
- In order to balance profitability and risk when pricing commercial loans, banks need to assess customers' total relationship value along with their credit worthiness.
- Banks must improve product costing to ensure that pricing of wholesale banking products and services meets their profitability targets.

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Report Coverage

Banks must thoroughly scrutinize relationship-based pricing for their business customers, especially in challenging economic times. Wholesale bankers are operating in an era of declining profitability, increasing regulatory burdens, and unrelenting competitive pressures. Relationship-based pricing enables banks to shift from a product-based approach to a customer-centric strategy, rewarding business customers for total relationship value and loyalty. Banks are turning to relationship-based pricing solutions that combine deposit, credit, and fee-based products to evaluate new business pricing scenarios that meet their risk and profitability goals. Financial institutions must accurately price new business to maximize profitability while retaining valuable customers.

This TowerGroup Research Note discusses the business issues driving improvements in commercial relationship-based profitability and pricing along with historical pricing approaches, profitability components, and pricing attributes. A forthcoming TowerGroup Research Note will examine implementation challenges, emerging best practices, and third-party solutions for commercial and small business customer relationship-based profitability and pricing (RBPP).

Background

Not too many years ago, when banks wanted to assess a commercial customer's profitability, they brought in specialized external consultants or third-party providers. Banks created data extracts from legacy systems, and the consultants crunched the numbers. A few months later, the consultants handed the bank a marketing database with customer profitability profiles. Usually, the results followed the classic 80/20 rule: 20% of the customers contributed 80% of the profit.

Profiles of commercial customers' profitability were critical in helping banks create segmentation and product strategies. Unfortunately, the profitability analysis represented a point in time and the

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stale, static data did not reflect the dynamic nature of banking relationships. As discussed in this Research Note, innovative banks and third-party providers evolved profitability and pricing methods into sophisticated solutions that calculate relationship profitability and determine pricing across product silos.

It would be sensible to wonder why banks are focusing on improving commercial relationship profitability and pricing during the global economic downturn following the 2007 US subprime mortgage collapse. Surprisingly, commercial and small business cash management revenue and loan volume continue to grow in 2008. Participants in Ernst & Young's 2007 Cash Management Services Survey forecast a 6.5% US cash management revenue increase for 2007 that TowerGroup expects to continue into 2008. On the lending side, Euro Zone commercial loan outstandings grew 3.7% in the first quarter of 2008, setting the stage for the same double-digit growth in 2008 as occurred in 2006 and 2007. In the United States, growth in commercial loan outstandings is slowing but still increased 1.7% in the first quarter of 2008. Growth occurred across all loan types, including the hard-hit commercial construction and commercial real estate sectors.

Although volumes continue to grow, margins are declining. Net interest margin for US banks declined in the first quarter of 2008, continuing a five-year declining trend. Net interest margin is the interest earned on loans (assets) less the interest expense on deposits (liabilities). As intense competition for deposits and loans continues, banks find themselves unable to decrease interest rates on deposits or increase loan spreads. Exhibit 1 shows average loan spreads for three categories of commercial loans.

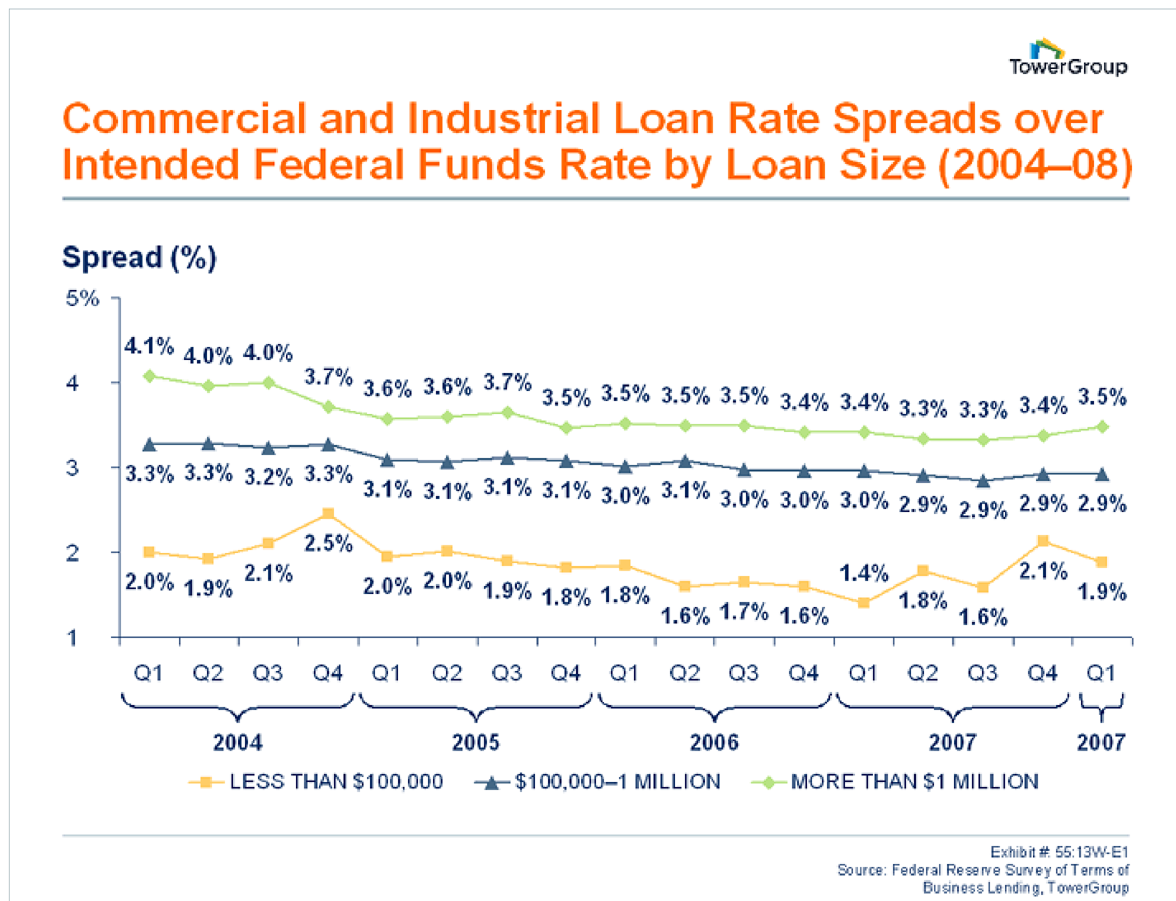

Exhibit 1
Commercial and Industrial Loan Rate Spreads over Intended Federal Funds Rate by Loan Size (2004-08)
Source: Federal Reserve Survey, TowerGroup

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Commercial and industrial (C&I) loans of less than $100,000 (USD) are micro business loans, usually targeted at sole proprietors. C&I loans of $100,000 to $1 million are classified by the US Small Business Administration (SBA) as small business loans. C&I loans greater than $1 million range from middle-market commercial to large corporate loans. From 2005 through early 2008, rate spreads on micro and small business loans remained constant. Rate spreads on larger loans are trending upward, but competition for C&I loans in early 2008 put downward pressure on lending rates.

With ongoing revenue, profitability, and margin pressures, it is critical that banks set prices for new and renewing business that provide the bank sufficient profit while sustaining the customer relationship.

Relationship-based profitability and relationship-based pricing are closely intertwined. 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 is using a customer's relationship profitability to calculate the price of a specific bank product or service. Without relationship-based profitability, there is no assurance that pricing adequately compensates the bank for the products and services provided while providing customers with a price that rewards them for their relationship with the bank.

Importance of Commercial Relationship-Based Profitability and Pricing

TowerGroup Research Note V53:53W, *2008 Top 10 Business Drivers, Strategic Responses, and IT Initiatives in Wholesale Banking*, provides insight into the major business trends driving the wholesale banking industry, the strategic responses TowerGroup expects to see from those firms, and the resultant technology initiatives. As shown in Exhibit 2, commercial RBPP influences several business drivers, strategic responses, and technology initiatives. The following sections explain the impact of commercial relationship-based profitability and pricing on the top 5 business drivers.

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Impact of RBPP on Wholesale Banking Business Drivers, Strategic Responses, and IT Initiatives (2008)

Business Drivers				
1. Risk mitigation	2. Regulation	3. Revenue growth	4. Market instability	5. Declining profitability
6. Client sophistication and globalization	7. Increased competition	8. Inefficient processes	9. Concentration of market share	10. Payments convergence
Strategic Responses				
Minimize fraud and security risk	Tailor solutions based on customer segment	Improve customer and portfolio analytics	Improve operational efficiency	Break down the silos
Focus on commercial deposit growth	Offer private-label and insourcing capabilities	Enhance internal and external supplier partnerships	Improve ability to respond quickly to market changes	Leverage industry utilities to share risk
Technology Initiatives				
Improve authentication technologies	Improve relationship management tools	Rationalize systems	Unify corporate banking portals	Enhance data management and analytics
Create workflow tools for straight-through processing	Implement more flexible architectures	Enhance client integration	Automate enrollment and onboarding	Provide client self-service & exceptions management

Note: RBPP = relationship-based profitability and pricing.

Exhibit # 55:13W-E2
Source: TowerGroup

Exhibit 2
Impact of RBPP on Wholesale Banking Business Drivers, Strategic Responses, and IT Initiatives (2008)
Source: TowerGroup

Risk Mitigation
In light of the 2007 subprime mortgage crisis, risk mitigation is a key business driver for wholesale banking. By aggregating data across the enterprise, RBPP enhances customer and portfolio analytics while improving data management.

Regulation
RBPP contributes to improved credit quality and performance data to feed the internal risk rating models required for Basel II compliance.

Revenue Growth
Fee-based cash management services contribute to consistent revenue growth even in tough economic times. RBPP enables customer-centric, tailored product bundles, and pricing that contribute to increased customer retention. RBPP identifies profitable cross-sell and up-sell opportunities across product silos at price points that benefit both the customer and the bank.

Market Instability
The credit crunch challenges that financial institutions face following the 2007 subprime mortgage defaults highlighted potential weaknesses in wholesale banking strategies. A key weakness was in the area of credit profitability and pricing. From 2002 to 2007, many banks extended credit with bargain interest rates because of fierce competition from banks and nonbanks. Loan pricing did not reflect the repayment and collateral risk banks took, contributing to declining profitability in 2008.

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Declining Profitability

Because of the credit crunch, banks faced dramatic declines in bank profitability that were in stark contrast to record earnings in 2006. Strategic responses include growing commercial deposits and improving customer segmentation. As banks add deposits, they must price them appropriately to ensure that profitability meets their targets. A key component of profitability is differentiated sales and service segmentation. Expensive commercial relationship managers (RMs) and cash management specialists need to focus on businesses with higher profit potential. RBPP identifies high-potential customer segments, industry classifications, and bank products.

Traditional Profitability and Pricing Approaches

TowerGroup Research Note V48:13C, *Profit-Based Pricing: Time to Stop Leaving Money on the Table*, discusses various pricing methodologies used to price bank products and services. These methodologies have matured and become more sophisticated over time.

- **One-price pricing.** One size fits all. All customers pay the same price for a product or service, regardless of differences in risk or profitability.
- **Cost-plus pricing.** The bank aggregates the costs associated with the product (marketing, operations, overhead, risk, etc.) with an added mark-up for profit.
- **Market-based pricing.** The bank establishes pricing for a product or service based on what the market will bear. It surveys competitors to understand the established pricing of a product or service in the market.
- **Index-based pricing.** The bank pegs the pricing of a product or service to a moving index such as US Prime Rate, London Interbank Offered Rate (LIBOR), US Treasury Bills, or Eurodollar deposits.
- **Risk-based pricing.** In a variation on cost-plus pricing, the bank adds a risk assessment to the costs of a product or service based on the customer's credit worthiness. Banks use this type of pricing for lending products.
- **Profit-based pricing.** This is one of the newest approaches. Banks use a profit-maximizing combination of costs, risk, and customer price so that each segment receives the appropriate price offer to optimize profit and revenue for the portfolio.

Wholesale bankers use a combination of these methods to price products across product silos. For treasury and cash management services, corporations issue requests for proposals (RFPs) to financial institutions. Corporations select banking providers based on factors such as product characteristics, service capabilities, quality assurance, institutional capability, and pricing. This competitive RFP process results in market-based pricing for treasury and cash management products.

For credit products, financial institutions use a variety of methods to set lending rates. Over the past few years, intense competition from banks and nonbanks resulted in market-based pricing for many commercial lending deals. Flush with cash, firms such as pension funds, insurance companies, venture capitalists, and private equity firms provided financing at bargain lending rates. To maintain target asset levels and retain key commercial customers, banks felt pressured to offer credit at competitive rates. Banks retaining their focus on credit risk management use risk-based pricing, one of the more sophisticated pricing methods. Risk-based pricing assigns higher capital costs to riskier loans while applying funding costs from a funds transfer pricing (FTP) system.

In market-based pricing, the focus is on winning new business, not on ensuring that the new business is profitable or, at a minimum, break-even. Another problem arises when RMs undermine profitability by granting overrides and waivers. For example, the initial terms of a commercial line of credit may include a quarterly unused commitment fee or annual commitment fee. If the customer balks at paying the fee, an RM will grant a fee waiver in order to retain the business.

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Incentives are important for driving new business. When they target quantity over quality, however, banks "get what they pay for." Given volume as an incentive, RMs grant loans and sell cash management services with minimal attention to profitability and long-term credit worthiness. As banks implement relationship-based profitability and pricing, they also must adjust incentive programs to drive rewards so that new business deals meet the banks' goals for risk and profitability.

Relationship-Based Profitability and Pricing Components

Banks can take a building-block approach to developing a comprehensive RBPP methodology. This process enables a bank to evolve profitability and pricing as it gains experience and improves data quality. As shown in Exhibit 3, RBPP components include customer relationship profiles, product and customer costing, credit quality and risk rating, loyalty assessment, and pricing calculations.

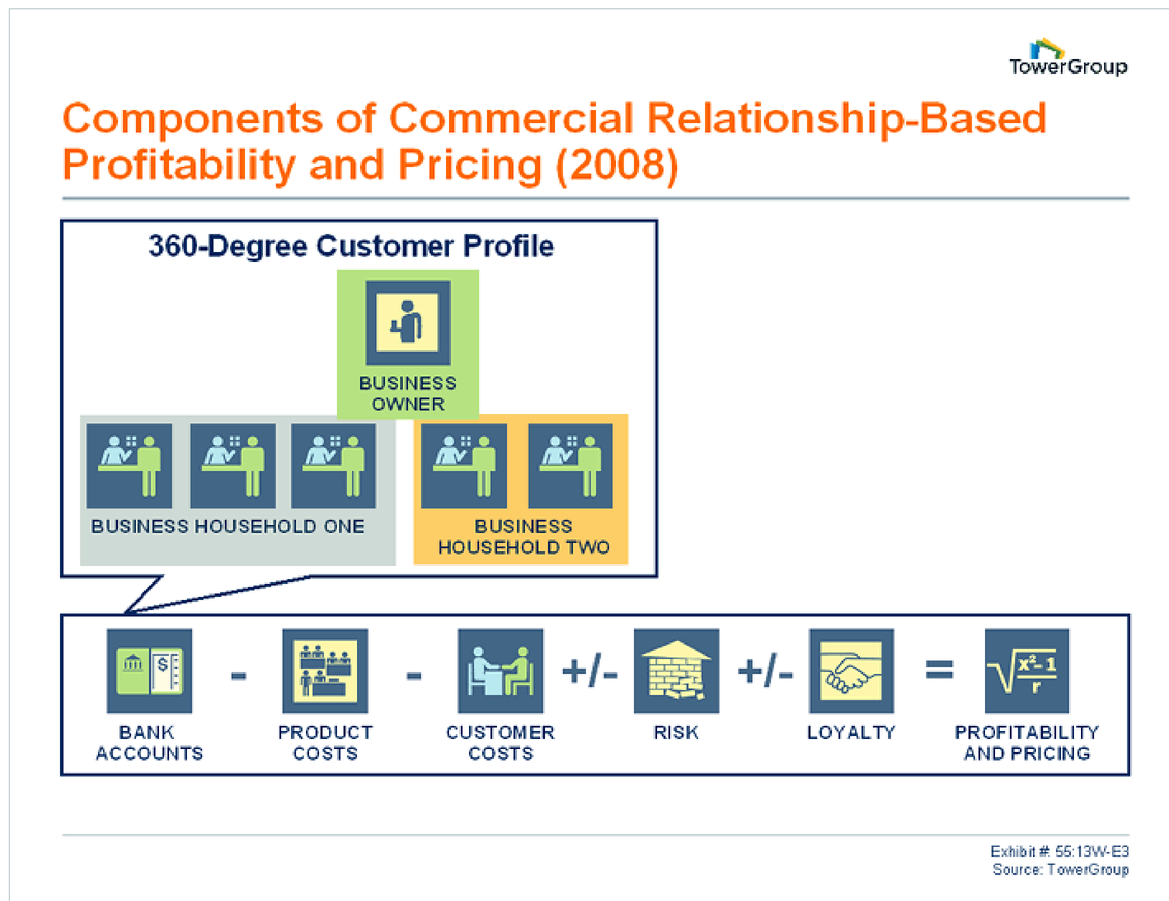

Exhibit 3
Components of Commercial Relationship-Based Profitability and Pricing (2008)
Source: TowerGroup

360-Degree Customer Profile

As discussed in TowerGroup Research Note V53:23W, *360-Degree Small Business Customer Profiles: Around the World of Entrepreneurs*, creating a profile of a small business or commercial customer composed of related businesses and individuals (such as owners and guarantors) yields a comprehensive 360-degree view of that customer. Bankers that look at the profitability of a single small business or commercial entity without considering the total banking relationship risk

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underestimating the economic value of the business to the financial institution.

Bank Accounts

Core operational customer information files (CIFs), deposit servicing, and loan accounting systems provide information on existing products, services, and accounts along with associated transaction data. Beyond core deposit and loan accounts, banks must gather data for investment, insurance, credit card, and other ancillary products. This component includes transaction fees and earnings credit for commercial deposit balances.

Product Costs

Many banks use activity-based costing (ABC) to determine the cost of providing products and services. ABC tracks all activities involved in delivering a service and allocates fixed and variable costs based on those activities. Variable activities include origination and servicing, while fixed costs include administrative overhead. For credit products, product costs must include the cost of funds, meaning the interest expense associated with financing lending activities. A side benefit of calculating product costs is identifying operational inefficiencies in product development and delivery.

Customer Costs

Once the costs associated with delivering products through various bank channels are determined, banks turn their attention to costs associated with specific customers. Customers unwittingly affect profitability when they choose to interact with the bank through a high-cost channel. Small business customers who repeatedly call their relationship manager to request loan advances are much less profitable than customers who perform the same activity through small business online banking. It is important for banks to be able to track customer interactions by channel because transaction costs vary greatly by delivery channel.

Risk and Credit Quality

The risk component encompasses the concept of risk-based pricing for loans. Banks measure credit worthiness using data from financial statements, credit bureaus, and ratings agencies. At this stage of calculations, the bank estimates Basel II credit risk measures such as profitability of default and loss given default. For profitability calculations, banks incorporate additional measures such as loan structure, construction cash flows, prepayment projections, and projected changes in collateral value.

Loyalty

Loyalty is the most subjective component of RBPP. The goal is to calculate the economic benefit of long-term customer relationships. Benefits arise from cross-selling, retention, and referrals. For new customers, banks may estimate future customer "lifetime" value, limiting lifetime to a two- to three-year horizon based on bank attrition experience. Profitability models must incorporate the expense of customer loyalty and rewards programs in either product cost or loyalty calculations.

Profitability and Pricing Calculations

Using the components outlined in Exhibit 3, banks calculate various profitability measures. Measures include risk-adjusted return on capital (RAROC), shareholder value added (SVA), economic value added (EVA), return on assets (ROA), and return on equity (ROE). At this stage, statistical models generate multiple pricing scenarios, varying inputs such as pledged collateral, deposit balances, or cash management service usage. Banks evaluate the profitability and pricing of each deal against profitability targets and hurdle rates, at the level of either the bank or the product. As relationship managers negotiate deal pricing between senior bank executives and customers, RMs must document and track exceptions.

Summary

Commercial and small business relationship-based profitability and pricing enables banks to shift from product-based pricing to customer-centric pricing and still meet their risk and profitability

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goals. Customer-centric pricing rewards business customers on their total banking relationship and lifetime value to the financial institution. Relationship-based pricing ensures consistent application of a bank's pricing methodology and tracks exceptions to policy. Incorporating risk-based pricing ensures that pricing adequately compensates the bank for credit worthiness and facilitates Basel II holistic measures of risk.

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