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Profit risk: The third leg of risk management

By Rich Weissman

Let's face it. The financial services industry for banks and credit unions is all about managing risk. Risk management allows the industry to determine who is qualified for credit, and how much to set aside for potential bad credit and tough economic times. It lets us know how to set rates, identify what the appropriate mix and tenor of our loan and deposit portfolios should be, and determine which types of products we should be developing and selling. Ultimately, it allows us to sleep at night, knowing that we are safe if things go sour because we've prepared for the good and bad that may come our way in the future.

However, that dream of managed risk can become a nightmare more quickly than you expect. Like a bad dream where everyone else is dressed but you are naked and cannot seem to find your clothes, the fact is that our financial institutions are naked as well. They are missing a critical component in the risk management business: profit risk. The financial services industry operates on two important risk management components—credit risk and asset-liability risk—but it make for a wobbly stool if you miss profit risk, the third and vitally supportive leg.

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A risky business

The first and oldest risk management concept is credit risk. From risk ratings for businesses to scoring for consumers, developing methods for evaluating credit risk was an important advance in creating tools that assessed credit criteria and potential losses. From these innovations, the ability to manage loan rates, loss provisions and capital was significantly enhanced. By putting credit forms and review committees in place, and with credit bureaus and Fair Isaac in hand, financial institutions had a much better handle on credit worthiness and losses.

The second and more recently developed leg is asset-liability risk management. Certainly, the savings and loan debacle taught us a lesson. We cannot lend at 30-year terms and source those loans with six-month deposits—the rate environment is just too volatile. From this experience, financial institutions learned how to manage interest rate risk through a variety of techniques, including matched funding, secondary market sales, participations and swaps/collars/caps. With treasury and ALCO functions in place, we have a far better handle on the asset-liability mix.

Even better, by implementing credit risk and asset-liability risk management, your financial institution will have met the regulatory requirements for safety and soundness. So, you are all set, right? Unfortunately, you might be in for a rude awakening.

Profit risk—The vital third leg

Profit risk refers to the concentration of the income statement that is housed in a small group of customer/member relationships, as well as products. In its simplest form, profit risk can be defined as a ratio of net income (profit) generated by the top 10 percent of customer/member relationships divided by the total net income of the institution. The higher the ratio, the greater the concentration of income within a limited number of relationships or products, and the greater your profit risk potential. Having a large portion of the income statement housed in a small group of customer/member relationships means that this small group dominates the income statement. If they are not retained, and retained at current profitability levels, then the overall net income of the institution is at serious risk. This small group "owns" the institution's profits, and this is not a good position to be in.

You would expect that the old "80/20" rule applies here, but it does not. There are real-life examples where financial institutions have seen profit risk ratios as high as 300 percent. Their top 10 percent of customer/member relationships accounted for three times net earnings—a "300/10" rule! Better-managed institutions often have a profit risk ratio closer to 150 percent, but even this is a whopping number and needs to be brought down significantly.

Profit risk is different from balance sheet concentration. Typical institutions may find themselves with a balance sheet concentration between 60-80 percent of all outstanding loans, and between 70-80 percent of all deposits housed in the top 10 percent of their customer/member relationships. But, when assessed on a profit-risk basis, the ratios can exceed well over 150-200 percent. Simply relying on balance sheet concentrations does not measure profit risk or provide the tools to account for it.

Effectively addressing profit risk takes time, but it is essential, and the earlier a bank or credit union starts, the better. The initial step in minimizing the risk is to understand what all of the "profit risk metrics" mean. These are measurements that can show how a very small group of customers/members and products are generating more than the total earnings of the institution. If just a few of them are priced inappropriately in the future, or worse, if just a few of the top customer/member relationships leave, then an institution's earnings are seriously impacted. With our example's high ratios, a loss of just one percent of the top profitability tier can severely damage the earnings of the institution and even jeopardize its future. Now, there's a thought that will make you lose some sleep!

How to manage profit risk

The good news is that there are ways to minimize profit risk, such as the step-by-step process developed by the Portland, Oregon-based DMA, which provides database-driven profit risk services to client banks and credit unions.

The first step is to quantify a variety of profit risk ratios, including those noted previously. These ratios are then broken down into very specific customer/member relationship group metrics. This shows exactly where the risk is heaviest and also identifies where the break-even points are. Second, an institution needs to understand the relationship between product profitability and customer/member relationship profitability, and how these come together in creating profit risk levels.

The next step is actually developing specific programs aimed at each risk group and product. The objective is to implement programs at two levels. The first level is to retain the most profitable customer/member relationships and ensure their continued contribution to the income statement. The second level is to move profit risk down and target specific groups and products for movement up in profitability. This spreads profitability among a larger base and brings your profit risk ratios to more acceptable levels. Finally, an institution should set profit risk goals and metrics, tracking them monthly to assess progress and refine programs more closely.

Sweet dreams

Considering the key component of risk management that profit risk addresses, it could simply be a matter of time before the concept becomes officially recognized. Regulators may soon start demanding that banks and credit unions formally manage profit risk, requiring committees, reports and very clear action plans. Profit risk may be a relatively new concept, but in today's competitive financial services environment and the current economic uncertainties, it is a crucial third leg of an institution's overall risk management. Once you know what your profit risk ratio is and have taken the steps to bring it into line, those nightmare worst case scenarios will be nothing to lose sleep over anymore.

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