



**Calculating and Reporting Customer Profitability at:
North Shore Credit Union**

A Case Study

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Site Visit Location: Vancouver, British Columbia

Site Visit Hosts:

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CALCULATING AND REPORTING CUSTOMER PROFITABILITY

I. General Overview of Calculating and Reporting Customer Profitability

Company Snapshot ¹	
Industry:	Financial Services
Revenue:	\$35.5 Million
Employees:	300
Headquarters:	North Vancouver, British Columbia, Canada
Web Site:	www.nscu.com

Since 1941, the North Shore Credit Union (NSCU) has provided financial services to approximately 40,000 members. Membership is open to any local business or individual consumer. With over 13 branches, the company offers the following financial services:

- full-service brokerage through its **Credential Services** business,
- mortgage lending through **United Mortgage Group**,
- insurance through **North Shore Insurance Services Ltd.**, and
- venture capital through **North Shore Capital Corporation**.

NSCU members have access to financial products and services such as savings accounts via various vehicles including the Internet, a call center, or in person at branch locations. The company's competitors include local branches of the five major Canadian banks and other credit unions.

In 2000, the company was the first financial institution in Canada to develop a member relationship management system. During this time, customer profitability analysis consisted of an automated process through the treasury function, driven by spread (on term deposits, investments, loans, mortgages, etc.) and deposit transaction costs. In 2004, the manager of market segments and products joined the company to further the efforts of customer profitability analysis. For NSCU, relationships are at their core of the company's operations:

¹ Source: www.hoovers.com (retrieved November 2005)

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Together we build long-lasting relationships with our members and our communities by providing mutually-beneficial financial solutions to help you succeed.

NSCU's stated core purpose

Hence relationships are key, the company cites that it is not a price or product leader and must differentiate based on service, of which member relationships are critical. The company believes that it provides mutually beneficial solutions. "Mutually beneficial" is important because although NSCU is a non-profit business, the company is still accountable to its members. Moreover, the company takes a holistic approach to its members overall financial health where a good understanding of customers' financial wellness is essential.

Governance and Structure

NSCU is led by a board consisting of nine members who are elected from the membership; the CEO reports to the board. Customer profitability includes various functions within the company. The CFO is responsible for finance, accounting, treasure, and security. Information Technology Services (ITS) is responsible for application development, infrastructure, central administration, and facilities management. The HR and communications functions also have an essential part in the customer profitability effort.

Most of the customer profitability work has been done in the retail business of the company. Mike Watson is the vice president responsible for branch network, the call center, insurance, wealth management, and marketing where segmentation work is conducted. The company's manager of market segments and products is responsible for propensity models used in conjunction with member profitability information that create campaigns and business processes to deliver products and services with appropriate pricing to its members. Because the company is relatively small, cross-functional teams are leveraged to work on customer profitability. For example, when assembling a task team focused on a Fall campaign, resources came from various areas of the company working together on how the segmentation model should be applied.

From a standpoint of delivering information, research, and analysis, NSCU has a small marketing department that manages those activities. A resource is responsible for communications, another for the segmentation work, who works with another resource responsible for research and product development. The group also has a campaign and ad manager and a manager for Web services. The development team within ITS is responsible and manages the CRM system.

The Evolution

NSCU's customer profitability efforts were ignited in the late 1990's by senior management when the first profitability model was launched along with the company's CRM implementation. The goal for the CRM implementation was to obtain a "single view" of the customer. The company sought to create a consolidated view of customers that would include all of their data and be delivered or presented in easy-to-understand interfaces. The board of directors strongly supported this effort with the clear understanding that the effort required a significant budget, but along with that sizeable investment; there would be significant expectations in terms of ROI. For NSCU, the CRM would be able to provide information on customers that would result in increased opportunity. This evolution occurred with a 20 percent ROE financial performance over five years. Further, the company cites that this effort was a major change in process for the staff and obtaining their buy-in and understanding of the process was critical.

II. Customer Segmentation

Segmentation Overview

In the past segmentation efforts focused on life stages, with groups such as "starting out," which consisted of people with criteria such as first time home owners or just starting a family. These groups were identified with a specific set of financial needs. Unfortunately, this approach was not very successful because NSCU found out that age is not a true predictor of behavior for example a person who is 35 years of age could be part of the starting out group depending on their individual circumstances. Hence, age was not a true predictor of financial services need.

It was at this time, that the company sought help from Tenor solutions who assisted in the modeling effort. Since 2003, Tenor has helped NSCU to create predictive models based on internal customer behavioral data such as product history, balances, etc; current models used are:

- propensity models,
- term deposit models,
- mutual fund models,
- line of credit models, and
- attrition models.

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In 2004, the company implemented a new segmentation process which included customer profitability as one of its components utilizing propensity models to calculate member profitability scores. An application for segmentation information is in formulating campaign strategies. The company is able to review its member base and apply propensity models and income estimators to “come up” with a target base for the campaigns. Member scoring aided account management teams in understanding and driving member interaction.

From an analytical perspective, Tenor is creating segments attributed to profitability. When Tenor segments NSCU’s customers, it is at the individual level and assigns profitability to all members within a particular account.

Further, the information is used to create two scores for current members; one is a value score based on their current profitability and a propensity score looking at their potential value to the company. NSCU understands that profitability is only indicative of present conditions as it does not really provide any insight into future member value. While, the company does not have a mechanism to forecast lifetime value of its members, the company does use a matrix that provides insight into potential value. Hence, NSCU leverages four key customer segments with the top 20 percent being the protect group who represent a major portion of the company’s overall profitability.

1. Protect—this group drives 60 percent of the company’s profitability/business;
2. Invest/Grow—NSCU focuses on growth with this group by maintaining the relationship to increase the share and depth of wallet of these members;
3. Maintain—the “messy middles”: This large group of members are only marginally profitable; and
4. Reduce cost—this group consists of 10 percent to 15 percent of the member portfolio consistently losing the company money for various reasons, primarily aggressive spread (e.g., giving them at or above the cost of funds).

Segmentation information is leveraged to drive investment decisions, pricing, account management, and marketing strategies. NSCU has the ability to review costs and revenues on an individual member basis, and transactional level and is able to assign them to a particular segment. Each individual member has a CIF (customer information file) identifier based on the Dataquest banking system that enables the company to identify each individual member. So, on a monthly basis, the company is able to obtain a data snapshot (from a relational database) of all the products a member is using and each relate to one another.

Customer Profitability

NSCU uses an advocacy index as a leading indicator for profitability of its customers. The advocacy index is based on voice of the customer (VoC) metrics based on a number of factors such as changes in how a customer does business within the past 12 months. The company takes VoC responses and applies a formula that results in the advocacy index. This effort is conducted on a monthly basis with a group of members in order to obtain a rolling report. The company knows that its best members (in terms of value) are also the best advocates. This effort links to NSCU's balanced scorecard approach. From a performance management perspective, the advocacy index is conducted at a branch level, at a consolidated level, and at an individual account manager level where each level forms part of the balanced measurement system, for example if the advocacy index is "X" percent of overall performance review, the profitability of the company's portfolio is X percent of the overall performance.

Segmentation and Business Strategy

The company's strategy is to increase member intimacy specifically focused at providing different levels of service to different levels of membership. To drive this strategy, NSCU identified a number of tactical efforts stemming from its segmentation endeavor.

III. Understanding the Cost to Serve Customers

Customer Profitability Process

The company estimates the value of its members based on current and future relationship. Member potential value is calculated based on expected activity over the next 12 to 18 months considering such assumptions such as how likely they are to renew services. This insight enables the company to anticipate which members will be profitable to the organization in the future.

NSCU understands which segments are most profitable down to account level. The company analyzes cost allocation, particularly in securities as it impacts commissions paid (sales costs). The company acknowledges that this is the most challenging area for them as it is difficult to calculate cost to serve. Cost allocations are deposit account transaction costs where overhead, salaries, and fixed and variable costs are not included.

Cost of Sales

As noted, cost of sales is challenging to calculate because when someone comes into a branch to conduct a transaction, are they really adding to costs or are they utilizing fixed overhead? Costing has been applied on a transactional basis and also applied to service delivery (i.e., cost of providing services via the Internet versus on-site). For the company, it does not make sense to assign higher costs to members who are obtaining services on-site at the company's branches. Further, Activity based costing (ABC) is currently used in residential mortgages. NSCU states that cost allocation systems on overhead are fairly subjective because the question that must be answered with a certain amount of accuracy is, how much of the cost is variable and how much is fixed? And also is the cost direct or indirect? The company is currently reviewing this process to answer those questions and be better able to calculate cost of sales.

Challenges of Customer Profitability

A challenge for NSCU is customer definition, where a customer can be a number of things, such as an individual member, a household or some other arrangement such as a member who has multiple memberships. An example of this challenge can be exemplified with a member who has a joint account with someone else; how does profitability get calculated and assigned (to whom)? If there is \$100,000 in the account, how is profitability calculated? How do you assign value? The company's CRM looks at the individual because it is all about one person. For segmentation, NSCU focuses on a primary member on a membership, so that the analysis provides information on that specific individual. Hence, the company's challenge is to balance the different views.

Working with Stakeholders

NSCU created a CRM strategy after the implementation of the CRM software tool that includes ongoing communication to all stakeholders. The company notes that this was very important in delivering to a tight timeline. Many discussions took place in order to ensure that stakeholders were kept up to date on the changes that would impact them.

Managing Unprofitable Customers

The company manages unprofitable customers by being selective in terms of providing rate discounts, or in how the members are serviced and managed. For example, member profitability information is leveraged to assign accounts relationship managers in the retail banking group who are able to convert unprofitable customers into profitable customers.

Enabling Technologies

The driver of calculating customer profitability was the CRM implementation. And the company believes that perhaps they started at the end (with technology) instead of the beginning (with an effective process). Hence, NSCU first acquired the tools, then developed processes and philosophies. The company believes that they led with technology because the idea that “CRM is your strategy” was widely accepted by the company. Therefore, the tool enabled the company’s strategy; however, since then there has been a shift from this paradigm to, “relationship management and member intimacy is the strategy and CRM is an enabler.”

The company uses five separate systems that are linked and integrated via a warehousing system. The data is obtained at a granular level and the company then has the ability to allocate costs at different levels and analyze accordingly.

Moreover, the company leverages technology to identify profitability from various products. NSCU states that from a process engine environment, CRM, warehousing, ICE (information center environment), and content engine are the three key engines used for calculating customer profitability. The CRM engine is Pivotal, and the other product engines are purchased or offered via service provider models. The company uses an FTP engine starting with the funds transfer pricing system gathering information account by account and transaction by transaction, and FTP allocations. This gets rolled up with the FTP component, resulting in a view of the spread over the cost of money. Next transactional costs and revenues are analyzed that provide actual net income for each member. What this technology provides is that the company is able to know with a specific level of certainty and on a relative basis which member is earning the company more and hence is more valuable. A key element of effectively leveraging technology for NSCU is the relationship marketing has with ITS. The ITS group has a very in-depth understanding of corporate strategy resulting in two groups working together towards a common goal.

IV. Reporting Customer Profitability Information

Reporting

All employees at NSCU have access to the company’s CRM system. Figure 1 below **INSERT SCREEN SHOT PROVIDED AT SITE VISIT** shows the detailed profitability for the different lines of business (LOBs) at an individual level. Further, figure 2 shows **INSERT SCREEN SHOT ON PAGE TWO** detailed information member profitability. This screen provides product mix as

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well as transaction information. Hence, reports are easily accessible and also easy-to-understand.

NSCU has an assigned resource, a “segmentation person” who on a regular basis provides reports to the executive team, and the account management team to assign portfolios. Reports are provided to other stakeholders on an “as-needed” basis reactively. The company uses Microsoft’s SQL Server analysis server for financial warehousing and Crystal Reports enterprise level for reporting. Reporting directories provide a large number of reports based on selected criteria. The reports do have security permissions built-in so that there is some control associated with the reporting of the profitability information. Resources are able to “pull” any reports he or she wants as long as they have the permission to view that specific information, it is a self-service system.

Customer Profitability Information

Customer profitability information drives the strategy and operations of NSCU. The company cites that both the CRM system and customer profitability information are the two most valuable tools the company leverages. The customer profitability information drives pricing decisions down to the retail level, it drives sourcing decisions down to the staff level at the retail branch, and it is a measurement system for branch performance as it enables the branch to understand how well the organization is doing based on profitability modeling.

Further, the customer profitability information has enabled NSCU to drive behaviors down to the individual level. For example, a retail profitability report is created at the branch level that includes profitability margins and controllable expenses than consequently drives behavior. Hence, the branch manager is able to view branch profitability, and the individual account manager is looking at individual client profitability and making changes at that level to drive branch profitability, so the accountability framework flows down to the account manager level. The performance targets are the profitability measures, they are not exclusive, but provide a balanced approach with leading and lagging indicators.

Employee Motivation

Portfolio profitability is one of the key drivers of compensation for the company’s account management group. The company looks at how account managers are growing their portfolios and provides bonus compensation to those account managers that meet or exceed target growth levels. The account managers have performance standards around contact management; they use the advocacy index to understand their assigned

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customer base. For NCSU, it is important that account managers focus on managing 100 percent of their accounts, not just the top 30 percent.

Moreover, the company engaged with a human capital expert in Ontario who will be creating a causal model to uncover how employee satisfaction impacts customer profitability. The company administers extensive employee engagement surveys. The goal is to take all of the raw data from employee engagement surveys and combine it with the profitability data. The human capital expert will then create a relational model to enable the company to understand how employee engagement is related to member advocacy. This information will be part of NSCU balanced scorecard as it believes that there is a strong link between employee engagement and customer profitability.

V. Lessons Learned and Critical Success Factors

Critical Success Factors

In marketing, a critical success factors (CSF) is that information is king, as customer segmentation enables many of the strategies and supports effective campaigns and promotions. Another CSF that the company cites is effective and continuous communication. Hence, communicating to stakeholders and to the resources that will be “digesting” the customer profitability information is critical. These people must understand the information and then behave and act accordingly. NSCU is currently working on revising and enforcing the business rules around this CSF. Moreover, delivering information to the sales force in a structured way assists in that essential understanding of the data. The company’s branches and all of the sales staff own customer relationships, but the marketing and segmentation groups are the experts on segmentation and therefore, it makes sense that the analysis is performed by the marketing and segmentation groups that will then “serve up” the information to the sales group in a structured and easy-to-understand format.

From a technology perspective, a critical success factor was that the ITS group roll out the system focusing on the areas where the group was confident about their science. In other words, they began implementing the system where they expected to be most successful. The group also spent a lot of time communicating with stakeholders on how the system worked. Further, the group provided assumptions about the system so that the stakeholders would better understand the change.

The group notes that collaboration helped to maintain expectations in check. If their was a problem or an error made, the group was quick to address it and state that the system like people are not perfect and that “bugs” and issues would be solved. Cooperation with the stakeholders in the various groups was certainly a critical success factor.

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Top Three Lessons

NSCU understands that they need to continue to improve how to move customers from one segment to the next. For example, there may be a member who is paying his or her mortgage down, and so they appear to become less profitable because at the beginning of the mortgage, the company was making a lot of money. Hence, if NSCU only looked at the profitability piece of this member, opportunities may be missed. Therefore, it is important that the company pay close attention to members and change their placement to the appropriate segment. The company hopes that work on modeling will enable it to better address ease-of-move for its members from segment to segment. Lifetime value and attitudinal profitability elements must continue to be considered in how the company manages customers

NSCU must continue to improve communications around what to do with the profitability score of its members. Resources may not be using the score to add value to what they do. There are some instances where resources are not using these score to drive their behavior. Hence, improvement in this area will continue to be a priority for the company.

Future Plans

A cross-functional committee will be working on integrating customer profitability information and financial information to obtain more reports that focus on the financial side. This work will better support capital investment decisions. The company notes that there are two macro components to this work: 1) in what area of the line of business (LOB) is the most revenue generated? And once that is identified then investing should be focused in that area; 2) analyze the LOBs to understand which service/product is generating the most revenue.

Further, the CEO communicated a new vision for the year 2010 that is currently being rolled out to the company, called "Rocking the shore" which involves continuing to do well financially and strengthening the commercial business. On the retail side, NSCU is focused on a key target market, the mass affluent (members who have more than \$100K in investable assets). Hence, the vision and tools will support and enable plans to open between five and eight additional branches in the next five years.