Customer Relationship Management

Segment Your Customers Based On Profitability

Michael Meltzer

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Abstract

The old ways of segmentation have served the marketing managers well but it is time for a new approach. Segmenting your customer base is more effective than segmenting the market for a Financial Services Provider (FSP) but: Which segment is more profitable? Which has the greater long-term payoff?

This paper explores how centralised information sharing technology and clear marketing strategies can be used to understand who are the right customers to focus on. Why the current accounting systems don't really help and how granular data that can be turned into useful information can help in understanding where the profits are really made. Understanding who to focus on is another step towards building customer loyalty and retention, more effective cross-selling, improved direct marketing campaigns, and marketing 'one to one' or more pragmatically to "a segment of one."

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Michael Meltzer

Michael is an associate director at DMR Consulting, with over twenty years experience as an end user and consultant in Information Technology. He has authored many articles on banking and computing using the customer focused approach, and is a frequent speaker at industry conferences. With a first degree in marketing and an MBA, Michael is ready to help your organisation create your own sustainable competitive advantage. He specialises in three related areas: e-business, Customer management, performance management and benefits realisation with an overall emphasis on Customer Relationship Management.

Michael can be contacts on: +44 (0) 20 8917 1000 or
via email : michael_meltzer@dmr.ca

CUSTOMER RELATIONSHIP MANAGEMENT PAPERS BY MICHAEL MELTZER:

⇒ Getting Started With SDW
⇒ Business Case Blues (Building A Business Case)
⇒ Discovering the Value of Customer Information
⇒ Are your Customers Profitable (What About ABC)
⇒ Effective Channel Management
⇒ Customer Retention, Development and Acquisition
⇒ Understanding What Do Consumers Value?
⇒ **Segment Your Customers Based On Profitability**
⇒ Customer Profitability just isn’t enough
⇒ Integrating the Call Centre with the Data Warehouse
⇒ Data Mining Dispelling The Myths
⇒ ALM With A Customer Focus Forms A Virtuous and Profitable Cycle
⇒ How to Recreate Customer Intimacy for Profit
⇒ Channel Management the Dilemma Remains
⇒ Driving Customer Retention, Development and Acquisition in the Insurance Industry (with Chris Saunders)
⇒ Survive and Prosper by using Customer Information - an Insurance Perspective
⇒ Customer Profitability Just Isn’t Enough
⇒ **e**-Mining Myth & Magic
⇒ e-Insurance a CRM Perspective
⇒ e-Demand the consumer connection

If marketing to the right customers makes sense, why do many organisations still count acquisition and increased market share as major strategic initiatives? And why is it that many marketing textbooks still extol the virtue of segmenting the market rather than an existing customer base as a starting point? I f you were starting to build your financial services company from scratch, segmenting the market to identify opportunities might be the right first steps. However established banks and insurance businesses just don't have that luxury. You must look at your current customers for increased profit and insights. The profit comes from greater focus on the right customer relationships to retain and develop whilst the insights enable the institution to profile (the right) potential new customers it wants to attract. The basic premise is that FSP's should first look to customer profitability as a means of identifying the right opportunities for spending their marketing money. With the introduction of new analytical techniques and technology marketing itself is at a turning point. Centralised information made available to the enterprise when sensibly applied in a planned iterative manner is changing the marketer's lives forever.

If You Don't Look After your Existing Customers Someone Else Will!

Existing customers, who needs them?

LETS OFFER NEW CUSTOMERS BETTER HOME LOAN RATES - THE EXISTING CUSTOMERS DON'T CARE????????

The main objective in most companies is to generate new sales in the belief that this leads to profit or increased shareholder value and for many years this has been interpreted as meaning getting new business. The customer once on board may be passed to customer service whilst the sales specialist moves on to the next new customer. Segmentation is a means of attaining a focus for effort and is just one element in a planned marketing environment. Undifferentiated service levels and 'the one size fits all mentality' is fading even when applied to your existing customer base. Yet few marketing texts recognise the existing customer base as a valid place to start segmentation analysis. I assume that many of the texts are written with the student in mind rather the practitioner. It may be that few marketers or even the strategy consulting firms (that have grown wealthy giving marketing advice) really understand enough about financial services, applied accounting or the uses of data warehouse (as a base for CRM - Customer Relationship Management) technologies to offer valuable insights into the segmentation of a financial services companies customer base.

LETS OFFER BETTER RATES FOR NEW ACCOUNTS RATHER THAN PROVIDE OUR EXISTING CUSTOMERS WITH BETTER SERVICES AND PRODUCTS

Marketing

Marketing has been defined as a process which: "consists of analysing market opportunities, researching and selecting target markets, developing marketing strategies, planning marketing tactics, and implementing and controlling the marketing effort" (Kotler). However what is said in the textbooks often describes a world that is alien to the managers that have to actually do the

work. Marketing itself may be at a watershed according to a Coopers and Lybrand study:

Is Marketing Delivering?

- undertaking an ill-defined mixture of activities
- being short-sighted and missing opportunities
- lacking clearly defined responsibilities and accountability
- rarely leading the drive to enhance business performance
- being marginalised in their organisations

To see just how marketing has reached this state I will look at some of the history of marketing in FSP's. Much of the original work carried out by the marketing teams within FSP's has dealt with product extension, creation and simple increasing sales. Few marketing managers were given the opportunity or remit to look at customer relationships holistically. Organisational structures such as profit/cost centres and divisional stratification have often forced them to be parochial. The major access to and usage of technology has been second hand. They have advertising agencies or market research organisations to provide insights into the customer's perceptions of the bank's brand image, products, services and or quality levels. Some have even attempted to measure that still elusive quality - loyalty! There is a need for a new marketer that understands technology and the financial aspects of marketing as they relate to performance enhancement. "….there is less and less reason to believe that the traditional approach can keep up with real customer wishes and demands or with the rigors of competition" Regis Mckenna..

Marketers Must Learn To Use The Available Technology And Then Go That Extra Mile!!

Banks Learn To Market?

It has not been an easy job getting marketing accepted as being needed in some banks! Kotler a major influence on marketing's evolution believes that Bank marketing has gone through five stages and refers to this as "… the slow learning of bank marketing":

1.Marketing is advertising, sales promotion, and publicity.

2.Marketing is smiling and a friendly atmosphere.

3.Marketing is segmentation and innovation.

4.Marketing is positioning

5.Marketing is marketing analysis, planning, implementation and control.

It is stage five that is the most difficult to make happen and of course this article reflects the need for analysis as the enabler for the marketing process to be successful. The essence of strategic marketing is Segmentation, Targeting and Positioning (STP). Banks have been seen to be very slow when it comes to using some of the basic techniques of marketing. "*Banks stand out as one of the weakest industries in effectively segmenting their customers*" (Fred Reichfield Bain & Co)

Segmentation

Targeting

Positioning

Success In Target Marketing

The main area where the marriage of marketing and technology has been successful in the last few years in banking has been the direct/target marketing activity. Bankers discovered what mail order had known for many years that your best customers are the ones you already have. They however did not use this data to cross or up-sell but to profile the existing customers so they could acquire new! These innovative banks created the data warehouse before the term was popularised. They could look at their existing customers and review their current holdings, review credit ratings, profile activity and so on. From this they could create very effective target marketing campaigns to reduce the cost of customer acquisition. FSP's that have adopted the data warehouses, data marts and or online data stores support tools for their approach to marketing have been able to grow their businesses and increase income, whilst reducing costs. The tangible benefits can be clearly measured as can the spin off benefits relating to enhanced customer service and staff morale.

''The Investment Paid For Itself Many Times Over''

The typical results of marketing activity show a 200% to 400% improvement in converted response rates in a direct mail campaign. The actual results vary by product, but a 'rule of thumb' would say that whatever the rate of response was before this approach, it can be multiplied by a factor of 2 to 4 times.

Predictive Models

One UK bank developed a complete array of models that offered the capability to predict each customer's propensity to buy each product in the consumer range. It also was able to pre-score all customers for each of four lines of credit - overdraft, credit card, unsecured loan and debit card. They also considered recent behavioural patterns, cross-sell propensity models and sensibly considered pre-approving applications. This combined approach to marketing and risk management enabled the bank to start thinking about a new way of planning to get a greater share of the customers wallet and to deliver a more focused way of achieving its revenue targets. With limited objectives these projects have been highly successful. The existing customer was used as a template then forgotten by many banks. The more thoughtful of the banks started to see the possibilities of cross

selling and up selling. But to achieve this they needed to look at other factors such as customer value expectations. They also started to look beyond the basic means of analysing and segmenting their customer base.

Customers Create Profits

Banks have attempted to get greater customer focus. They recognised that their customers were the key to provide sustained profitability and increasing shareholder value. As new technology became available many banks central accounting systems moved from being account number based to customer based and they started to build customer information files (CIF). The change to a customer based accounting system kicked off the opportunity for a new use of data warehousing technology. They could now start looking at customers usage patterns at a transaction level as have the large retailers such as Wal-Mart have been for years. But many banks still looked at sample data and used statistical methods to analyse their customer base. This data does not reflect household-by-household information. Profiles taken of particular types of household did not represent the individuals and their likely propensities to act in particular ways. A reliable predictor of future behaviours in humans is actual past behaviour, that is why transactional information is key.

WITHOUT CUSTOMERS THERE CAN BE NO PROFITS!?

The future success of your bank is about knowing as much as you can about each individual customer rather than what you know about all of your customers. Some early adopter FSP's then began to actually implement large-scale data warehouse projects to track customers at a transactional level. The concept as always was to get a holistic picture of the customer from one trusted source.

Customer Relationship Management

Customers could now be viewed from a much richer perspective than simple demographics and social measures. The banks could start looking at psychographic tendencies (lifestyle or activities, interests and opinions (AIO's)) and geo-demographic clusters (uses both geographic and demographic data on the basis that 'birds of a feather flock together'). Customers were tracked over time as their usage and purchase patterns changed as did their lifestyles. The banks then began to embrace the concept of customer relationships and the idea that customer loyalty was something to value.

Activities

Interests

Opinions

AIO's

Through understanding the customer's behaviours banks have been able to better price products and create numerous new ways to treat different perceived customer needs and values. "If you understand how customers behave, and how they prefer to interact with you, you can redesign core product offerings" (Bobby Mehta Vice President Boston Consulting Group). Banks could now spot customers that were likely to defect and attempt to create customer retention programmes.

CREATE SPECIAL TREATMENTS FOR SPECIAL CUSTOMERS

At each turn the banks have been moving towards a greater understanding of their existing and potential customers. They had even begun to understand the need to retain customers. This change has had a major impact in their relationships with many customers. Many banks are now moving towards implementing customer management systems as an approach to effectively profit form their customers changing lifestyle values.

Customer Profitability

How Much Is A Lost Customer Worth To The Bank?

But with all this, the innovators have still been missing that vital ingredient - customer profitability. "Some form of customer profitability analysis is important to all financial institutions, although the level of detail applied will vary ….." (Julie Mabberley) For all their success in improving direct marketing response rates and additional product sales there has been little understanding of each customers profitability let alone the profitability of the product set the customer was using.

There has been no appreciation of what a lost customer costs the bank, or what is the potential profit in acquiring a new customer product by product. However, the key to the profitable success of any customer related action must be based on whether the cost of the activity to be undertaken will add or detract from the current and long term value of that customer to the bank.

Lifetime/Long Term value

The concept of lifetime value (LTV) can only work in the context of a real understanding of existing customer profitability across the range of products and services in the customers portfolio. From this portfolio extrapolations based on lifestyle and geodemographics enables the FSP's to assess an overall lifetime value. ***Customers can be treated in different ways relating to their different past, current and potential value to the FSP.*** A text entitled Advances in Relationship Marketing suggests: "…Companies should segment their market by level of profitability and identify which groups of customers the company wishes to retain and which are likely to provide the most profitable returns. This will help identify the type and frequency of the marketing activity which should be directed towards the different segments" (Moira Clark and Adrian Payne).

By understanding profitability at a customer level the bank can deduce important information: fees charged, account balances, support costs, acquisition/retention costs, channel preferences, and transaction patterns. By having access to the key profit drivers the bank can then create clearly targeted activities to improve profits.

"SEGMENTING BY CURRENT AND POTENTIAL PROFITABILITY SEEMS SO LOGICAL"

The value of implementing customer profitability systems is high but marketing seems to be slow in coming forward. The latest ideas have concentrated on the Marketing Information System (MkIS) "A formal system designed with the objective of creating an organised, regular flow of relevant information for the use and analysis by marketing decision makers" (Marhshall and LaMotte). Others believe an enhanced Marketing Customer Information File (MCIF) is the answer. For all this effort the marketers continue to shy away from embracing "profitability" as a foundation for their work!

Banc One

The need to use profitability as a basis for segmenting an existing banking customer base is well expressed by Craig J. Kelly, senior vice president and director of marketing at Banc One where they have found that the old 80/20 rule does not apply. "We used to think that 80% of our profits came from 20% of our households. We suggest it is far worse than that. In fact, our higher-profit households may in fact represent in excess of 100% of our profits because the unprofitable ones subtract so much" They are one of the banks that has embraced the need for warehouse based profitability measurements. They actually input data from their various mainframes and the MCIF into their data warehouse. Armed with this information Banc One has been creating new ways to target profitable customers with better products and services. It has enabled them to cross sell to the right customers.

THEY ACTUALLY INPUT DATA FROM THEIR VARIOUS MAINFRAMES AND THE MCIF INTO THEIR DATA WAREHOUSE

BANC ONE

If you cross-sell to the wrong customers they become even more unprofitable and you are digging an ever deepening hole for your bank. By understanding your profitability at an atomic level you are able to uncover internal weaknesses that can re-tuned and gain a better understanding of the cost dynamics of the bank.

There has been little love loss between marketers and the bean counters (accountants). Neither really understood what each had to offer and each thought of the other in very unsavoury terms. Accounting has never been user friendly and its historical application in banks has not lent itself easily to the marketing approach. Added to marketing's lack of understanding with the accounting fraternity is their slowly maturing relationship with information technology.

If you as marketers however wanted to get at the profitability of your customers you might expect to be able to get help from your tame accountants. You might additionally think that customer profits are simply the total of account/customer level profits for all the accounts held by the customer - a simple approach that is not so simple apply.

Existing accounting systems just don't cut it!

To determine customer profitability you would normally look to your existing costing systems. These systems which are invariably based on the standard accounting rules will only look at profits for the current year. Accounting systems take no account of the potential profits or losses attached to individuals, customer segments or the range of products they take. Cost attribution is focused on cost/profit centres plus profit and loss reports that eventually roll up to the institutions overall profit and loss statement. The accounting system is not focused on customers or bank performance but on cost allocation. Management accounting systems were created in the industrial revolution (textile industry) and were further developed in the 19th century to account for the railways, manufactured goods, retailing and machine tools. Material costs and direct labour were the largest proportion of total costs in a manufacturer's world and the rest was overhead. In the new world of service-dominated economies the old accounting methods distort profitability.

19TH CENTURY ACCOUNTING SYSTEMS FOR 21ST CENTURY BANKS

Accounting methods tend to be rear facing. They look at activities that occurred in a past period so that a measure for future activities can be created. Almost every activity can be seen as undifferentiated overhead. In many banks the whole accounting process is still geared to an older banking world paradigm and even the use of marginal costing is frowned on (or still not accepted).

There is an opportunity today given the new technologies like Data Warehousing with analytical extensions to refocus accounting systems to reflect what measures of performance are important to your bank. Traditionally, individual customer profitability measurement has been attempted via the General Ledger. The data warehouse augments these systems in that it can drill down below the aggregated data held on the ledger to the original underlying transactions. When incorporated with statistical cost driver data the warehouse can then reveal profitability in many dimensions e.g., divisional, segment, relationship manager/group, customer, channel and product. To achieve this a bank could work towards establishing profitability by simply collecting the relevant data for a profitability model as outlined below. This step in itself is an advance for many banks. A number of banks just don't trust those numbers coming out of their accounting departments.

THE GENERAL LEDGER USES AGGREGATED DATA

Customer Profitability Model

Interest Margins (by account)

- Loans: average balance times (interest charged - cost of funds)
- Deposits: average balance times interest earned - return on funds)

PLUS **Fees and Commissions (by account)**

- Annual or fixed fees (amount)
- Fees per transaction times number of transactions
- Fee Percent times account balance

LESS **Operating Expense (by account)**

- Cost of transactions times number of transactions

LESS **Credit Risk (by account)**

- Loans and overdraft accounts: weighted average balance times provision rate

EQUALS **Customer Profitability (total accounts)**

- aggregate account profitability to individual customers

Adapted from Gartner Group.

OVERALL PROFITABILITY

Interest Income
less Interest Expense
Net Interest Income
plus Non Interest Income
Total Income
less Direct Expenses
less Indirect Expense
less Provisions
=Profit Before Tax

And What Of Funds Transfer Pricing?

RAROC

Once you have implemented this on a data warehouse you can review customer and product/services profitability in numerous ways:

1. Geographic breakdown -
   Branch, region, city, town, village, postal code, channel, relationship manager, plus time stamp etc.,.

2. Activity/event breakdown -
   Transaction type, account, product, division, area, time stamp etc.,.

3. Customer breakdown -
   Customer, household, personal, attributes, personal propensities, segment types, lifetime value, and even as a potential loss value etc.,.

CUSTOMER

ACCOUNT

TRANSACTION/EVENT

You Need A SDW Based Profitability System!

To be able to get from a state of little effective information about profitability to the state outlined above requires working to create a data warehouse based profitability system. A scaleable data warehouse (SDW) solution creates is probably one of the only ways to create the flexibility required to enable FSP managers to finally manage customer profitability over time. Management accounting systems are designed to collect data to enable management to make decisions but they are not useful in a diagnostic sense and don't easily support strategic decisions. They can tell you where you have been but shed little light on the future. They can tell you that you made a loss or are over or under budget, but you really cannot use them for decision support in any real sense.

MANAGEMENT ACCOUNTING CAN TELL YOU WHERE YOU HAVE BEEN BUT SAYS LITTLE ABOUT THE FUTURE!

You cannot really flex a general ledger or ask what-if and then expect it to tell you the truth next time? An SDW enables you to ask what-if, profile customers cost with attributable incomes, and identify revenue enhancement or cost reduction opportunities etc.,. To do all of this you need to be able collate all the interest income generated on a per customer basis and apply it. Similarly you must collect and apply all fees attributable to each customer (or as much as you can get as a start).

USE ACTUAL TRANSACTION DETAIL TO MANAGE YOUR CUSTOMER RELATIONSHIPS

The main problems surface when a FSP has to start apportioning costs. The warehouse/data mart (profitability data mart) as the store of historic transactions can be successfully utilised to enable simple revenue/cost apportionment and recognition rules to be applied. Apportionment rules that are currently accepted in the bank can be used or new more acceptable ones can be worked out. Most costs are shared and support several business units and several products. Allocation routines are often tied to a defined hierarchy and chart of accounts. This was fine when designing for unit profitability measurement because the responsibility centre hierarchy is usually reflected in the overall general ledger system. Unfortunately, these systems are far from optimal to use for product or customer profitability purposes. To break this inflexibility the warehouse can utilise account and customer detail to drive allocation rules. Naturally, how you decide to allocate costs is driven by the decisions you want to make and the dimensions of profitability that you wish to implement. It has also become a fact that many organisations have been stopped from implementing robust performance management systems as in the main they could only use data that was General Ledger based which, by it's very nature holds only aggregated data.

A Scaleable Data Warehouse (SDW) Is Flexible

The beauty of the SDW is that rules can be amended as new information comes to light and as different applications are built. The bottom line to this is that allocation of shared costs among business units, products, customer accounts and channels of distribution is required to make good profitability decisions. The implementation of a data warehouse based cost allocation system gives the flexibility to view the organisation any way you choose together with an ability to access detailed account level information.

THE MODEL CAN DRIVE THE EFFORT TO FIND EQUITABLE ALLOCATION RULES

Many FSP's that have or are now implementing a SDW solution have found that their inability to allocate shared costs was not an inhibitor in moving forward with the profitability model. The model in fact turned out to be a driver for this effort. At the first iteration the proportional split between direct and indirect costs was heavily skewed to the indirect cost side. However, over time, work was undertaken to establish the drivers necessary for the transition to direct costing (and in some cases to Activity Based Costing depending on the FSP's needs) in controlled, reconcilable steps.

As Easy As ABC

Activity-based Costing is a relatively new way of analysing costs and was first appeared in articles by Professor Robert Kaplan, Robin Cooper and H. Thomas Johnson in 1988 Harvard Business school. "***The concept behind ABC is that costing should be much more than a financial system used by accountants: it should be part of the profit making process of the business***" (Julie Mabberly). Within a service environment such as a bank most of the costs incurred are related to overhead and for many years remained undifferentiated. As FSP's tried to get more sophisticated new ways of allocating costs appeared. The attention was then focused on the method of allocation rather than the management of the underlying costs. In many FSP's the allocation method became the basis for the annual budgeting process and many heated discussions. ABC emphasises the need to understand the behaviour of overhead costs and how they relate to products and services. Activities (account openings, payments, system development and so on) in the bank create the need for the services provided that cause costs and the products/services provided to customers create the demand for the activities. Activities are linked to products/services by the assignment of costs to those products/services based on their actual consumption or demand for those activities. The design of an ABC system can involve the following steps:

ABC IS NOW AN ACCEPTED PART OF THE ACCOUNTING PROFESSION'S TOOLKIT

1. Identifying the major activities that take place in the bank;

2. Creating a cost pool/cost centre for each activity in the bank;

3. Determining the cost driver for each major activity;

4. Assigning the cost activities to products/services according to the products/services demand for activities.

Adapted from Colin Drury

The SDW supplies much of the needed detail that will enable an enterprise wide implementation of ABC to be effective. ABC in its self is a tool that enables management to focus its attention on relevant costs. This leads to a methodology to analyse the value chains that exist within a bank. Because ABC can used to create new management metrics behaviours can altered with potentially positive effects on expenditure patterns, operational processes, support activities, and management accountabilities throughout the bank.

''CONSISTENT VIEWS OF ORGANISATIONAL, PRODUCT AND CUSTOMER PROFITABILITY''

Ernst & Young

One large bank was able to provide a much clearer link between its actions, costs and the level of profitability. "Also, Activity Based Costing helped the bank to provide more consistent views of organisational, product and customer profitability". (Ernst & Young).

Data Marts, ABM And The Balanced Scorecard

Once you have built a respectable profitability system within your SDW you could consider putting onto a Data Mart. The DM (data mart) draws it's data from the SDW but it is especially tuned in this instance to handle profitability.
Once profitability measurements become part of the fabric of the bank then you can start implementing other performance metrics. The new view on management accounting is that it should support strategic as well as tactical activities to this end some practitioners are promoting Activity Based Management and the use of the Balanced Scorecard. The idea is to develop measures that enable you to manage the business. This will include reviewing processes and other non accounting based measures. Well it maybe the discussion of how you incorporate these new measures into your bank and the SDW should form part of another article and another time!?

ABM

meets

The Balanced Scorecard

To be able to manage customer relationships and sustain a profitable bank you need to understand customer profitability. One of the only and perhaps most effective way of achieving this is implementing a data warehouse based solution. Once implemented you of course have the benefit of being able to use the derived measure to help drive the business. The SDW also enables the bank to ask what if type questions and move in to data mining.

Don't Segment The Market - Segment Your Own Customers First And Use Profitability To Do It

A bank must segment it's customer base according to the profit it derives from customers. It can then take actions that will enable it to incorporate it's loyal customer base into the foundation of it's own continuously growing competitive advantage!

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Michael Meltzer

Michael Meltzer

DMR Consulting
Status 4, Status Park
Nobel Drive
Hayes
Middlesex
UB3 5EY

Via email: michael_meltzer@dmr.ca
+44 (0) 20 8917 1000