INTEGRATED PROFITABILITY ANALYTICS – THE NEED, STRUGGLES, AND FUTURE

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Introduction

The financial services industry enjoyed relatively high margins for a very long time. But globalization, a digital economy, and ever-increasing regulatory compliance requirements (especially on capital adequacy) have led to significant decrease in margins. In addition, rapid innovation in banking and technology has rendered it extremely difficult to increase the customer base and retain existing ones. Against this backdrop, to sustain, grow, and compete with new fintech (finance technology) startups, financial services enterprises need to continuously evolve and provide more value to their customers at a much lower cost.

Most recent surveys and research reports estimate that the top 20–30% of customers generate 70–80% of the revenue. This makes it important to identify the key customers as well as the products and channels to develop further, to enhance the growth potential. Understanding profitability based on the product, channel, geography, and even at the individual account and customer level is crucial to support decision-making and set objective business goals. This level of profitability analytics comes not just from direct revenue and expense analysis, rather, it needs a holistic view of the direct and indirect cost, the revenue allocation, and an analytics model that can drill down to the customer and account level. The right analytics framework with a multidimensional and holistic profitability view can give an edge to the enterprise in making informed decisions.

Key business developments impacting profitability

- **Higher regulatory capital requirement:** The increasing capital requirement decreases profitability. It means that banks have to earn more from less capital available to them. This increases the focus on profitability management and efficient cost management.

- **Intense competition and value-added services leading to the vulnerable customer:** Heavy competition due to new banking startups that are more agile and serve the customer's specific needs is putting every business in jeopardy, affecting a long-drawn loyal customer base. Customers are always ready to explore and change their finance partners even for small benefits, given the ease of switching and attractiveness of terms from the competitor.

- **Onset of newer payments and banking platforms:** Newer technology platforms and channels with more digital presence offer much easier and economic alternatives to the customer. These additional channels become the drivers of cost and profit pools.

- **Higher cost of funding:** Typically, banks borrow short-term and lend long-term and this is an inherent risk in banking. Due to the flattening yield curve, the long-term rates do not fluctuate in parallel to the short-term rates, offering a thin margin and significant reduction in net interest income.

Key focus of financial services enterprises

The famous management consultant Peter Drucker once said, "If you can't measure it, you can't manage it." The key business developments discussed earlier will not mean much unless we are able to measure and take informed decisions on the parameters that can be changed to achieve the desired results. No matter the quality or quantity of data available, unless it is put in perspective with the right level of analytics, results cannot be obtained. For instance, if an enterprise doesn't know the breakup of interest income / expense, indirect cost, and capital cost of a customer / account, how can they answer questions such as what additional services they can provide, which cost factor can be reduced, or can they provide differential pricing for a customer? Therefore, the focus should be on measuring and then managing.

Due to the key business developments and challenges, the focus on enterprise-wide profitability measurement has increased. Along with this, the direct-indirect cost allocation plays a key role in arriving at the profitability. Based on the allocations model, the profitability will change. The focus is more on managing information rather than accounting information – information which can be used to support business decisions based on the granular customer-level analytics. Mentioned alongside are the key focus areas for a financial services enterprise to grow and sustain in today's environment:

- Enterprise-wide and multidimensional view of profitability based on product, channel, customers, etc.
- Effective cost allocation models at the customer level based on business drivers
- The profit margins earned at the customer level
- An understanding of where the revenue is coming from and where the cost is going
- Timely availability of analytics for multiple dimensions, including customer-level profitability to act before it's too late

Components of profitability – What to measure?

A profitability management system should be able to answer one key question: how much profit is the bank earning from a particular arrangement? To arrive at the profit number at the arrangement level is not an easy task. It involves having a clear view of all the revenue and expenses at the account level. It is easy to arrive at more direct income and cost such as interest income, fees, etc., which is at the account level. The real challenge is to arrive at indirect cost, capital cost, taxes, etc. Profitability can also be used to do a comparative analysis of two different products. We should be able to derive profitability at multiple levels such as the net interest income (NII), profit after unit-level overhead allocation, profit after organization-level overhead allocation, and net income.

Below is an example with a high-level view and breakup of the revenue and cost components for an asset product that can be looked at:

Description	Amount	Amount	Amount	Amount	Amount	Total
Interest income	1000	1500	800	500	2000	5800
Interest expense (FTP charge) 8%	-800	-1200	-640	-400	-1600	-4640
1. NII	200	300	160	100	400	1160
Add: Fees (Non-interest income)	50	25	40	0	100	215
Less: Unit level overheads	-25	-37.5	-20	-12.5	-50	-145
2. Profit after allocation of unit expenses	225	287.5	180	87.5	450	1230
Less : Marketing, adv. overheads	-25	-37.5	-50	-12.5	-50	-175
3. Profit after allocation of organizational expenses	200	250	130	75	400	1055
Less: Taxes	-50	-75	-40	-25	-100	-290
4. Net income	150	175	90	50	300	765
Geography	US	Asia	Europe	Asia	US	
Product	Mortgage	Corp. Lending	Corp. Lending	Mortgage	Corp. Lending	
Arrangement	Customer 1	Customer 2	Customer 3	Customer 4	Customer 5	

Having a clear view of all the revenue and cost components at an arrangement opens a plethora of opportunities.
This will support a relationship-based pricing and we will be able to answer key questions related to profitability, such as:

What is my profit from a particular arrangement?
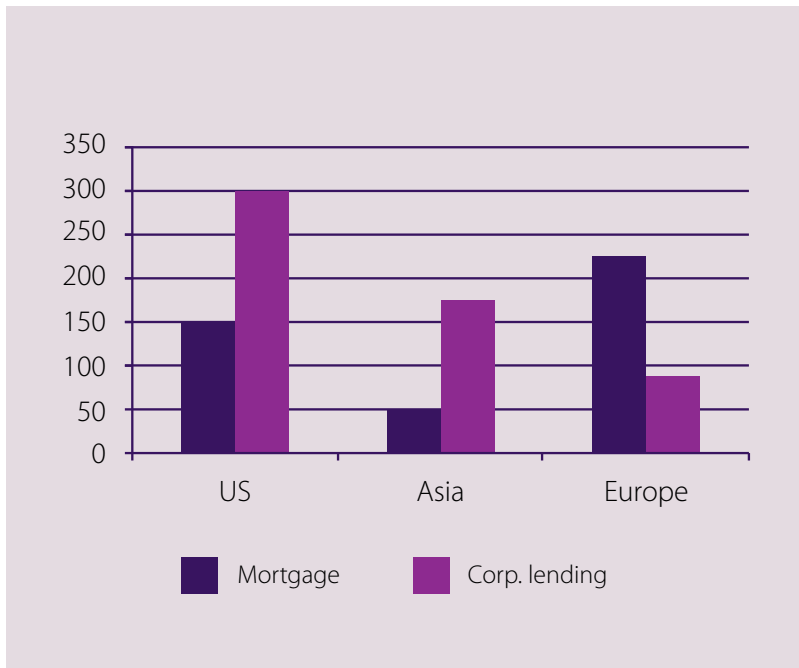
What drives the profitability?

Which parameters can be changed to increase profitability?

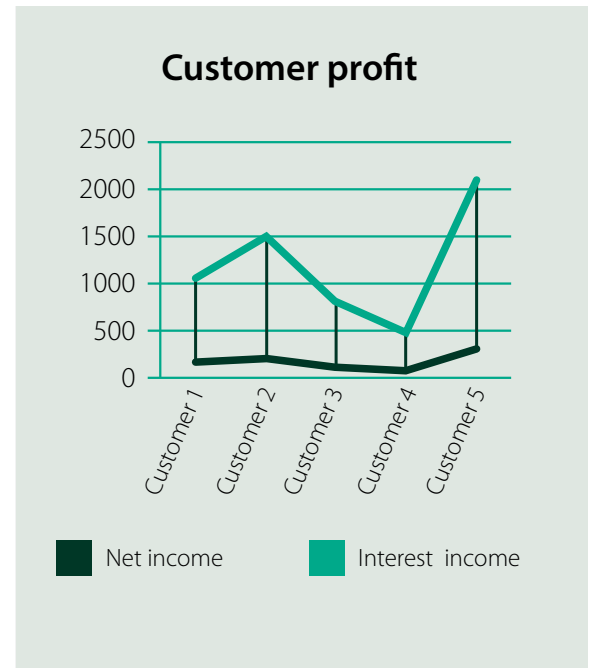How do product and geography relate with each other?

Which are my highly profitable customers?

1. Geography-wise income and expense

2. Product and geography view of the net income

3. Customer-level profitability view

Challenges on the road to achieving integrated profitability analytics

As financial institutions face multiple challenges and threats, it is imperative to adopt the right solution which can produce the required information accurately and in a timely manner to support decision-making. The solution should be able to provide a holistic view of profitability across the enterprise at an account and customer level. Typically, financial institutions face the following challenges in achieving a 360-degree and granular view of profitability:

• Multiple systems operating in silos, due to which information is scattered and reports lack transparency

• Custom and in-house solutions for customer-level profitability become complex to maintain, and in the end, defies the purpose of accuracy of data. In addition, most of the standard solutions do not provide customer-level granularity.

• Due to a complex landscape, data integration and analytics consume

so much time that by the time the information is received, it is too late to act

• Static allocation model becomes inefficient and incurs high operating expense due to regular changes in cost drivers

• Solution cannot take inputs from other modules such as fund transfer pricing, capital calculation, customer analytics, etc.

Desired features of a solution to support profitability analytics

As financial institutions face multiple challenges and threats, it is imperative to adopt the right solution which can produce the required information accurately and on time to support decision-making. The solution should be able to provide a holistic view of profitability across the enterprise at an account and customer level. Typically, financial institutions face challenges in assigning indirect activity costs to products and customers, unlike the interest expense component, which can directly be linked to the product. This requires the solution to have a robust

and dynamic allocation framework adaptable as per business needs.

Key features a solution must have to support profitability analytics:

• **A multidimensional view** of all the income and expenses

• **Rich allocation framework** which can allocate cost dynamically at any level based on multiple cost allocation approaches

• **Ease-of-rule creation** with no rule modification due to hierarchy changes

• **Timely availability** of required information based on which crucial decisions and actions can be taken, giving an edge to the enterprise in terms of go-to-market

• **Accuracy** of profitability analysis reporting

• **Capability to process huge volumes of data** across the legal entity, geography, product groups, business segments, and customer segments makes the result far more accurate and provides actionable insight

Oracle financial services profitability management

Oracle financial services profitability management (OFSAA) enables financial institutions to have an enterprise-wide view of profitability across multiple dimensions such as product, channel, and even individual customers. Oracle financial services profitability management leverages a single, transparent data model and platform with the ability to share components across various applications. It comes with an open allocation engine allowing you to mix-and-match your preferred methodologies from simple to more complex

Key features of OFSAA profitability analytics:

- **Integrated and granular data model** framework which can capture account, transaction, and driver data from multiple sources at the most granular level. Data model is also common for all the application suites.

- **Flexible and easy to maintain allocation model** which can dynamically allocate cost at the customer level based on the driver. It can be used to build any costing methodology based on customer features. It can also aggregate cost or revenue based on multiple dimensions. Hierarchy management and filters make rule creation and modification simple and easy.

- **Highly reliable** and single source of cost and profitability information at the most granular level which gives confidence to business for critical decision-making

- **Intuitive dashboard** which can present a 360-degree view of profitability based on multiple measures and time dimensions

OFSAA profitability management can also be integrated with budgeting and planning to incorporate the planned forecasts for actuals and variance analysis and to have a more proactive way of 'Actuals' driving the subsequent forecasts.

OFSAA profitability management can be integrated with OFSAA analytics solutions such as enterprise, retail, and institutional performance analytics to gain an in-depth view and ready-to-use dashboards across the enterprise at different levels such as customer account and ledger.

Profitability management is built on Oracle Financial Services Analytical Application infrastructure (OFSAA infrastructure). OFSAA is an integrated solution which provides the best-in-industry solution for risk, performance, compliance, and customer insight. Other solutions from OFSAA such as fund transfer pricing, loan loss forecasting and provisioning, Basel, etc., can be leveraged for profitability to get the entire cost component in an integrated manner.

Business benefits of the solution

- **Gain a multidimensional view of profitability**

- **Actively incorporate risk into the decision-making process**

- **Prioritize customers based on profits generated**

- **Achieve a consistent view of performance across the enterprise**

- **Get timely profitability insights for go-to-market strategy**

Conclusion

It is quite evident that times have changed. The industry has become more competitive, margins squeezed, and customers, more ready to look at other available options. 'Customer growth and retention' strategy has taken a whole new turn with services customized to the customer need and relationship-based pricing. This brings the focus to customer-level profitability analytics, understanding revenue and direct / indirect cost for each customer. This is not an easy task and requires an enterprise-wide framework, which can perform cost allocation at the customer level, provide multidimensional profitability view, customer-level revenue, and cost information in a timely manner.

With the increasing need for personalized products and services, the financial services industry would look for more detailed analytics that would enable them to offer a bespoke product to cater to the specific needs of a customer. Hence, customer and other dimensional analytics will be an essential part of the business processes and a key component of any business decision. This kind of systematic analysis of data not only helps the management to evaluate the existing avenues but also explore newer opportunities and thereby, achieve superior customer value quotient.

About the Author

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Ankush has 6+ years of experience in implementation of banking solutions like OFSAA. He has deep domain understanding in core banking and performance management. He has been part of various end-to-end implementation projects of the solutions in his career.

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