Reflection 5. Follow the Money

Follow the Money: It seems obvious to say this, that financial institutions should know where they make their money, after all, their business is money, intermediating funds, providing payment services, loans, and savings. However, the reality for many smaller financial institutions is different.

The reality comes out when an institution is asked the question, “where do you make money”?

Let me explain: Typically, a financial institution makes money from interest income, from investments and from fee income. Today, with the growth in payment-based services the balance between interest income, investment income and fee income is changing, but the principle is the same. So, at the level of the profit and loss account financial institutions have visibility.

But it’s important to go deeper if a financial institution wants to learn how to make more money. To do that start asking questions:

1. Which of our products or services make money?
2. Which of our products or services lose money?
3. Which of our branches makes money?
4. How do our channels contribute to our making money?

With this understanding a financial institution can take strategic decisions:

1. How should we change our product mix?
2. How should we refine or reprice loss making products?
3. Which products should we kill?
4. How should we refine our branch or channel strategy?
5. What transfer pricing should we set to ensure that deposit taking branches are rewarded and assessed for their contribution to the bank?
6. How should we refine our product strategy?

From a technical perspective, there is the easier allocation-based costing, the more involved, but technically superior activity-based costing. I would always advise institutions to start with the quicker easier allocation-based costing, institutionalise this, then if you are extracting value from allocation-based costing, move onto activity-based costing. Allocation based costing will deliver 80% of the value to the institution with 20% of the effort.

In assisting multiple institutions to deliver product costing, a typical allocation-based costing exercise takes a few weeks from start to finish with the time required mostly related to gathering the data required for cost allocation drivers. So, the cost is modest, even if consultants are involved.

The benefits in terms of informing decisions, can be huge. Decisions taken to promoting profitable products, reviewing loss making products, revising delivery channel strategy, re-pricing where required – all reduce losses, reduce costs, increase income, all contribute to the bottom line.

I’ve worked with very many financial institutions across Africa and Asia over the last thirty years. I’ve trained on product costing, and prepared product costings on many occasions, and seen institutions modify their product mix or delivery strategies as a result.

So, the question becomes, if product costing makes money, why doesn’t everyone do it?

I wish I knew the answer.

First Principles Consulting can help you to follow the money, can train your team in product costing, and can help your team see the strategic implications of product costing and pricing.

If this reflection speaks to you… speak to me so that we can inspire change, together.

David Cracknell

Additional reflections in this series can be downloaded from www.firstprinciplesinfinance.com

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