Three Key Areas Impacting Customer Profitability

business customers customer profitability

Summary: It appears that we are nearing the tail-end of the pandemic and so it is an important time to review customer profitability. To guide you through this assessment, we cover three key areas that impact customer profitability: interest income, noninterest income and expenses, and credit costs.

According to National Geographic, the land mammal with the longest tail is actually a giraffe, which can reach 8 ft. This was a bit of a surprise to us! Another surprise is that we seem to be at the tail-end of the pandemic.

As more vaccines are administered and more businesses open, there are several factors impacting our local and national economies which will affect bank profitability. Better, faster decisions will be made if our data and assumptions are current and if customer profitability is reviewed regularly. To guide you with this review, we provide you with three key areas impacting customer profitability.

1. Interest income

In the current low-rate environment, many variables are impacting how long interest rates will stay low (stimulus, split-congress, vaccine rollout, etc.). During the last downturn, rates started above 5%, with lows just below 4%.

Today, most banks are seeing rates below 4%. Depending on the region, some financial institutions are seeing sub-3% rates for their best credits. As the Fed eased rates historically, we saw interest income come down over time.

With the Fed signaling an expectation that short-term rates will stay low for the foreseeable future, yields may continue to stay down. If the relationship between the 10Y CMT and yields holds true, we may see net interest margins closer to 2%. However, in the current downturn, credit spreads are much wider than in the last downturn.

2. Noninterest expenses and noninterest income

Community financial institutions (CFIs) have adopted digital services and a wider adoption is expected to continue. So, it is important to plan accordingly.

Although it is difficult to have much impact on overhead and branch infrastructure in the short term, it may be time to analyze and address how you do business in the long run. How and for what services branches are currently being used should be examined and compared with the institution's needs for the long term.
Changes to branch infrastructure may be a very difficult discussion with the board, but the decisions made now could impact your institution's longevity and long-term profitability.

Looking at the fee side, CFIs have made some improvements in generating fee income in the last couple of years. However, the larger institutions still have a leg up, even though they have had to reduce their fees over the last decade. Fintechs have put a lot of competitive pressure on retail banking to reduce fees and transactional costs. The onset of the pandemic has only accelerated this pressure and the resulting changes.

3. Credit costs

With more pressure on CFIs from regulators looking at how they are making pricing decisions, we should consider the continued importance of a risk-adjusted approach to pricing. Although a CFI may not have much control over actual credit charges, with risk-adjusted pricing, CFIs can help ensure they are being compensated for the risk they are taking on.

Let's consider what impacts pricing from a credit risk perspective. In practice, a CFI can apply an expected loss rate when pricing a loan based on the CFI's reserve rates or CECL rates, to capture the institution's history and expectations. If the CFI's loss history is minimal, it can be helpful to apply a probability of default (PD) and loss given default (LGD), based on various elements of the loan and the current environment.

Additionally, consider what sources there are to recoup the losses, in the event of default. The LGD should be based on the type of collateral as well as the loan-to-value (LTV). Reassessing and updating LTV is costly, but performing this exercise on larger transactions and on deals that may be more susceptible allows you to better assess the risk of new deals and the existing portfolio.

As always, taking a holistic view of profitability and pricing can provide flexibility to compete for the business. A holistic perspective will include looking at all loans, deposits, and all other services the customer has with your institution. This especially helps when your institution cannot compete on interest rate alone. If you need any assistance with customer profitability, we are here to help. Just let us know.

ASSESS CUSTOMER PROFITABILITY IN THIS MARKET