

# ESTABLISHING A PROFITABILITY DISCIPLINE WITHIN YOUR ORGANIZATION

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## INTRODUCTION

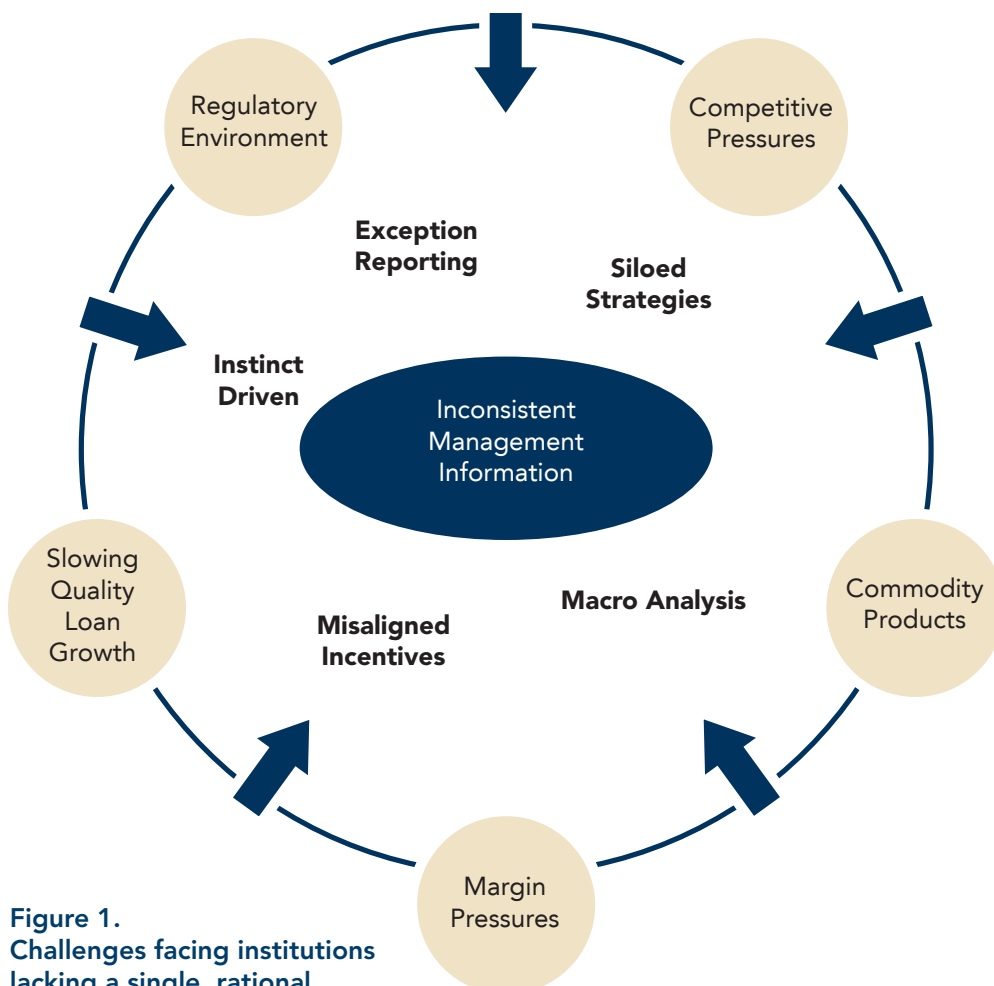
Forward thinking financial services organizations recognize their long-term success depends upon coordinated strategy execution supported by comprehensive and measureable performance analytics. Fortunately, today's profitability systems provide financial institutions end-to-end solutions for analyzing and measuring performance at many levels. But implementing even the best system does not guarantee success. The key to driving value from these systems lies in establishing a bank-wide profitability discipline. Call this discipline a cultural foundation, building block or mindset; what it does is ensure executives, line managers and individual contributors all line up on the same page--measuring what matters most to the institution.

The following provides guidance for those organizations that are implementing – or thinking about implementing—a profitability solution. By describing the common obstacles financial organizations face when implementing a solution, how to overcome those obstacles and the recommended stages for a profitability implementation, bankers can learn how to implement a profitability solution that drives shared understanding and achievement of the organization's goals rather than a 'nice to have' profitability system that remains at the periphery of the organization.

## THE PROFITABILITY IMPERATIVE

Creating shareholder value in the financial industry has never been easy. It was hard 20 years ago, it's tougher today and—judging by current trends—it's likely to be even more difficult in the future. With a pinched net interest margin, regulatory obligations cannibalizing operating expenses, and fierce competition for customers' financial resources, the simple adage of borrowing short and lending long no longer applies. Long term shareholder value will only come by having cohesive organization-centric strategies supported by the robust analytics needed to drive the execution of these strategies throughout the organization. The source of these analytics requires a single, rational and actionable view of the organization, which a well-implemented profitability solution can provide.

By having a single, rational and actionable view, all contributors in the organization drive to the same strategic goals using consistent underlying data and assumptions. Whether the CEO is looking at the profitability of a specific banking division, a branch manager is looking at their branch performance, or an officer is looking at the profitability of a customer, the underlying performance drivers all support a shared understanding of the organization, its value drivers, value inhibitors and risk profiles.



**Figure 1.**  
Challenges facing institutions  
lacking a single, rational,  
actionable view.

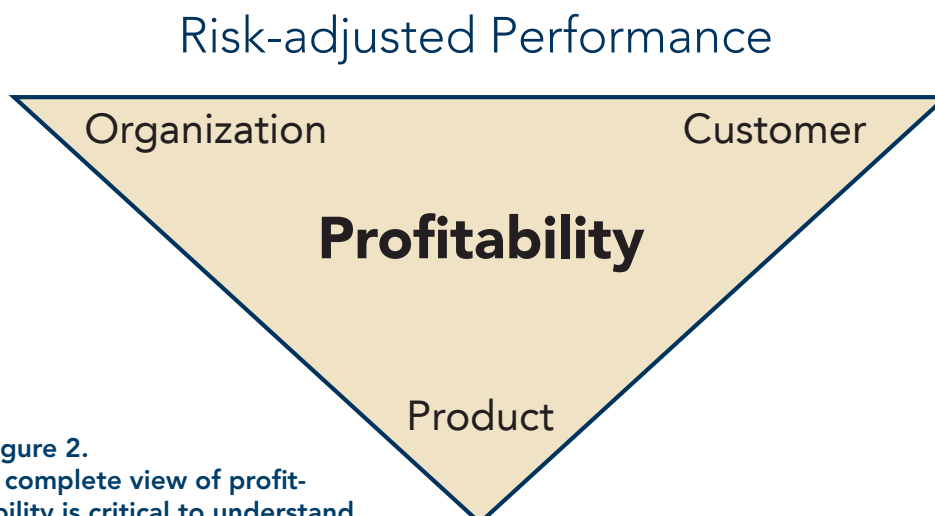
The consequences of organizations using inconsistent management information to drive performance are detailed in Figure 1. Contributors in these organizations don't have a consistent understanding of the institution's value drivers. As a result, they manage by exception, incent on the wrong opportunities, and drive their strategies in silos. They are unable to proactively identify real opportunities and threats as they occur and miss profit opportunities available to them.

It's surprisingly easy for this kind of inconsistency to thrive in financial firms. Existing internal systems—general ledger, budgeting and planning, data-warehouse—provide fragmented perspectives and, by their nature, do not provide the detail necessary to support the analysis used to understand and drive increased shareholder value. A well-implemented profitability solution can help an institution achieve the laser-like focus needed to drive long-term profitable growth. By using profitability information to identify opportunities and threats in each line and level of business, it becomes possible to develop and measure the targeted goal-oriented strategies that will drive value creation into the future.

## THE IMPETUS FOR RISK ADJUSTED VALUE

'Profitability' can take on many different meanings in organizations. Financial institutions have historically measured profitability using Profit Contribution, Net Profit, the Efficiency Ratio, Return on Assets (ROA), or Return on Equity (ROE), to name a few. While all of these can be valid measurements for regulatory or external reporting, they do not provide the entire story when making and measuring strategic decisions. They do not include the impact of economic risk and the cost of risk to an organization and its shareholders.

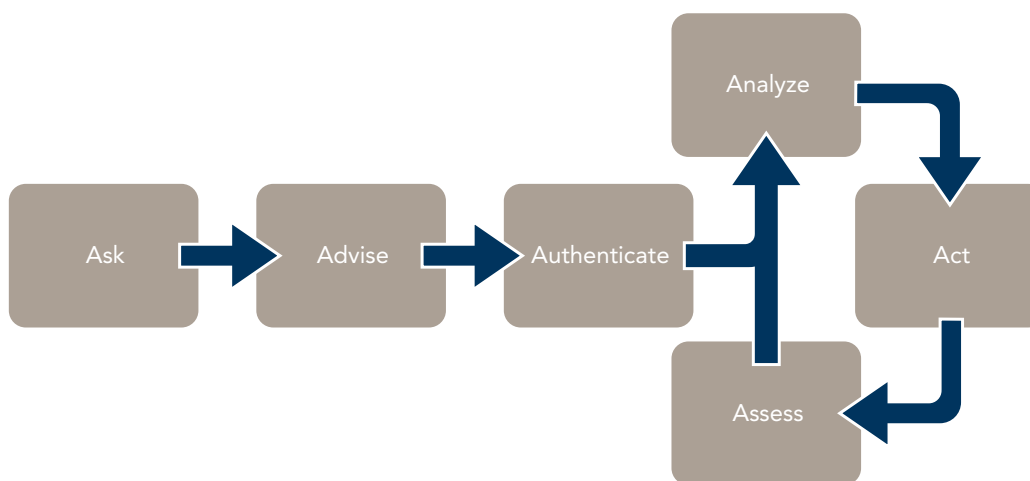
Risk management, previously understood by a select few in a banking organization, now permeates the entire enterprise. Not only is it imperative to understand what is driving profit contribution, one must measure the risk being absorbed in a transaction in order to understand its true value to the organization (Figure 2). As an example, it is better to engage in a transaction that affords an institution \$100 in profit with minimal



**Figure 2.**  
A complete view of profitability is critical to understand organization value drivers

risk of loss than to make \$100 in profit with a potential loss ten times that. Understanding the economic risk and capital required to support a transaction enables organizations to make intelligent decisions about the use of their capital through risk adjusted performance measures, like risk-adjusted return on capital (RAROC), Shareholder Value Added (SVA) or Economic Value Added (EVA).

## The “Six A’s” to implementation



## A DISCIPLINED APPROACH

While many forward thinking financial executives agree on the need for risk adjusted profitability analytics, too often emphasis is placed on the implementation of the profitability system, without the right ground work to plan the project and win over players who are essential if the right system is to be built . . . and used. In order to encourage a profitability discipline within an organization, a systematic methodology from the onset will help provide greater assurance that the solution will be embraced and any obstacles will be overcome if they are encountered. The following presents a disciplined, logical methodology for implementing a profitability solution (Figure 3).

### ASK

Prior to making the decision that a profitability system is required within an organization, it is imperative to understand what problems and challenges the system will solve. It is equally important to understand that a profitability system will not solve all issues. In order to effectively approach the task of understanding, financial institutions need to eliminate all biases and understand the firm’s issues before proposing a solution.

In order to understand the issues and challenges an organization is experiencing, an impartial individual(s) needs to be assigned to ask probing questions and listen objectively – a Profitability Advisor. The Advisor can be internal to the company or an external consultant. Their responsibility is to interview and objectively document the challenges and issues encountered that inhibit the success of the organization. The key areas and individuals interviewed should include (but are not limited to):

- All C-Level Officers (CEO, CFO, CLO, CRO, CCO, etc.)
- Head of Retail
- Head of Marketing
- Head of Small Business
- Head of Trust
- Heads of Other Business Units (Brokerage, Insurance)
- Select Branch Managers
- Select Lenders

All areas of the organization should be interviewed to obtain a list of challenges and opportunities. Once these are identified and documented, they should each be evaluated to determine the type of action needed to address the concern. Perhaps a process change or a different sort routine on an existing report will provide a solution to the issues identified. However, if many of the issues revolve around measuring and understanding the value drivers in an organization, there is value in embarking on a profitability discipline.

As the Advisor further refines and defines the need for a profitability solution, the requirements and benefits of the solution should be fully documented and verified. This helps capture the broadest range of improvement opportunities as well as foster open communication with stakeholders.

As support and interest in a profitability solution increases, it is also important to address objections to implementing a solution. Most organizations will have at least one individual that has experienced a failed attempt at implementing a profitability solution. The failure will most likely be from one of the following obstacles:

- Lack of strategic direction from executive management
- Belief in a “magic bullet” that the system will become a solution with little effort
- Too thin a team committed to the project
- Drowning in the details of how the assumptions were calculated instead of using the results to drive better decisions

A further description of these obstacles and how to overcome them are detailed later in this document. Addressing these obstacles as soon as they are identified is very important. It may be necessary to solicit other management team members or outside experts to serve as catalysts to bring reluctant managers on-board once the decision to move forward with a profitability solution becomes a reality.

## ADVISE

Once the decision is made to move forward, the Advisor will advise on priorities. Using the information obtained during the ASK phase, the Advisor will work with management to determine what requirements and benefits are most important to the institution and develop a high-level implementation approach. It is highly recommended that the organization take a stepped approach to the implementation and not try to integrate all aspects of a profitability solution at once. One of the many benefits a profitability system affords is the ability to implement individual components as needed. It is critical to keep a continuous focus on building profitability calculations

for strategic reasons, not venturing too far into the land of “nice to haves”. For example, many banks initially use profitability systems for net interest income analysis and implement costing, loan loss provision and other components as they become priorities. Deriving value from a profitability investment early in the implementation process encourages further investment and validates management’s decision to invest in the solution.

At this time, a Profitability Steering Committee should be established that includes key individuals from all areas of the organization that will be using the profitability data. This Committee will be responsible for guiding the major assumptions that will be used in profitability and support the Advisor in the project. The Advisor or an individual(s) well-versed in profitability methodologies (e.g., funds transfer pricing, costing, capital assignment) should also begin setting expectations with the Committee on the challenges and opportunities that go hand-in-hand with building a profitability solution. These discussions will help drive reporting requirements, system requirements, and data priorities.

A Committee member who is a strong profitability advocate and has the potential to obtain some quick wins with the data should be identified as a potential first user of profitability results. Priorities identified during this stage should include and support this user’s requirements. This individual will ultimately be a spokesperson for the benefits garnered once the profitability solution is implemented.

During this stage, the organization will also determine if the solution should be built in-house or if a vendor solution will be used. A Request for Proposal (RFP) will be written using the requirements gathered. The Advisor will recommend and coordinate with the individuals needed to attend the vendor briefing and will document the pros and cons of each vendor’s solution. Ultimately, a recommendation and decision will be made on a specific vendor or an in-house solution.

## AUTHENTICATE

Once this decision is made, a project roadmap and plan are formalized using the priorities determined by the management team (e.g., should Funds Transfer Pricing be implemented prior to Activity Based Costing?). Figure 4 gives an example of a high-level roadmap. The profitability project will be off to a strong start due to the pre-work done in the previous phases of the Discipline. The information will now need to be authenticated by combining the relevant data and assumptions to generate profitability results. The human resource requirements are greatest in this phase due to the detailed validation exercises required to ensure the data inputs, assumptions, calculations and outputs are sound. The Profitability Steering Committee should be updated on a regular basis on how this phase is proceeding. Towards the end of this phase, the organization will start to see the results take shape through the development of dashboards, reports and other decision support tools.

## ANALYZE

But before management uses the information in decision making, there will need to be further data and assumption validation. The results coming from the system will need

to be analyzed to ensure that the individual elements, when combined, are directionally correct and reflect the bank's overall position in the area being analyzed. For example, if a manager has determined through other reporting mechanisms that the pricing on commercial loans is sub-par, the profitability system should show this as well. If the results coming from the profitability system are directionally different than what has been seen in other analyses, the reasons will need to be understood and substantiated. The goal through this analysis is to ensure the information being relied upon will drive better decisions within the organization, not to reconcile the information back to other financial results (which should have happened in the previous phase).

Through this analysis, an organization will also begin to understand the underlying drivers of the profitability results they are seeing and will begin to formulate alternatives on how to respond to the results. For example, an unprofitable product could result in an organization exiting the product if it is not strategically viable, or they could embark on a different pricing strategy or address some of the significant expense drivers. All of these are alternatives an organization can consider once they analyze and understand the underlying profit components.

## ACT

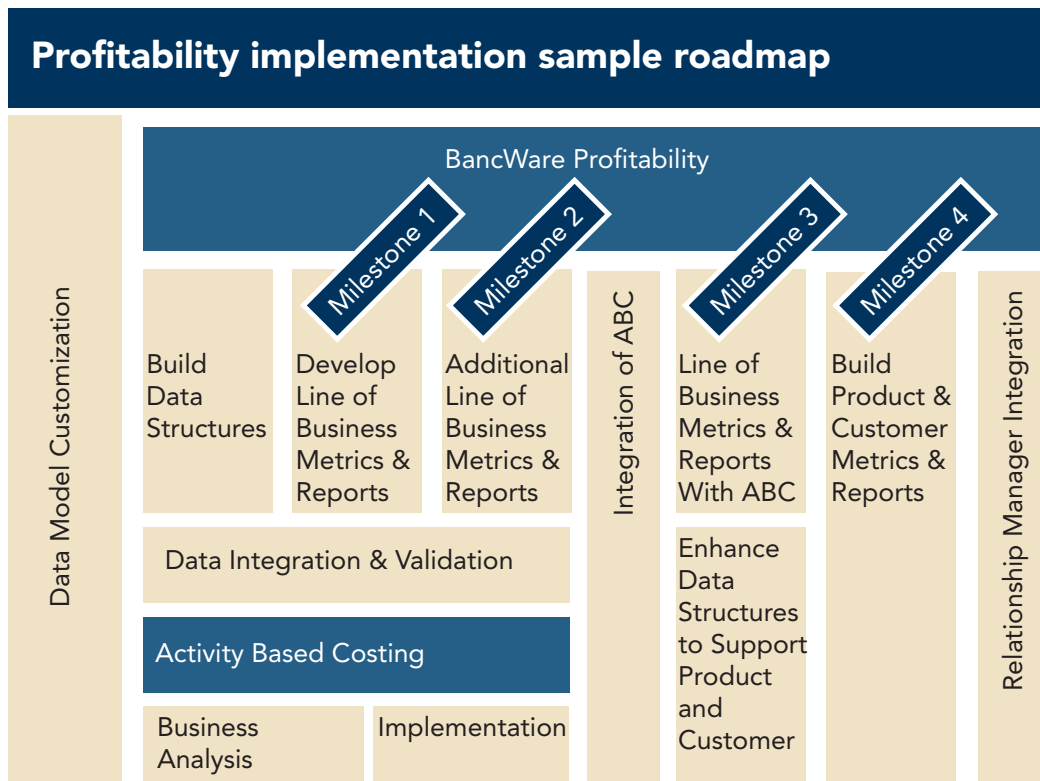
Once there is comfort in the results being generated from the profitability system, the organization starts to use the data in decision making by acting on the results. This is the phase where the rubber hits the road and where many implementations fail due to a lack of support, belief and understanding of the underlying assumptions.

Armed with the results obtained during the ASK phase, the Advisor works with the manager in the organization that agreed to be an initial user. The manager will analyze the profitability results and determine what action should be taken. In the example of an unprofitable product, if the organization decides to address some of the significant expense drivers or embark on a different pricing strategy, Key Performance Indicator (KPI) will need to be defined in order to measure the success of the underlying strategies developed to drive change. The determination of the optimal KPI may take several months as the manager begins to understand how the profitability information is impacted by changes in the organization.

Typically, the initial KPIs established are very straight forward and grow in complexity as the understanding of profitability information grows. For example, a manager might want to begin developing KPIs to measure the Net Interest Margin on loan officers' portfolios. As the comfort with the underlying data and Funds Transfer Pricing methodologies grow, the manager could then charge his officers with meeting a specific yield on their portfolio and then might begin managing the yield based on the different types of loans. Ultimately, the manager could incent his officers on customer relationship level RAROC. Obviously all of this takes time and can't be accomplished overnight.

## ASSESS

Once the KPIs are established, it is extremely important to assess the success of the strategies by reviewing the changes in the KPIs. Initially, successful uses of profitability information should be communicated throughout the organization in order to reinforce



**Figure 4**

and drive home the underlying value of the tool and assumptions. During this phase, organizations should also re-assess, enhance and modify the underlying assumptions and strategies to support the changing organization. This is also the time when other profitability components are integrated into the solution—but only if the organization's strategies support the need for the component.

As Figure 4 shows, the last three steps of this process form a continuous loop. As profitability successes continue within an organization, the willingness—and necessity—for managers wanting to analyze, act and assess their profitability results becomes commonplace. A profitability discipline has been born!

## OVERCOMING THE OBSTACLES

Following the six stages described will not unequivocally guarantee success. Financial executives engaged in developing profitability disciplines within their organizations also need to be aware of the obstacles institutions routinely encounter implementing a profitability system (Figure 5). While the obstacles are manageable, they must be identified, acknowledged and addressed to ensure a return on any profitability system investment.

Firms must bridge these obstacles through a mix of cultural change and sure-footed implementation. The following are the priorities that must be understood, embraced and executed to ensure organizations end up with a profitability-centric organization instead of an organization that has a profitability system.

- Obtain Strategic Direction
- Get Committed
- Assemble a Broad Cross-Functional Team
- Manage the Details

## OBTAIN STRATEGIC DIRECTION

The informed support of senior executives is critical to the success of any profitability solution. Management must have an understanding and be able to communicate how the results of a profitability solution will be used within the organization. Waiting to see results from the system before promoting its value to the organization will result in failure.

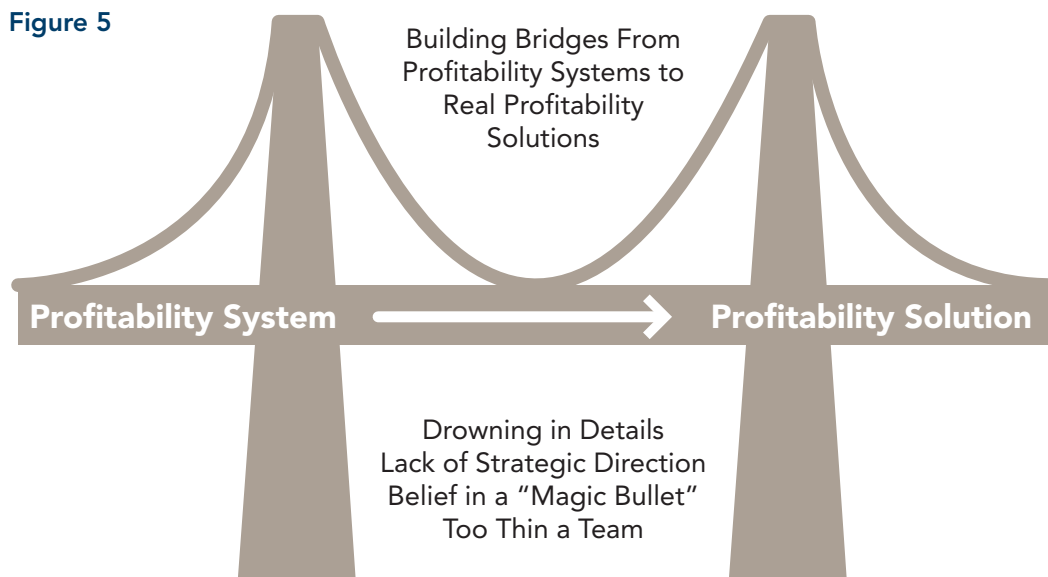
Banks looking for a solid return on their profitability investment must link their strategic objectives to their implementation plans. Without an understanding of how the information will be used in strategic decision making, individual contributors will flounder in their attempts to determine the system's structure and components and will take a 'best guess' approach to implementation decisions.

## GET COMMITTED

Once ink goes to contract on a profitability system, there can be a tendency for those involved in making the technology decision to say, "Our job is done". This is a mistake. A well constructed front-end reporting interface with exceptional drill-down capabilities will not eliminate the work required to drive actionable results.

Profitability is not a 'plug-and-play' solution but a long-term strategic initiative. An enterprise-wide, fully implemented profitability solution can take years to mature. While this may sound daunting, it needn't be. The Profitability Steering Committee and the Profitability Advisor, mentioned earlier, must commit to managing the value proposition developed and keep the implementation focused on delivering the defined requirements. Do not allow individuals to add or modify requirements to the initial solution without a thorough discussion on how that will impact the project plan. Adding a costing component or a provision allocation to the initial scope is not trivial. It is critical to develop 'wins' with profitability results as early as possible and any additional requirements will, more than likely, delay the project and may create unneeded pessimism towards the solution.

Figure 5



A profitability solution requires dedicated resources from many areas of the organization. The Steering Committee needs to be committed to prioritizing, supporting and managing the organization's resource requirements. After the project is well into its implementation, it is inevitable that individual contributors will be given other priorities that will pull them away from the project. The Committee needs to understand and support the profitability project resource requirements, remain committed to the investment and actively participate in decision making and status meetings to keep the project on track.

## ASSEMBLE A BROAD CROSS-FUNCTIONAL TEAM

While the accounting, finance and information technology groups within an organization are instrumental and tend to be most involved with the profitability initiative, a standing committee with wide-spread user representation best advances the cause of creating a bank-wide profitability discipline. There is wide-spread knowledge within any organization and, to be most effective in decision-making and understanding the drivers of individual business lines, it is important to harness that knowledge and involve those individuals in developing profitability assumptions.

Excluding areas of the organization that will ultimately use profitability information is highly discouraged. Spending weeks developing loan provision assumptions only to find out the lending area has hired a consultant to do the same thing is nothing short of wasted time. Additionally, involving individuals in the decision-making at the onset creates pride and ownership of the results. Knowing managers and peers were involved in the profitability assumptions gives users a higher level of comfort that the assumptions are appropriate. This should positively impact the solution by reducing the time spent defending the results and allowing more time on how it can be used to drive shareholder value.

## MANAGE THE DETAILS

Individual contributors and users of any profitability system must recognize that the components and results encompass elements of both art and science. Some of the assumptions that go into developing a profitability solution require significant analysis and may ultimately require an innate sense of wisdom to achieve. Regardless of how the assumptions are derived, the elements that drive an assumption must be disclosed, discussed, documented and supported by management.

If the profitability results do not reconcile with other internally generated reports (e.g., financial, regulatory) questions may arise about the credibility of the information. Users of profitability information need to understand that this is common and could be due to many things: allocation methodologies, non-general ledger methodologies (e.g., funds transfer pricing) or reclassifications. This does not invalidate the results. While financial institutions disagree on whether the end user should be able to reconcile disparate results, it is important for users to understand, at a minimum, the effort that went into developing the results. Regardless of how much detail an end user is provided, profitability assumptions need to support the organization's strategic goals

and end users need to focus on what actions are required to rectify a situation or drive additional value within the organization.

## CONCLUSION

The results of any profitability analysis will never be perfect and will most likely conflict with the results of other internally generated reports. This is both inevitable and welcome – there would be no point in investing in a profitability system unless the information it gave to management differed from other kinds of analysis.

The implementation process outlined is designed to make sure that the users of any profitability system recognize that, while profitability encompasses both art and science, the system's key assumptions have been agreed upon across the firm, are backed by executives and support more informed decision-making across the organization.

At the moment, many institutions are driven in the wrong direction by a poor understanding of what creates long-term shareholder value, e.g., business volume rather than risk-adjusted value. With a carefully prepared solution that supports the organization's goals, executives can be sure the firm will make decisions that are directionally correct, rather than exactly wrong.

## ABOUT THE AUTHOR

Kelly Lutinski is a CPA and principal banking consultant at SunGard BancWare where her responsibilities include assisting financial institutions in driving bottom line value with their technology investments.

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