6552 – Customer Profitability

CRMToday.com – Customer Profitability Topics
http://www.crm2day.com/customer_profitability/

AMR Research Customer Profitability Resource Center
http://www.amrresearch.com/content/resourcecenter.asp?id=432

Resource: Database Marketing Institute
http://www.dbmarketing.com/

Conference: Linking Customer Satisfaction to Customer Profitability
http://www.iirusa.com/customer/
see Agenda for company names
http://www.iirusa.com/customer/index.cfm/Link=8/goSection=1
http://www.iirusa.com/customer/index.cfm/Link=9/goSection=1
http://www.iirusa.com/customer/index.cfm/Link=36/goSection=1
http://www.iirusa.com/customer/index.cfm/Link=37/goSection=1

Archived Webcast: How to Use ABC to Increase Customer Profitability (audio seminar)
Originally Presented
Thursday, June 12, 2003
http://www.bettermanagement.com/seminars/seminar.aspx?l=6052

Article: Customer Profitability
http://www.teradata.com/t/pdf.aspx?a=83673&b=119580

Article: Building Successful Retail Strategies Using Customer Lifetime Value
http://www.dbmarketing.com/articles/Art181.htm

Article: The customer is always right? Not anymore
http://www.sfgate.com/cgi-
bin/article.cgi?f=/news/archive/2004/07/05/national1332EDT0564.DTL

Article: CRM Today: The Role Of Billing In Customer Profitability
www.crm2day.com/highlights/EpuFpykpykMFDHxUra.php

White Paper: Customer Profitability
http://www.grantthornton.com/downloads/CustomerProfitability_9-6-04_102405.pdf

White Paper: Managing Customer Profitability And Economic Value
http://www.crmproject.com/documents.asp?grID=347&d_ID=2906#

One-on-one: Customer profitability

Business leaders everywhere are under intense pressure to cultivate more profitable customer relationships—to understand and accelerate customer equity growth. But, what is customer profitability, and how does measuring it give you insight into the true value of your company? Why is measuring customer profitability increasingly important to companies and their business strategies? Dr. Sunil Gupta, Meyer Feldberg Professor of Business at Columbia University, explores answers to these questions in this exclusive one-on-one interview with Teradata Magazine. Specifically, Dr. Gupta discusses:
The push toward customer profitability as a new trend. Why is it happening and what does it mean for companies today and in the future?
The difference between customer profitability and customer relationship management (CRM).
The connection between customer profitability and a company's true value.
The convergence between finance and marketing and what that means in terms of measuring customer profitability.

Q. Is the push toward customer profitability a new trend?
A. Firms have been interested in customer profitability for many years. However, about seven to 10 years ago, customer profitability as a measurable component of marketing really started to evolve for three main reasons.

First, we now have the technology that enables us to store millions of data points. Second, in the last 10 years the sophistication in analytics and modeling has increased immensely. These models allow us to turn customer data into knowledge.

The third catalyst is the push for marketing to be more accountable. The emphasis on marketing metrics has greatly increased. More and more managers are asking themselves, "How do we know we're getting a return on our marketing expenditure?"

Before these three changes, businesses paid attention to profitability—just not on a customer-by-customer basis. The attention and analysis was focused on either product-level profitability or on broad customer segments. Now, because of increased data storage and analytical and modeling capabilities, we can drill down to customer-level detail. And because of the need for marketing to be more accountable, we know we need to get to that level.

Q. What is difference between this push toward customer profitability and current customer relationship management (CRM) programs?
A. Early on, CRM programs simply collected data at the customer level. There is a huge difference between that and converting CRM-based data into customer profitability.

The first fundamental component for understanding customer-by-customer profitability is understanding the revenue and the costs for each customer. However, most companies' accounting systems do not allocate costs on a customer-by-customer basis. To turn CRM data into a customer profitability model, a company must switch from activity-based cost accounting to customer-based cost accounting. This means allocating costs by customers.

The second component is to move away from a brand management focus to a customer management focus. In a brand management model at a bank, for example, one manager handles mortgages, another checking accounts and another credit cards. The managers don't know how any one customer interacts across the entire business. For each product, a customer may be a low-value customer, but he may be very valuable across the entire organization. Yet because the brand managers cannot know this, they may under-invest in the customer. If the bank followed a customer manager model, however, the customer's true value would be apparent and could be managed accordingly.

One of the best examples of the customer management focus is Harrah's. This company had numerous individual properties that were managed as separate profit centers. But once the company linked customer activity from property to property, the company could do a much better job of cross-marketing.

It's important to be able to change the focus so that brand or property or departmental managers don't manage customers and their information, but rather, the central organization of the company does.

Q. Are boards of directors or company managers driving this trend toward customer profitability today?
A. The real reason is the push for marketing to be more accountable. The typical response of a marketing manager used to be, "I will improve customer satisfaction." Knowing customer satisfaction levels is fine and important, but it's no longer enough. Now senior management wants to know the return on that investment so they can understand exactly how much they should be spending to improve satisfaction.

Q. So is there a connection between customer profitability and the actual value of a company?
A. Yes. Revenue comes from customers buying products. If you can value one customer, you can value the entire customer base of a company. Then you can project at what rate the company is acquiring customers and at what rate they are leaving. Combining those components enables a company to derive the projected value of the customer base, which should be close to the value of the firm. Our research shows that customer value provides a strong proxy for company market value.

Q. Where is the convergence between finance and marketing? Do you think there is a difference between customer value and customer profitability?
A. CEOs and senior management both care about the market value of the firm. Typically market value is estimated as discounted cash flow. The critical component in this approach is the projection of future cash flow.

What is the basis for projecting cash flow? A common approach is to use past data for this projection. I think this approach is simplistic and potentially misleading.

Marketing takes a bottom-up approach. Our premise is that cash flow is a result of customers buying products. Therefore, we can project cash flow and build the ultimate value of the company from the bottom up by looking at each customer as a building block.

Historically, when marketing talked about customer profitability, the notion was "How do I provide value to the customers? How do I make my product more valuable to the customer?"

What customer profitability talks about is the flip side of customer value—how valuable the customer is to the company. So you can think of it in two dimensions. How do I provide value to the customer and how does the customer provide value to me? If I don't provide value to the customer, he won't buy anything. On the other hand, if he doesn't provide value to me, then should I spend valuable resources on pursuing his business?

In marketing, we say the customer is the king, that we have to provide value to the customer. In finance, cash is king—how much value do I get from this particular customer? Customer profitability brings together these two dimensions.

Q. Are most companies today using cost and revenue to understand customer profitability?
A. Revenue is easier to track because it looks at how much a customer actually gives a company. Customer cost is a harder measure to track because most companies' accounting systems were not designed to track customer-by-customer costs. Unfortunately, this means that acquisition and marketing costs are grouped together and averaged. Slowly, companies are beginning to allocate costs by customers because they can see how many times a customer uses an ATM or frequent flyer cards and so on. But I see plenty of room for improving customer-by-customer cost tracking.

Q. Does the theory of detailed, behavior-based profitability make sense?
A. Yes. It is important not only because it makes intuitive sense, but also because a focus on customer profitability can lead to decisions that are quite different from the decisions based on other metrics, such as market share. For example, higher market share is not necessarily better because a firm may be acquiring low-value customers. One study of U.S. banks found that in the early 1990s, only 30% of a typical bank's customers were profitable over the long run. In other words, 70% of the customers destroyed value! Therefore, instead of acquiring low-value customers, banks may be better off focusing on profitable customers and even "firing" unprofitable ones.

Professor Gupta is a former visiting scholar of the Teradata Center for Customer Relationship Management at Duke University and is currently a visiting professor at the Harvard Business School. His expertise lies in the areas of pricing, promotion and

customer management, and his work in these areas has garnered many awards, including the best paper award for the Journal of Marketing Research. For more information, go to www.exgroup.com.

http://www.teradata.com/t/page/121419/

Customer Relationships: How Profitable Are Your Customers?
Companies that understand total customer profitability can move from decisions based on gut feeling to those based on facts

Illustration by Malcolm Tarlofsky
by Tony LoFrumento, executive director of CRM, Morgan Stanley
Optimize Magazine
April 2003, Issue 22

To be a truly customer-centric business, it's vital that you understand the profitability of every customer.
A key to releasing the value of CRM lies in differentiating your services and offerings in a way that's commensurate with the value of each client. If you don't know the client's value, your company may be misallocating valuable resources. Very profitable customers may be underserved, while marginally profitable or even unprofitable customers may be receiving too many services. If this happens, your most-profitable customers essentially subsidize those less so—an environment ripe for attrition by those most valued.

But simply knowing the profitability of individual customers—while a good start—isn't enough; it's what the company does with the information that counts. So the second requirement of being a customer-centric company is to share customer-profitability information throughout the enterprise. Then, it's essential for all participants in the customer experience to use that information effectively and in the best interest of the overall company—not just a single department.

No business can afford to offer the highest possible level of service to all its customers. The airlines have epitomized this with their first-class/business-class/coach model. As they've shown, it's all about delivering an appropriate level of service based on what a customer contributes to your company.

The evolution toward a customer-centric company requires knowing the current and future value of all your clients. Without this information, a company is essentially flying blind. What level of service or special offers should a customer receive? Which products should receive additional marketing support and budget? Which services should be discontinued? Lacking customer-profitability data, many companies answer these questions by gut feeling. But today, that's simply not good enough. And with high-powered software, it's no longer necessary.

Value not volume
One huge flaw with management by intuition—and a problem that calculating customer profitability can overcome—is the tendency to equate sales volume with success: "We're selling a lot, so we must be making money." This can be extremely dangerous. If a product or segment is unprofitable, then every new customer is actually hurting the bottom line.

Many businesses have had this experience, and it's what happened at one large bank in the early '90s. The bank, working on instinct, dedicated just 5% of its marketing budget to attracting small-business clients, but 15% to attracting college students, which the bank thought would become lifelong customers with high-income potential. The bank also paid its branch sales teams higher commissions for bringing in new students than it did for attracting small businesses. When it actually analyzed the relative profitability of these customers, the bank found it had gotten things exactly backward: The small businesses were actually the bank's most-profitable clients, while the college students were money losers because they tended to use the services of bank tellers on a daily basis, taking out small sums of money. In fact, the bank's internal forecasts showed that the students were costing the bank far more in losses than they'd ever be likely to earn back in profits as nonstudent bankers.

To reallocate its resources, the bank used this customer-profitability data to replace its gut-feel approach. The next year, small-business recruitment efforts received much more of the marketing budget, and the sales force was incented to bring in small-business customers. Within a year, the program to attract college students was shut down.

The extra profitability gained from such programs can be impressive. One bank turned an $18 million loss into a $4 million profit simply by analyzing the profitability of individual clients. The bank had offered retail banking accounts to employees of large corporations who were entitled to low minimum balances, low fees, and other benefits. The bank picked up a lot of customers, and because they were all on direct deposit, these were customers who would rarely be in the branches consuming the tellers' time. Based only on the volume of this program, managers estimated their annual profits at $18 million. But after installing a customer-profitability system, the bank discovered the program actually resulted in an $18 million loss. The basic technology used was a database, calculation engine, and reporting capability.

The bank's profitability system also provided the information needed to fix the problem. It showed that the group was losing money due to lower-than-average balances, lower revenue, and higher expense. Because the profitability system tied every transaction to the account/client level, it discovered that only half the customers had signed up for direct deposit; the other half visited their branches regularly. Having the tools and information, the bank could diagnose, understand, and change the program's costs and offerings. Within a year of the fixes, the program was earning a profit of $4 million. So the bank enjoyed a $22 million turnaround on a problem it would have never even known existed without the ability to measure customer profitability. These systems are usually part of an integrated analytical CRM application.

How many pockets of unprofitable customers are hidden in the customer numbers of every industry you deal with? That's a question you need to ask in relation your own company.

A detailed explanation of customer-profitability implementation follows, but first, a quick definition. Basically, it's the ability to identify all revenue and expenses that can be

attributed to a client or customer. But two views of customer profitability need to be considered:

Current: The amount of profit an individual customer contributes to the company during the current month, quarter, or other unit of time.
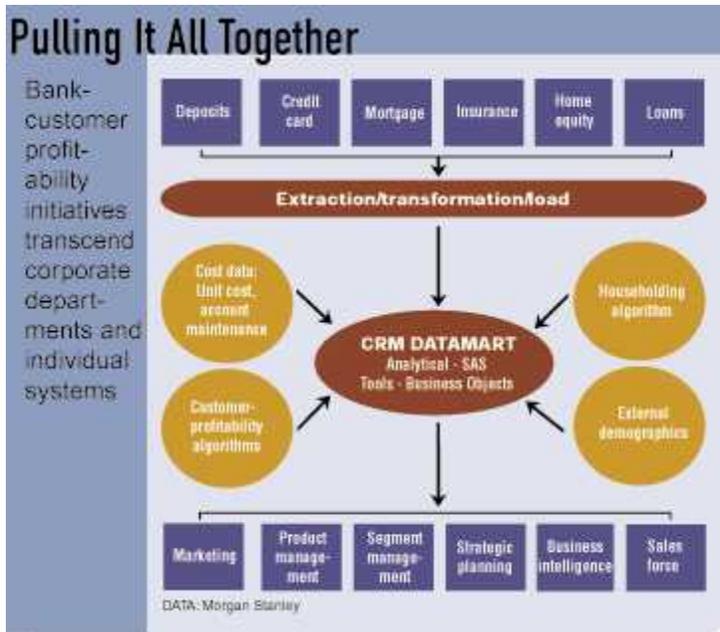
Forward-looking: Also known as the "lifetime value" of a client, this measure considers attitudinal and demographic data—along with economic, growth, and attrition projections—to forecast the likely profits from the customer in the future. For example, a retailer may have two customers with the same current profitability, but one is a 30-year-old surgeon who's just about to launch a lucrative practice, while the other is 65 years old and about to retire. From a potential-profitability point of view, there's a huge difference. Statistical modeling is often applied to the above attributes to derive a lifetime value for a client.
It's critical to understand both the current and future profitability and value of each client. In fact, it's impossible to run successful CRM initiatives without this information. This may be one reason for some highly publicized CRM failures. If you can't differentiate among your customers and you've spent a lot for contact-management software, you can't tell the support staff how to treat one client versus another.

The measurement of customer profitability—determined by subtracting the total cost of serving a particular customer from the total revenue derived from that customer—shouldn't be confused with the measurement of customer loyalty. Loyalty is about attitudes—a client's feeling toward a company (see "The Value Of Loyalty"). That said, profitability and loyalty are two of the most important customer-focused metrics, and they should be evaluated in tandem. The goal is to achieve the highest level of customer-loyalty and customer-satisfaction scores from your company's most-profitable customers or customer segments. The ability to report this information at the customer or segment level, rather than for the total customer base, is critical for a true assessment of the franchise's health.

Silos to households
There's a huge barrier to analyzing the relative profitability of each customer: Most large, multiproduct companies store their product and customer data in data silos. A financial-services company, for example, might have one silo for credit-card information, another for mortgage data, and others for checking-account data, investments, loans, and so on. These silos are great for the individual groups—for example, the credit-card group understands its customers, at least within the context of the credit-card relationship. Yet for calculating the profitability of individual customers, this simply won't do.

Pulling It All Together

Bank-customer profitability initiatives transcend corporate departments and individual systems

Deposits | Credit card | Mortgage | Insurance | Home equity | Loans

Extraction/transformation/load

Cost data: Unit cost, account maintenance

Householding algorithm

CRM DATAMART
Analytical - SAS
Tools - Business Objects

Customer-profitability algorithms

External demographics

Marketing | Product management | Segment management | Strategic planning | Business intelligence | Sales force

DATA: Morgan Stanley

Instead, companies need a holistic view of each customer. Aggregating this customer information is known as householding. People have talked about this for years, often under the heading of the "single view of the customer," but implementation is still rare because information on various accounts is often stored in separate databases.

Imagine that you're a bank client with a $1 million investment account and a credit card. With your level of wealth, you're not likely to be "revolving" the credit card; rather, you're a "max payer," usually paying the entire amount when it's due. You're not very profitable to the credit-card company and, from the credit-card department's perspective, it makes sense to give you a fairly low level of service. But remember, you're a $1 million client to the whole company. If the credit-card group had the holistic view, it would give you the royal treatment—even though you're not one of that group's top clients.

This ability to calculate a customer's profitability is critical. Here are the basic ingredients:

Put all the accounts and associated data in one place—for example, a data mart or data warehouse.

Identify all associated revenue at the individual-account level.

Tie all transactions to individual accounts.

Apply unit costs and account-maintenance costs for each transaction to gain the total cost of maintaining the account.

Calculate account-level profitability.

Household the accounts via a householding algorithm to the customer level.

Calculate the profitability at the customer level.

Reconcile the customer-profitability results with the financial-management reporting systems.

Taken one step at a time, first, you must build or customize a data warehouse or data mart that extracts the account-level information and gathers it into one place. This pulls across all the silos; retrieves all the account information, including names, addresses, and transactions; and consolidates it in one place. Again, this is something that companies have been working on for years, with varying degrees of success.

Next, identify all revenue that should be properly assigned to each account. In banking, for example, this consists of the net-interest income generated by the loan and deposit balance, along with any account-related fees.

Then identify and assign all transactions at the individual-account level. This step provides critical input for calculating the true cost to serve. For example, a retail bank would ask: How many times did the customer visit a teller, use the ATM, contact the call center, transact through on-line banking? All these transactions must be attributed to the customer with the appropriate unit cost. That's how you understand the cost of serving the client or customer. Two clients could have the same balances and revenue profile, but if one is constantly in the local branch while the other is doing all his or her banking online, the latter will be much cheaper to serve. Gut feeling won't show you that.

Once that's done, it's time to implement accepted costing methodologies that assign the proper acquisition, transaction, and account-maintenance costs to each account. If your company has implemented a state-of-the-art activity-based costing system such as one offered by SAS Institute, you're already hitting on all cylinders. But few companies have, and that means they don't have the latest information on their costs. Either way, use the best cost information available to take all your expenses—IT costs, operations, sales force, branches, development, and others—and truly allocate them down to the lowest possible level. Sadly, cost allocation can seem dull, and senior management doesn't often consider it a high priority. Yet, without this information, the quality of customer-profitability data—information that should be used to run the business in a customer-centric company—will be limited.

With all the information available, a customer-profitability "calculation engine" can calculate the profitability (revenue expense) for each individual account. You can then aggregate those accounts up to any level you deem appropriate, whether it's a pricing relationship, customer, household, or customer segment. If you start too high, however, you can't disaggregate below that level. So the best practice is to start with the individual account.

But don't let this simple explanation fool you. A large retail company might need to calculate customer profitability for millions of accounts. To do this, you need a powerful calculation capability such as that found in SAS' customer-analytics application.

The next step is to apply a householding algorithm that looks across the name, address, and social-security number of every account to match all accounts owned by an individual customer. Algorithms can be custom developed by an IT department or bought as part of commercial application. The commercial solution has to be flexible for each

individual company's needs. Next, the householding process assigns a unique customer identifier to each client. So first we discover that John Doe has three accounts with the company; then we assign a common customer-identifier number to each account for a holistic view of the customer. Then, by adding up the profitability of John's three accounts, we know his individual-customer profitability.

If your company has adopted a customer-segmentation approach, and each customer is classified into a segment, you can calculate the segment's profitability instead. Do this by grouping the customers in each segment and adding up their associated customer-profitability figures.

The final step is to reconcile the results. Since there will probably be no comparative numbers at the individual-account or customer level, make sure that what you show as the total profits from all customers is close to, or reconcilable with, the number your company is showing through its financial reporting. This is your reality check. Senior management will not accept and manage by customer-profitability information if the totals don't reconcile with the numbers they're used to seeing.

If the customer-profitability results, for example, show customers are bringing in a total of $10 million of monthly profits, and the financial-management reporting system shows only $5 million, you have a problem. If your results are more than 5% to 10% off from the officially reported profit, then you probably need to adjust your cost-allocation model. Here's where the value of a powerful calculation engine comes in again. You don't want technology to be the limiting factor. Back in the '90s, one bank had an early calculation engine that needed more than 200 hours to run the complete customer-profitability monthly process. It was later replaced with a more advanced engine that needed only 54 minutes. That let the bank work with the cost-allocation model until the finance department was comfortable with the results. The technology was no longer the inhibitor to getting the right results.

Share the wealth
Once you've calculated the profitability of customers, it's time to share that information within your company. There are three main groups that need this data: customer service, call-centers, and other "touch point people"; marketing, product, and segment groups; and senior management.

Most companies believe that giving the first group the exact profitability figures is unnecessary. Instead, it can suffice to classify customers, create rules for how each class of customers is treated, and then share the classifications.

For example, you might decide to classify customers as A, B, C, and D, with A the most-profitable customer and D the least. Next, set rules for what sort of service, fees, and privileges each class of customer can receive. Finally, give a class rating to each customer. This way, when a customer phones the call center, the service representative types in the account or customer number and sees the customer's class—A, B, C, or D.

The service representative would then review the rules to see what level of service, fees, and privileges the customer is entitled to.

The second group—people in marketing, product, or segment departments—generally receives more-detailed profitability data. In many companies, this is information they've never had before. For example, say your company is planning a new marketing campaign. This data should help workers target various clients based on their relative profitability. You can also combine this with data mining to make campaigns more effective. The same is true for your product managers. You can aggregate the data so they can see—often for the first time—exactly what's happening with their product. For senior management, this information will clearly show how different customer segments, regions, and sales channels contribute to the bottom line. They can then use these findings to allocate resources to maximize overall profitability: in essence, to run the business.

For managers throughout the company, the information provided by analyzing customer profits is invaluable. If managers have the information, most will make the right decisions. Lacking this information, they go with gut feeling—and sooner or later, get it wrong.

Tony LoFrumento is executive director of CRM at Morgan Stanley.

Sidebar: 90 Day Plan
To help your company make the right decisions concerning the allocation of its resources to customers, you need to start replacing "gut feeling" with hard facts. The first thing that's needed is a foundation for a customer-profitability system. Here are the ideal starting points:

First month: Turn insight into action

Meet with senior management to understand your company's customer-profitability issues, concerns, and goals.

Identify team members and subject-matter experts in the finance, IT, marketing, product, sales, and segment departments.

Review internal studies and reports on your company's unit costs.

Conduct meetings and discussions to begin developing revenue and expense methodologies.

Second month: Get moving

Begin to identify the gap between the information required by your methodologies to calculate profitability and the information available.

Identify a process to move source data into a data mart or data warehouse.

Gain consensus with your subject-matter experts on which methodologies and formulas to use in allocating revenue and expense components to the individual-account level.

Third month: Gain momentum

Identify financial-management reporting systems and results. These figures will be critical later, when you reconcile the customer-profitability application's results with the company's reported profits.

Begin a review of vendor-provided and internally developed tools for both the calculation of customer profitability and the distribution of this information throughout the company.

Prepare a proof-of-concept report for senior management using live data and the allocation-of-revenue-and-expense components at the account or customer level.

http://www.optimizemagazine.com/issue/018/customer.htm

02849332   790122331
Using Activity-Based Costing to Assess Channel/Customer Profitability

Searcy, DeWayne L

Abstract:
Most firms are well aware of the 80/20 rule in which a small fraction of
customers accounts for a large share of revenues and most of a firm's
profits. As the above quote states, that small fraction of profitable
customers subsidizes the firm's other unprofitable or, at best, breakeven
customers. Instead of accepting the 80/20 rule, firms should strive to
identify those subsidized customers and work with them in either altering
the servicing of those customers (including pricing) to more equitable
arrangement or outsourcing the servicing of those customers altogether.
Temp Employment Company, Inc. (TEC), a firm the employment services
industry, used Activity-Based Costing (ABC) in assessing the profitability
picture in order to better understand which customers were profitable and
which were subsidized. This article describes the journey of TEC's chief
financial officer through the ABC implementation and subsequent analysis.
(Note: The name of the actual company has been changed and the financial
data altered to protect the company's confidentiality.)

Text:
BETTER UNDERSTANDING OF YOUR CUSTOMERS' PROFITABILITY PICTURE
IS IMPERATIVE
FOR SURVIVAL IN TODAY'S COMPETITIVE ENVIRONMENT. HERE THE CFO
OF AN
EMPLOYMENT SERVICES COMPANY USED ABC TO ANALYZE THE
COMPANY'S PROFITABILITY
PICTURE AT THE CUSTOMER CHANNEL- AND INDIVIDUAL CUSTOMER-
LEVEL.
"With better information and accounting systems, firms are beginning to
disaggregate revenues and costs to customer or account level. This analysis
often reveals previously hidden subsidies across customers, products, and
markets."1
Most firms are well aware of the 80/20 rule in which a small fraction of
customers accounts for a large share of revenues and most of a firm's
profits. As the above quote states, that small fraction of profitable

customers subsidizes the firm's other unprofitable or, at best, breakeven customers. Instead of accepting the 80/20 rule, firms should strive to identify those subsidized customers and work with them in either altering the servicing of those customers (including pricing) to more equitable arrangement or outsourcing the servicing of those customers altogether. Temp Employment Company, Inc. (TEC), a firm the employment services industry, used Activity-Based Costing (ABC) in assessing the profitability picture in order to better understand which customers were prof itable and which were subsidized. This article describes the journey of TEC's chief financial officer through the ABC implementation and subsequent analysis. (Note: The name of the actual company has been changed and the financial data altered to protect the company's confidentiality.)

ABC AND THE FIRM

TEC is a multi-office employment services firm offering temporary employment and permanent placements. The temporary employment division represents over 70% of TEC's business and is the focus of this article. Before covering how TEC used ABC information to assess its profitability picture, TEC's ABC implementation will be briefly discussed. Table 1 summarizes the four-step process TEC completed in transforming its cost management system.

Step 1. Develop the activity dictionary.

In the first step, TEC was divided into activities. It would have been possible to divide TEC into several activities, but it was important to develop a simple, yet meaningful, system. Three activities were defined as relevant to the operations of the firm: 1) filling work orders, 2) hiring temporary employees, and 3) processing payroll/billing.

The filling work orders activity begins once an order is received from a customer and ends when the customer is provided with the name(s) of the temporary employee(s) assigned to work for them. The hiring temporary employees activity involves the process of hiring employees for temporary assignments. This activity begins when an application is completed and ends once the employee is debriefed on company polices and entered in the system. The last activity, processing payroll/billing, involves the weekly payroll and customer billing process.

Step 2. Determine how much the organization is spending on each of its activities.

Once the activities were identified, the CFO assigned the direct costs associated with each one. Any resource that could not be directly traced to an activity was initially assigned to a general overhead account. Once the directly traceable resources were assigned to each activity, the general overhead was allocated. Table 2 summarizes the results of assigning the costs to the three activities of TEC. The general overhead was allocated to each activity on the basis of the directly traceable costs of each activity to total directly traceable costs.

Step 3. Identify the organization's products, services, and customers.

As mentioned earlier, TEC offers two services, temporary employment and

permanent placements. Within each service offering, TEC's customers are separated between two channels, industrial and clerical, depending upon the job classification of the position they are seeking to fill. Industrial customers hire temporary employees to fill touch-labor positions (such as assembly, machine operator). On the other hand, clerical customers seek to hire office positions (such as receptionist or secretarial).

Step 4. Select activity cost drivers that link activity costs to the organization's products, services, and customers.

The goal of identifying a cost driver for an activity is to determine the source that causes the consumption of that activity-what drives the activity. The cost driver identified must be quantifiable and reasonably accessible. The three activities and the related cost drivers are discussed next.

FILLING WORK ORDERS

The first activity identified was "filling work orders." As stated earlier, customer service coordinators begin to fill work orders once a customer calls in a request for a temporary employee. If a customer does not call in an order, there is no work order to fill. It makes sense then that the cost driver for the "filling work orders" activity is the number of temporaries ordered by customers. This is used as the cost driver instead of the number of orders generated because an individual order can be for more than one temporary employee. The more temporaries on an order, the more servicing of the account is required. Thus, the number of temporaries ordered is a better indicator of resources consumed by the activity than the number of orders.

HIRING TEMPORARY EMPLOYEES

The company cannot hire temporaries unless someone comes in seeking employment. The cost driver used for "hiring temporary employees" is the number of applicants seeking employment. Each person seeking employment at TEC requires significant resources and time before he/she is eligible for a job assignment.

PROCESSING PAYROLL/BILLING

Processing a paycheck for each employee and generating an invoice for each customer is performed weekly and is based on the number of hours worked. Because each hour worked requires this activity, the number of hours worked during the period in question appears to be the best cost driver for the "processing payroll/ billing" activity.

Step 5. Calculate activity rates for each activity identified.

TEC added another step, which was to calculate the activity rate for each activity identified. The following activity rates were calculated (see Table 2):

The information collected from these five steps was used to assess TEC's profitability at the customer level. Customer profitability analysis was conducted in three stages. The first stage assessed customer-channel profitability (industrial and clerical channels). In the second stage, the information obtained from the first stage was used to assess classes of

customers within each channel. Finally, the third stage involved assessing the profitability of individual customers.

CHANNEL PROFITABILITY

Table 3 displays the profitability picture by customer channel. When the gross margins are examined, major differences between the channels become apparent. TEC's margin in the industrial channel is significantly less than its margin in the clerical channel. The industrial customers demand lower rates for temporary employees, but the tight labor market prevents TEC from lowering wage rates. Also, industrial customers have significantly higher workers' compensation rates than clerical customers, which we will discuss later. Customers in the clerical channel demand quality over price, so a higher bill-to-pay rate is permissible.

In allocating activity cost between channels for the "hiring temporary employees" activity, the CFO discovered there was no easily accessible procedure for determining if an applicant applied for clerical or industrial employment. That information is documented only if the applicant is hired by TEC. For the initial analysis, the CFO decided to use the ratio of the number of temporaries ordered by channel to total temporaries ordered across both channels. Multiplying this ratio by the total number of applicants provided the number of applicants for each channel.

There is some logic with the formula. The number of temporaries ordered determines the types of temporaries needed; this, in turn, forces the firm to focus its energies on hiring those types of temporaries. In other words, there is a close relationship between the number of temporaries ordered and the type of individuals applying for employment at TEC. Procedures were instituted to capture the relevant information during the application process to assign "hiring temporary employees" costs more accurately to the appropriate channel in the future.

As shown in Table 3, the industrial channel comprises only 16% of total company profits, while its sales are over 86% of total company sales. The channel's net profit is only 0.3% of sales. In sharp contrast, the clerical side shows profits of 8.2% of sales. From the initial analysis of Table 3, the CFO began to see potential signs of trouble. TEC's largest customer channel is on the verge of going into the red. The clerical channel does not have enough sales to support the entire company for any length of time. Conclusion: The industrial channel must be an income producer for the overall success of the company. The initial analysis shows overall signs of weakness, but the CFO decided to analyze the industrial channel in more detail by applying ABC to the three classes of customers in the industrial channel to identify problems better.

INDUSTRIAL CLASS PROFITABILITY

By examining the composition of the industrial channel, the CFO discovered it was possible to divide the channel into three classifications by workers' compensation (WC) rates. As previously stated, the industrial customers are charged a much higher workers' compensation rate than clerical customers. In addition, there is a wide range of rates charged

within the industrial channel. The industrial customers are divided into three classes by workers' compensation rates: Low WC class (WC rates under $5.00/$1,000 of wages paid), Average WC class (WC rates $5.00 to $8.99/$1,000 of wages paid), and High WC class (WC rates $9.00 and over/$1,000 of wages paid). Table 4 displays the cost allocation of the industrial channel by workers' compensation rates.

Low WC class

The Low WC rate class is 20% of the total industrial channel, but it is responsible for over 400% of the industrial channel profits. An obvious conclusion is that the company is incurring losses elsewhere (i.e., the Low WC rate class is subsidizing other unprofitable customers). TEC budgeted an 18% gross margin for the industrial channel; the Low WC class's gross margin is in line with the budget. From this analysis, the Low WC class appears to be contributing to the overall success and profits of the company. The goal of TEC should be to maintain the current pricing arrangements for these customers. The company also should look into targeting industries that would fall into this class to increase the sales volume and, in turn, the net profits of the company.

High WC class

As expected, the gross margin is lower in the High WC class than in the other classes due to the large increase in the WC rate. What is surprising, however, is that the wages paid to the temporary employees are over 73% of sales as compared to just over 70% for Low WC class employees. Ideally, higher rates should be charged to those customers with higher variable costs, but the company is unable to do so because of the competitive nature of the industry. The low gross margin is partly attributable to one customer who accounts for nearly 70% of the total sales generated in this class. The customer, a trailer manufacturer, is a consistent user of long-term temporaries. TEC conceded a price break to the customer due to the high-volume use of temporaries.

The High WC class generates a net profit even with the low gross margin. The overhead allocation is significantly less than with the other two classes because of the long-term nature of the assignments of the temporary employees in this class. Only 165 temporaries were ordered during the period of analysis. The low number of temporaries ordered (the cost driver for the "filling work orders" activity) results in the class being allocated less cost for the "filling work orders" activity.

Average WC Class

The last class in the industrial channel to examine, the Average WC class, is suffering from a net loss. The largest class in relation to total sales volume, it is also allocated over 77% of the overhead costs based on the activity analysis and is responsible for only 69% of the industrial sales. Is the Average WC class being penalized with excessive overhead allocation? No. The customers in the Average WC class consume considerable time and effort to service.

The typical job assignments within this class vary from one day to several

weeks. Customers order from one to more than 20 temporaries for these assignments, and customer service coordinators are continually searching for temporaries to fill these jobs. The firm's classified advertisements heavily recruit for employees in this class, and the heavy recruitment means more individuals apply for employment. The Average WC class should be allocated a large portion of overhead. The activity analysis accomplishes that task.

Examining the net profits shown in Table 4 demonstrates the classic whale-curve effect. The Low WC class generates over 400% of total profits while the Average WC class loses over 400% of total profits. This leaves the profits generated by the High WC class comprising nearly 100% of the industrial channel profits. Even at this second stage of analysis, areas that need further investigation are revealed.

CUSTOMER PROFITABILITY

Table 5 summarizes the activity analysis of the four largest customers of TEC according to sales volume. The four customers account for almost 42% of the total sales volume of the company and over 48% of the industrial channel sales. Using activity-based costing, an analysis of these four customers was undertaken to uncover problem areas with them.

Chemical Company

TEC supplies 100% of the chemical company's production and supervisory personnel. Initial results indicate a net profit of 9.8%, much higher than even the clerical channel net-profit percentage. One reason for this is the low overhead allocation to this customer. For example, under the "filling work orders" activity, only 86 temporaries were ordered, a relatively low number. One of the reasons for this is the long-term nature of the assignments. Another reason is the hiring practices of the company. The chemical company has one person on-site to recruit employees. Once the chemical company hires a recruit, TEC is notified about the new employee, and the application is sent to him or her. For these two reasons, the overhead consumed by the chemical company is minimal as compared to other customers. As long as the company continues the use of an on-site coordinator to recruit, it should continue to generate profits for TEC.

Trailer Manufacturer

Similar to the chemical company, the trailer manufacturer requests long-term employees. Orders for the trailer manufacturer are for normal turnover and peak periods of production. For the period under examination, only 56 temporaries were ordered, normal for the time of year. The gross margin for the customer is uncomfortably low due to the billing arrangement with the customer and the high WC rates incurred. Because the customer does not consume a large portion of the activities identified, however, it is not burdened with a high overhead allocation and is generating just over 3% net profit. As long as the trailer manufacturer maintains the low consumption of activities, TEC should be able to maintain the current profit level.

Newspaper Publisher

The newspaper company is a good example of the typical customer in the Average WC class. It manages its temporary employment needs differently from the other two customers discussed. The customer calls daily to order the number of temporaries needed that night, usually ranging from 10 to 40 individuals. Customer service coordinators are constantly searching for temporaries to fill the needs of this customer. The newspaper publisher consumes a significantly higher proportion of activities than the other two customers.

One of the peculiar situations regarding this company is the standing request by a few of the temporary employees themselves to work at the newspaper publisher. As a result, the customer service coordinators only have to call the temporaries and ask what shift they want to work. Even though the company requested 928 temporaries during the time period investigated, some of those requests were filled rather easily. How was the situation handled by the activity-based costing model? Basically, the situation was ignored. The newspaper company was allocated the same rate no matter how easy or difficult it was for TEC to fill the orders. This was one of the deficiencies of the activity analysis performed by the CFO. Table 5 illustrates some startling results for the newspaper publisher, the first being the low gross margin. The culprit is the low ratio of bill-to-pay rates. TEC was required to lower its rates to retain the customer. The low bill rates along with the high overhead allocation result in a large net-loss situation. The company is allocated 27% of the "filling work orders" activity while accounting for just over 6% of the industrial channel's revenue. A similar pattern holds true for the "hiring temporaries" activity. Some tough decisions must be addressed regarding the future of servicing the newspaper publisher.

Food Processing Company

The company uses temporary employees for its production line on a consistent basis throughout the year, with a mix of long- and short-term assignments. As displayed in Table 5, the company generated higher sales than the newspaper publisher, but it only had requests for 332 temporaries as compared to 928. The gross margin for the food processor is the highest among the customers examined, but the high gross margin does not offset the activities consumed by the customer. The bottom-line result is a net loss. As with the newspaper publisher, TEC must address the net-loss situation.

FINAL ANALYSIS

The activity analysis conducted by the CFO generated some startling results. It reaffirmed some beliefs and destroyed others held by TEC's management. The company held to the notion that the sales composition of the company was 60% industrial and 40% clerical. Table 3 clearly indicates the composition as 85% industrial and 15% clerical. This is one explanation for the overall weak profit. As explained earlier, the industrial customers traditionally generate lower profits. Driving the analysis to the industrial channel class provides a richer description of TEC's profitability picture.

Table 4 shows that the largest industrial class, the Average WC class, is generating significant losses. In other words, almost 70% of the company's business is generating losses. What can be done to reverse this situation? An immediate response might be to attempt to increase the bill rates charged, but the industrial temporary employment industry is very elastic, and any attempt at increasing rates will produce an immediate decrease in demand. Another area of concern is the pay rates. TEC has been forced to increase the pay rates due to the low unemployment rate. The pool of temporary employees is small, so they demand a higher rate. Because the company cannot raise billing rates or lower pay rates, the only area available for improvement is overhead reduction.

Some revealing results are encountered in Table 5. TEC's first problem is with the newspaper publisher. The bill rates and pay rates are fixed, so can the overhead allocated to this customer be lowered? One way is to change the way the customer requests and uses temporaries. As mentioned earlier, the customer calls daily with an order for temporaries and is unconcerned whether the temporaries are new or repeats. A preferred method would have the customer call, or be called, once a week with an order for the entire week. The temporaries could be assigned on a weekly basis. Also, an analysis of the number of temporaries usually ordered would be helpful to determine if a small core of long-term assignments could be employed. This method would reduce the consumption of activities by the customer and turn it into a profitable venture for TEC.

A key point: A reduction in the overhead allocated to a customer will not, in and of itself, reduce the overhead incurred by the company.

Activity-based costing does not reduce costs-it only reallocates them based on the consumption of activities identified. As a result, a customer who begins to consume fewer activities without the simultaneous reduction in overhead by the company will only result in a shifting of overhead allocation to another customer, creating a possible death spiral effect.

Once a customer consumes fewer activities, the company must either permanently remove the associated overhead to benefit from the reduction in costs consumed by the customer or utilize the freed capacity to generate additional revenue.

Overall, the activity analysis described here has shown that activity-based costing can be used as a strategic tool. It produced useful information to provide management with direction for costing and marketing strategies. The ABC model used will allow for betterinformed decision making at TEC. Traditionally, TEC used gross margin analysis to set prices and develop budgets. Now it can use ABC for setting prices and developing budgets. This case study also demonstrates that ABC information can be used for more than just costing products and services: It can be used to develop a firm's profitability picture.

Developing strategic initiatives designed to transform TEC's unprofitable customers into profitable customers is the CFO's next challenge. In addition, the activity analysis will assist in bidding for contracts in the

future. Before the ABC analysis, a bid was prepared without understanding the true cost of servicing the contract. As a result, the company was awarded contracts in the past that did not generate profits. By using ABC, the company can better understand the costs associated with servicing a contract and provide a competitive bid that, if won, will be profitably serviced.

Table 1: Four Steps in Developing an ABC System
1. Develop the activity dictionary.
2. Determine how much the organization is spending on each of its activities.
3. Identify the organization's products, services, and customers.
4. Select activity cost drivers that link activity costs to the organization's products, services, and customers.
R. S. Kaplan and R. Cooper, Cost & Effect: Using Integrated Cost Systems to Drive profitability and Performance, Harvard Business School Press, Boston, Mass., 1998.

1 J. N. Sheth, R. S. Sisodia, and A. Sharma, "The Antecedents and Consequences of Customer-Centric Marketing," Journal of the Academy of Marketing Science, Vol. 28, No. 1, 2000, pp. 55-66.

BY DEWAYNE L. SEARCY, PH. D., CMA, CPA
DeWayne L. Searcy, Ph.D., CMA, CPA, CIA, is an assistant professor in the department of accounting at the University of Miami in Coral Gables, Fla. His research interests are supply chain management, lean enterprises, and continuous auditing. He can be reached at (305) 284-4821 or dsearcy@miami.edu.

THIS IS THE FULL-TEXT.

Geographic Names: United States; US

Descriptors: Management accounting; Cost accounting; Financial management; Profitability ; Financial reporting
Classification Codes: 9190 (CN=United States); 4120 (CN=Accounting policies & procedures); 3100 (CN=Capital & debt management)
Print Media ID: 57048

Seven Mistakes in Managing Customer Profitability

Kugel, Robert

Abstract:
Using IT systems to gain a deeper and more comprehensive understanding of
how to maximize profits from customer interactions is still in its infancy.
There is a lot of theory out there, but not enough experience. Companies
have made, and continue to make, a wide range of mistakes in their attempts
to manage customer profitability. Some of the most common mistakes to avoid
include: 1. The project is too complicated. 2. The project is too simple.
3. Critical information is not collected or is inaccessible. 4. The data is
either not trustworthy or trusted by everyone who needs to use it. 5. The
wrong question is asked. 6. The wrong analysis is used. 7. Organizational
issues are missed.

Text:
Taking the right approach can lead to a sustainable competitive advantage
USING IT systems to gain a deeper and more comprehensive understanding of
how to maximize profits from customer interactions is still in its infancy.
There is a lot of theory out there, but not enough experience. Companies
have made, and continue to make, a wide range of mistakes in their attempts
to manage customer profitability. Here are some of the most common mistakes
to avoid:

The project is too complicated One of the promises of large CRM systems was
their ability to gather and organize large amounts of customer information.
Trying to cover all the bases may be counterproductive, because it
introduces too much complexity, which can overwhelm a project and make it
fail. Focus on what is important in a specific area that is likely to
produce a quick win.

The project is too simple At the other extreme, projects have failed
because they tried to do too little. Although the attempt was focused, it
did not accomplish enough to become a worthwhile undertaking outside of the
group using it. It may have been a very tactical approach that was
impossible to use in other parts of the company. It may have been useful,
but only to a specific channel, product, or customer's industry. Quick wins
are important, but there must be follow-through in applying the experience
to other parts of the company.

Missing data Even well-thought-out plans can founder if critical information is not collected or is inaccessible. Most corporations have plenty of accounting data, but they lack operational information. Figuring out how to make the data available or determining a feasible workaround is a must.

Bad data Even when companies have data, it is not always trustworthy or trusted by everyone who needs to use it. Problems can stem from how data is collected, or the use of vague definitions to classify the data. The data may have been derived from accurate information, but not in a way that means the same thing to everyone in the organization (e.g., business units do not calculate gross profit the same way). Understand the source of the data and its quality before you bet your project's outcome on it.

Asking the wrong question "Who are our most profitable customers?" is the obvious first question to ask. Yet if your analysis shows 5 percent of your customers contribute 150 percent of your profits, you probably asked the wrong question-the answer does not lend itself to a useful course of action. Ask, instead, Why are our least attractive customers costing us so much? Identifying the customers or customer types that are unprofitable and addressing this issue maybe the most useful approach to a fatter bottom line.

Using the wrong analysis Avoid relying on accounting measures only. Using the right decision model is critical. A customer may be unprofitable today, but attractive from a life-cycle standpoint. Developing the loyalty of an unprofitable 20-year-old bank customer can produce a fabulously profitable customer in 10 years. Make certain the model you use fits the organization's strategy and objectives. Make sure people in the organization understand what the analysis can and cannot do.

Missing the organizational issues Since the solution to customer profitability issues usually requires some amount of organizational change, there is almost no end to the landmines one can step on when it comes time to implement a project. Having full executive buy-in at the appropriate level is a prerequisite for success. Without it, the chance of failure is high regardless of how well you execute the other parts of the effort.

A CUSTOMER MAY BE UNPROFITABLE TODAY, BUT ATTRACTIVE FROM A LIFE-CYCLE
STANDPOINT

Robert Kugel is vice president and research director of Ventana Research, an IT advisory and consulting services firm

THIS IS THE FULL-TEXT.

Geographic Names: United States; US

Descriptors: Competitive advantage; Customer relationship management; Profitability; Guidelines

Classification Codes: 9190 (CN=United States); 5240 (CN=Software & systems)
Print Media ID: 59452

==MEASURING The Stakes in Tracking Customer Profitability==

Abstract:
Banks that have not yet embarked on the task of measuring customer
profitability put themselves at risk of losing future earnings and not
remaining competitive. Getting the cycle moving isn't easy these days. For
one, many community banks are already pinched for time, saddled with
meeting the regulatory demands of new laws such as the Sarbanes Oxley and
USA-Patriot acts. Yet conversely, there has been no better time for
community banks to undertake developing systems to measure customer
profitability. Data warehouses have proliferated, and client/server
technology has allowed for much more flexibility with data crunching. The
speed and power of processors has increased, while costs have declined. And
storage - required to handle the vast amounts of transaction data - comes
much cheaper than it did 10 years ago. Still, for most banks looking to
start a system, or upgrade one, the effort takes time and investment.

Text:
Picture this scenario: a gentleman applies for an extension on the limit of
his credit card.
Its a modest sum, to $5,000, up from $2,500. Yet his community banker looks
at his credit picture and decides the increase is not worth the risk: the
customer rents his living space, has a new address, and doesn't use his
card very often. No go, the banker says.
Infuriated, the customer closes all of his accounts with the bank.
In this true story, the bank lost the credit card customer, and his
$170,000 in deposits. If the bank had realized how profitable the
relationship was, it would have raised the customers credit line
immediately and maybe even have invited him in for free doughnuts and
coffee.
But the bank failed to look behind the curtain-the gentleman lost his wife
a few years ago, and was looking to use the higher spending limit on his
credit card for some upcoming travel. He was renting because he had
recently sold his house and was in the process of having a smaller home
built. In the end, the bank's analysis rested solely on a product decision,

rather than on the overall relationship, costing the institution dearly. Similar situations are being played out in one form or another at community banks every day, experts say. Banks that have not yet embarked on the task of measuring customer profitability put themselves at risk of losing future earnings and not remaining competitive.

"You have to be out there doing this stuff," said Roy Balkus, vice president of technology at Naugatuck Savings Bank, a $581 million-asset mutual ACB member in Naugatuck, Conn. "It's almost defensive in some respects." Yet Balkus noted that being able to measure customer profitability makes for a good offense too. "We can deliver better service, and by delivering better service we get more profitable," he said. "Its a cycle."

Getting the cycle moving isn't easy these days. For one, many community banks are already pinched for time, saddled with meeting the regulatory demands of new laws such as the Sarbanes Oxley and U.S.A.-Patriot acts. Yet conversely, there has been no better time for community banks to undertake developing systems to measure customer profitability.

Technology solutions have become less expensive and much more widespread, giving financial institutions a variety of options depending on their size, staffing, customer base, and other needs. And the greater selection and feasibility of setting up customer profitability systems ensures that the very skill of doing so is becoming a necessity in banking.

"Without systems in place to measure customer profitability, banks are not going to have the growth and the bottom-line results they could potentially have," said Phil Hudson, president and chief executive officer of Aspen Consulting Group Inc. in Salt Lake City. "They are missing a significant opportunity to enhance their service to their customers."

Banks are unique in the world of services, as huge percentages of their customers don't even generate a profit, Hudson added. Estimates vary, yet it's the top echelon of a bank's customer base that puts it in the black: about 20 percent of a banks most profitable patrons generate 190 percent of its profits, according to Hudson. In other words, the top 20 percent generates so much revenue, it compensates for the part of the customer base that loses money.

Problem is, financial institutions are losing profitable customers at a faster rate than their unprofitable customers, Hudson said.

Measuring customer profitability helps banks set many objectives, cross-sell more effectively, and re-price products when appropriate, noted Jay Kassing, president of sales and marketing at Centrax Services Inc., a provider of customer profitability software in Plano, Texas. It also helps banks assess risk and opportunity among potential clients, generate higher return on investment from direct marketing, and institute incentive-base compensation based on profit generation.

"If they are not looking at what is profitable, how are they going to know where their next best growth opportunity is? Or what clients are the most important so as not to lose them? They need to know who they are," Kassing

said.

This is not to say banks should just jettison their least profitable customers-to do so would defy what community banks are all about. Unprofitable customers are untapped potential in the eyes of Thomas Caron, president and CEO at $89 million-asset Bank of Easton, an ACB member and mutual bank in North Easton, Mass.

"A customer who has $300 in a passbook and nothing else-are they profitable?" Caron asked. "We look at those customers not so much as 'We've got to get rid of them,' but what kind of effort have we made to make them a more profitable customer. We don't look at these single relationships as a drain on earnings. We look at them as potential-that we maybe have not done the best job to inform these people that we can offer a lot more."

Financial institutions historically had been hampered by limitations of their core processing systems when it comes to measuring customer profitability. In the 1980s, computer systems allowed transactions to be gathered in order to analyze a product line or a particular business. But they did not go so far as bundling them and distilling it all into a view of a customers profitability, said Kathleen Khirallah, a senior research analyst at Tower Group, a consulting firm based in Needham, Mass.

Yet over the last decade or so, a number of trends have converged to make the science affordable. Data warehouses have proliferated, and client/server technology has allowed for much more flexibility with data crunching. The speed and power of processors has increased, while costs have declined. And storage-required to handle the vast amounts of transaction data-comes much cheaper than it did 10 years ago.

Plenty of community banks are responding. Like many community financial institutions, Naugatuck Savings Bank has been using first-tier data-such as account balances and addresses-to get a snapshot of who is profitable. Using so-called marketing customer information files (MCIF) and "Marquis," software sold by Centrax, the bank targets its customers with the most potential to buy another product using direct mail campaigns. Response rates are in the 2 percent to 4 percent range, depending on the product being promoted.

"If we can increase the number of services that we have with any particular customer-any particular household-the chances of them staying with us are better," Balkus said. "So if we take a four-service customer and make them a five-service customer, then we make them more profitable and we increase the longevity of that customer." Similarly, the system helps the bank make marginal customers more profitable, and some unprofitable accountholders to become moneymakers for the bank.

Still, Naugatuck has only just begun. The current set up has its limitations. Account representatives can pull down an entire account relationship on the screen, but lacking are items such as number of ATM withdrawals, debit card transactions, number of checks written, and teller visits. Who is using voice response units, and who is using online banking? For many banks, this level of information is the next area to tackle.

Without it, the bank has a general idea of who is profitable, but the information is more relative than exact, Balkus noted. For example, the system now can produce a report that would give, say, all the DDA accounts that have balances greater than $5,000, along with names, addresses and current balances. But it won't give information on who wrote more than 15 checks last month and doesn't have online banking.

In the works are plans next year to upgrade to a data warehouse with Naugatucks processor, Brookfield, Wis.-based Fiserv Inc. That will allow the bank to download what it wants from the processor, using the Marquis software to analyze the data to further refine customer profitability.

"Unless you have the data you just run into a wall," Balkus said. "You need to keep digging deeper and deeper and deeper."

Measuring customer profitability also helps banks beat the competition. The Bank of Tampa is a $587 million-asset company with nine offices. Its niche is small business accounts and professionals, such as doctors, lawyers, and engineers. About 40 percent of its accounts are small business owners, another 40 percent are professionals, and the remaining 20 percent are defined as consumers. The bank views itself as high-touch: 20 people sell commercial services-high for a bank of its size-but in line with its strategy of wanting to be close to the customer. As a result, it courts customers that tend to use low-cost delivery channels such as ATMs, online banking, and debit cards.

Measuring customer profitability is all the more important as the system helps give guidance in bidding wars on pricing and terms for loans, and helps the bank stick with its specialty.

"We have to know what the return of a client can give us for that high cost of delivery," said Bill West, an executive vice president at the bank. "You have to stay really true to your niche. And this profitability system allows us to really understand when we are about to make a mistake-when we are about to invite a client into the bank who just won't be able to return what we need to have returned to us."

The bank started shopping around for a software system five years ago, and ended up purchasing three modules from IPS-Sendero: Product profitability, organization profitability, and customer profitability. Bank officials liked how the system gave them the flexibility to define what a relationship is. For example, a firm of eight lawyers might have a trust account and a large line of credit with the bank. If one of the lawyers wants to borrow money to buy a boat, the bank can strategically price its loans based on the value of the relationship.

"If we see that we are making an enormous amount of money on the relationship, then we can be much more aggressive on this loan and feel good about it," West said. "It's a competitive marketplace for all banks. We see loans and they might be priced very skinny and we would say, on its own, its not attractive. But if you know the value of the relationship, you might jump all over that loan."

Overall, the system has helped the bank focus its energies on where it

makes most of its money-and where it loses most of its money-on the account level and the customer level. About 120 percent of Bank of Tampa's profits come from 20 percent of its clients. "It's very important to know who those 20 percent are and where your biggest losses are coming from so you can develop strategies to improve the profitability in those accounts you're not making money on."

The system also helps them to tinker with existing products to make them more profitable, such as raising break-even points. For example, West says the bank couldn't figure out a way to make $10,000 equity lines of credit profitable, as costs of getting them closed and administered made them money losers. The bank as a result raised its minimum home equity line of credit to $25,000, its break-even point.

Similarly, account officers were able to look at relationships with multiple notes outstanding and get customers to consolidate them into one loan with the same payment terms. The result ends up saving the bank money on the processing end, with fewer loans to process. "We didn't let anybody go as a result of reducing the number of notes," West said. "But we had increased our capacity without having to add folks. So we have gotten some really good efficiencies just knowing how much an event costs."

First Federal Savings Bank, a $671 million-asset bank holding company subsidiary in Elizabethtown, Ky., has used Marquis software since 1999. The bank is now monitoring parameters such as how many visits customers make to bank branches, how many checks are clearing, and how many times they use a debit card.

"We have worked on getting the profitability as accurate as possible based on the customer usage of the bank," said Angie Skaggs, a marketing manager at the bank. "You can put a value to what that customer is costing the bank. Now we can identify the customer who is making the bank money-big money. When we are looking at the top-10 percent, we want our banking centers to know who those customers are. If we know they have their checking account and mortgage elsewhere, then we can go after that customer because we know they have got more."

Those top customers get a little extra tender loving care, with Skaggs making sure this group receives birthday cards and the first invitations to free seminars offered by the bank. "We open up to everybody but we want to make sure the top-10 get special treatment. You have to take care of that group."

Of course, measuring customer profitability doesn't come in a snap. Installing a system takes months or even years to perfect. One sticking point is coming up with accurate costs to plug into the system. "The hardest challenge for most community banks is assigning specific costs to products and services," said Kassing of Centrax. "You make a lot of assumptions when doing it."

One solution is to use the Federal Reserve's annual functional cost analysis figures, but these are just averages that might not work well with banks with specific niches. Early in the process, West and his colleagues

at Bank of Tampa realized using pre-baked averages would turn the system into "guessing software." The bank then started from scratch. Bank functions were defined, and officials took every dollar in the general ledger and allocated them out to those functions, which were in turn rolled up into products. Then the products were assigned to the clients to give the bank its customer profitability readings.

Still, for most banks looking to start a system, or upgrade one, the effort takes time and investment. Hours must be devoted to taking on such a project, and working with a processor's schedule for upgrades takes advanced planning. At Naugatuck, Balkus is the point person on technology, and his time must be budgeted into the project. Balkus' time was booked for 2003, pushing out the upgrade to mid-year 2004. "Time is as much as a problem as the money," Balkus said.

Another obstacle to measuring customer profitability is cost. Estimates vary widely, yet Hudson of Aspen Consulting noted that most community banks could get by with one to 1.5 dedicated full-time equivalents. This is the case at Bank of Tampa, which has 1.5 FTEs devoted to maintaining and building customer profitability.

In terms of product, a number of affordable solutions exist on the market. Marquis can run as low as $8,000, and banks generally spend $15,000 to $30,000 on the software. Other players include Fiservs IPS Sendero unit, and companies such as Harland Financial Solutions Inc. in Atlanta, and Bostons PCi Corp.

What type of system a bank purchases doesn't rest on cost alone, but its own needs as an institution. Two banks of similar size might have different technology capabilities, or varying marketing staffs. "There is more than one firm that is capable of providing this ability to measure customer profitability that is affordable to community banks," Hudson said. PCi sells Market Wiz, an MCIF tool that is good for banks that want to outsource the bulk of profitability measurement. The firm will take a bank's files, massage the data, provide back information relative to households, and help the bank understand who is profitable and who isn't.

As part of the planning process, banks need to involve multiple departments. Information technology staff should play a big role in making purchasing decisions, said Skaggs of First Federal Savings. Accounting can supply processing, salary costs, and other financial information needed for building a model. Strategic planning and marketing staff can also lend input. The overarching goal is customer retention. "It's a lot cheaper to go after a customer you already have, rather than do shotgun advertising in the newspaper," Skaggs said.

When building a system, community banks should look at measuring customer profitability as a long-term commitment. "This is not a plug and play endeavor," said Khirallah of Tower Group. "It requires time, effort, and investment."

"If we can increase the number of services that we have with any particular customer-any particular household-the chances of them staying with us are

better."
Charles Keenan is a freelance writer in Brooklyn, N.Y.

THIS IS THE FULL-TEXT.

Geographic Names: United States; US

Descriptors: Community banks; Profitability; Information systems; Relationship marketing
Classification Codes: 8100 (CN=Financial services industry); 9190 (CN=United States); 5240 (CN=Software & systems); 7000 (CN=Marketing)
Print Media ID: 11302

02583560   326035411
<mark>Top customer profitability pitfalls</mark>

Anonymous

Abstract:
The 7 key factors that keep companies from adopting and using customer
profitability analysis are presented. They include: 1. a lack of
comprehensiveness, 2. manual vs. automated processes, and 3. a lack of
integrity and user buy-in.

Text:
Here are the 7 key factors that keep companies from adopting and using
customer profitability analysis.
1 A lack of comprehensiveness. The majority of customer P&Ls lack enough
detail to provide a true view of total cost and customer contribution. The
most valuable customer profitability analysis captures data across all
functions and includes customer-allocated cost metrics related to
manufacturing, distribution, logistics, sales, trade marketing, order
management, administration and support, and customer overhead.
2 Manual vs. automated processes. Data for customer P&Ls are typically
extracted manually from various sources and entered into a spreadsheet for
review and analysis. This time-consuming process creates inconsistent data
gathering and analysis and infrequent updates, making its use and value
limited. In addition, customer cost and investment data need to be
continually updated, as actuals come in to replace estimates. If this
continuous feed of data isn't automated, it's very likely that it never
will be updated.
3 A lack of integrity and user buy-in. Manual and non-comprehensive
processes create results that tend to lack integrity. Data quality
compounds the issue, as critical data such as promotion cost/investment may
be found only on salespeople's laptops. Data integrity issues cause
business owners to second-guess analytical results and not use them to
engage in a mutually beneficial and productive dialogue with their channel
customers. Without sound data integrity, business owner buy-in is a
challenge.
4 Point-in-time and single use. This needs to be developed and automated
for continuous use and measurement, vs. a one-time tactic for negotiation

purposes or leverage.

5 The process is overcomplicated. Customer P&Ls need not be fully loaded and reconciled to corporate financial reporting statements and systems. The focus should be on business use and reporting vs. financial use and reporting.

6 The "80/20" fallacy. Promotional investment and spending are no longer representative of total investment and the cost of doing business with a customer. Years ago, an understanding of customerspecific trade promotion ROI would have provided manufacturers with 80 percent of the cost category of investment in a total customer profitability analysis. Today, size, complexity and individual customer requirements generate other significant costs and investments critical for accurate analysis, such as freight, inventory carrying cost, HR support investment, displayready pallet cost, "nuisance fees" and so on.

7 No linkage to strategy. As industries have rushed toward a solution, putting technology before strategy was a key shortfall. Companies must develop a transformation roadmap and plan for how they will use this type of analysis to affect their bottom line. How customer profitability analysis will be used is a key element to developing a strategy. An effective strategy and the use of customer profitability analysis should outline mutually beneficial (to manufacturer and customer), measurable and actionable uses and results. The manufacturer and the customer can engage in reinvestment dialogue, using the analysis to highlight mutually ineffective and inefficient activities such as returns, unsaleables, random-case picks and emergency orders - that are driving cost and, therefore, investment that could be more effectively reallocated and reinvested toward mutually beneficial activities, such as consumer marketing, branding and retailer equity development.

For more details on how companies use customer profitability analysis to decrease costs and increase cash flow, contact Marc Shingles, Customer Profitability, Cap Gemini Ernst & Young, at marc.shingles@cgey.com.

THIS IS THE FULL-TEXT.

Customer profitability

Anonymous

Abstract:
Increasingly, consumer products companies wield greater individual influence over the balance sheet. It is no surprise, then, that corporate leaders of consumer products companies are more carefully scrutinizing their relationships with trade customers. In particular, they are weighing the cost to serve those customers against the resulting revenue. The goal is to uncover strategies for making each customer more valuable while ensuring a lasting, mutually beneficial relationship.   It is the latest incarnation of customer profitability. The idea is to provide higher levels of service to customers that deliver greater profits. Although few have perfected it, the approach is becoming mainstream as executives recognize the value of a strong customer focus. Now, executives at consumer products companies are taking the same approach to their trade customers. They are developing strategies to analyze customer profitability to determine the total cost to serve each customer, identify ways to reduce those costs and take actions that ensure every customer relationship is as profitable as it can be.

Text:

Is the Customer King - or Cost?

Consumer products companies compete fiercely for the business of large retailers. Customer profitability analysis can ensure that those efforts deliver positive return on investment.

WHEN WAL-MART BECAME THE WORLD'S LARGEST COMPANY LAST year, the achievement reflected a decades-long trend in the U.S. economy away from manufacturing toward services. Yet there was an additional implication for consumer products companies that serve large retailers: Increasingly, such customers wield greater individual influence over the balance sheet.

It's no surprise, then, that corporate leaders of consumer products companies are more carefully scrutinizing their relationships with trade customers. In particular, they're weighing the cost to serve those

customers against the resulting revenue. The goal is to uncover strategies for making each customer more valuable while ensuring a lasting, mutually beneficial relationship.

It's the latest incarnation of customer profitability, a concept that began to take hold a decade ago among financial services providers and other organizations that directly serve consumers. The idea is to provide higher levels of service to customers that deliver greater profits - and upsell or even shed customers on the lower rungs of profitability. Although few have perfected it, the approach is becoming mainstream as executives recognize the value of a strong customer focus.

"The cost to retain existing customers is far lower than the cost to attract new ones," points out Kimberly Collins, Ph.D., a research director for Gartner in Stamford, Conn. "So smart companies are investing in ways to identify and better serve their most valuable customers."

Now, executives at consumer products companies are taking the same approach to their trade customers. They're developing strategies to analyze customer profitability to determine the total cost to serve each customer, identify ways to reduce those costs and take actions that ensure every customer relationship is as profitable as it can be.

The Cost to Serve

There are good reasons for this sharper focus on customer profitability.

"During the past several years, consumer products companies have been increasing their trade spend, providing new services to- trade customers and incurring greater costs to serve them," says Marc Shingles, customer profitability solution/practice leader for Cap Gemini Ernst & Young U.S. LLC (CGE&Y). "Much of this activity has been driven by competitive pressures as manufacturers strive to build more solid relationships with large retailers."

It started with services such as vendor-managed inventory. In exchange for point-of-sale data, manufacturers helped retailers optimize inventory levels and automate replenishment.

Manufacturers captured valuable information about consumer behavior, ensured that their products were always in stock and differentiated themselves from less sophisticated competitors. They also incurred tremendous cost. And as large retailers began requiring vendor-managed inventory of all manufacturers, the competitive advantage dwindled.

At LeapFrog Enterprises, a maker of interactive learning products, building relationships with its retail partners is critical to the company's growth net profits for the Emeryville, Calif., upstart increased a whopping 349 percent to $43 million last year, on a 69 percent sales increase to $532 million.

"We look at our partnerships with retailers over the long term," says Michael Wood, LeapFrog's founder and CEO. "We monitor on a weekly and sometimes a daily basis the sales of our major retail partners, their in-stock position, their margin, their inventory, their turns. We monitor our profitability and their profitability very closely, because the

relationship has to be strong on both sides."

"The strength of that partnership determines how many opportunities our ultimate customers - moms and dads and teachers and kids - will have to buy LeapFrog products," Wood adds.

The better the relationship with the retail customer, the more likely the company is to understand the particulars behind the sale - and the potential areas for savings. Consider the display-ready pallets many companies use. According to CGE&Y, end-ofaisle product displays were formerly an activity (and expense) of the retailer but are now assembled by the manufacturer in its distribution centers. This reduces cost and hassle for the retailer while ensuring prime shelf space for the manufacturer. But it also can involve millions of dollars in additional expenditure transferred from the retailer to the manufacturer.

Equally costly are customer-specific product configurations and marketing activities. Increasingly, retailers rely on manufacturers to deliver exclusive products that enable retailers to differentiate themselves.

"Account-specific activities can involve significant cost," notes Shingles. "But most manufacturers don't include this cost in their brand P&L, and the return on this customer-related activity isn't measured."

Finally, large retailers are taking advantage of their size and influence to demand special services or flexibility from manufacturers. For example, they may order less-than-truckload shipments but still expect to pay full-truckload pricing.

Executives are realizing that instead of managing a portfolio of products, they need to manage a portfolio of customers. Notes Collins: "In a 13213 scenario, every customer relationship is valuable. The cost to serve each customer is higher, and the prospect of losing a customer involves greater risk."

A Different Yardstick

All these factors point corporate leaders toward a pressing need to analyze and manage profitability by customer. Trouble is, most companies aren't very good at it, experts say. Service companies such as financial institutions are most effective, while manufacturers lag, reports Forrester Research, based in Cambridge, Mass. That's particularly true for manufacturers that sell through a direct sales force.

What's more, manufacturers haven't been able to map additional revenues to the increased cost to serve retailers - that is, they haven't effectively measured what returns, if any, they have achieved on their service investments. In fact, according to Forrester, customers with identical revenue potential can vary widely in service cost.

"Intuitively, you may know that one customer is high-maintenance while another is highly profitable," says Shingles. "But one manufacturer we worked with found a 300 percent difference in ROI between two apparently similar trade customers" - a situation the manufacturer wouldn't have recognized without thorough analysis. Profitability analysis for another manufacturer, he adds, revealed that "one customer delivered 35 percent

less in gross sales than a large retail customer but contributed 9 percent more in profit."

Consumer products executives know that their companies have long been adept at measuring profit and loss by product, by brand and even by channel. Measuring by product or brand helps them understand product performance, develop new products and pricing, establish sales quotas and create product-oriented goals. Measuring by channel helps them understand how to most effectively reach customers, how to allocate revenue and where to invest resources.

Now, executives want their companies to apply that same level of discipline And expertise to measuring profitability by customer. "What's necessary is a multidimensional approach in which you measure profitability by product, channel and customer," advises Collins. "A focus on product or channel profitability might lead to the elimination of a product or channel used by your most profitable customers. If you lose these customers as a result, your profitability could actually decrease."

You've Got Profits

Still, it's not enough for leadership simply to know that a customer is profitable or not. "You need to determine why the customer is unprofitable," Collins says. "That way, you can identify ways to make them profitable, such as collaborating and integrating processes to reduce costs and streamline operations."

For example, Shingles recalls a manufacturer that was shipping virtually all its products displayready. Yet customer profitability analysis revealed that for one retail customer only 30 percent of those shipments were being used for displays, while 70 percent ended up as regular shelf stock. The solution to this waste and added cost was to work with the retailers to learn which shipments would be displayed. "A simple code in the electronic data interchange (EDI) between the two companies, or better coordination among sales teams and order management, could enable the retailer to receive display-ready pallets only when necessary," he says. "The savings could then be reinvested in more value-added activities, such as in-store, consumer-oriented branding and marketing events."

Similarly, retailers routinely return products because the products are damaged, because they didn't sell or for other reasons. The manufacturer incurs the freight cost, along with the cost of quality inspections and determining what to do with the merchandise. "If, through comparative analysis, you determine that a retailer has excessive returns, you can work together to identify the reason for the returns and how to reduce them," Shingles says.

Some consumer products companies, particularly electronics manufacturers, can benefit from customer-specific pricing. Customer profitability analysis provides an objective, equitable way to set pricing in line with government regulations. Instead of basing pricing solely on volume, you can base it on volume plus profitability. Executives can also use customer profitability analysis to prioritize technology and process investments. If costs are

associated with marketing activities, then maybe it makes sense to invest
in a CRM system. If costs are associated with logistics, then perhaps you
need a new ERP system, or maybe you should bring in a logistics expert to
improve processes.
The cost savings that result from greater efficiencies can be reinvested in
the relationship - for example, toward activities such as trade spending
for consumer-oriented promotions. "The goal isn't to use your knowledge of
customer profitability to attack the customer with the information or make
harsh demands that customers change their behavior," Shingles says.
"Rather, it's to have a factbased discussion about ways to work
collaboratively to improve processes that benefit both parties, and
reinvest the savings in more mutually valuable activities."
The New Standard
The next step beyond customer profitability is customer lifetime value.
"You need to understand which customers have a large upside potential and
which are maxed out," says Collins. "Some customers may be unprofitable
today but have a high future value. So you want to invest in those
relationships."
Such a forward-leaning stance isn't simply academic. Increasingly, experts
say, Wall Street will expect organizations to map customer profitability to
overall financial performance. "Companies will have to be able to take
customer profitability, relate it to financial metrics and report on that
to drive shareholder value," Collins predicts. After all, in today's
economy, the customer is king - but it's all about profits.
Executives are realizing that instead of managing a portfolio of products,
they need to manage a portfolio of customers.
The next step beyond customer profitability is customer lifetime value.

THIS IS THE FULL-TEXT.

Geographic Names: United States; US

Descriptors: Manufacturers; Vendor supplier relations; Profitability; Strategic
management; Customer relations; Retailing industry
Classification Codes: 8600 (CN=Manufacturing industries not elsewhere classified);
8320 (CN=Health care industry); 2310 (CN=Planning); 3400 (CN=Investment analysis &
personal finance); 9190 (CN=United States)
Print Media ID: 16156

http://www.chiefexecutive.net/pdfs/4CEOInsightsfinal_April03.pdf

<mark>Customer Profitability:</mark> To Boost sales Banks Try to Be Mr. Fix-its: Banks and brokers
are trying to tune up loyalty outreaches and boost walletshare by finally moving away
from episodic cross selling to a long-term troubleshooting approach.

TEXT:

CRM pros see promise in an evolving change in how institutions reach out to
customers, with the use of data and service enhancements large and small to
gain customer intimacy finally winning out over quick product-focused
selling.
Ramesh Nair, BearingPoint's managing director for CRM solutions, says banks
and brokers are turning the corner from what he calls "episodic cross-sell"
to more coordinated, customer-centric campaigns based on updated versions
of "know your customer."
Such firms are trying to reorient themselves as advocates for their clients
by becoming more of a solution solver for their problems, in the hopes of
turning customers into loyal advocates for the banks.

These strategies aim to better tap customer intelligence from back office
databases and feed it to the front where the enterprise touches the
customer, whether it's the branch, call center or the Web-something that's
always been a challenge for financial institutions.
The hurdles are technological, strategic and perhaps most significantly,
organizational. Growth by acquisition has led to unwieldy legacy
environments and disconnected product managers, making firm-wide campaigns
to achieve organic growth difficult.
According to a survey released by BearingPoint and the Economist
Intelligence Unit called "Wake-up Call: To Fix CRM, Fix the Customer
Experience Now!," financial firms lack the "brand loyalty" and "deeper"
customer relationships enjoyed by clothing stores and car makers. As such,
Nair says changing perceptions demand a more service-oriented method for
banking and brokering, an approach known as "customer experience
management," or CEM.
Often, CEM is as simple as providing the little things that count. Ft.
Wayne, IN-based Three Rivers Federal Credit Union has trained employees to
seek customer advocacy roles via an interface called cView, a business
intelligence or Marketing Customer Information File (MCIF) system from
Open Solutions. "It doesn't necessarily have to be a sale" that bridges

the experience gap or prevents customer defection, says Jeff Meyers, Three Rivers' president and CEO.

If a customer forgets to grab their license from a canister at the drive-up, or leaves their ATM card in the money machine, staffers know to enter a message into cView, which automatically distributes the details of the situation to every customer contact point. Customer and card can be on the way to being reunited the next time he or she calls, drives up, or logs on.

The cView interface is fed by The Complete Credit Union Solution (TCCUS), an Open Solutions data processing product that overlays an Oracle database. "It's a big acronym, but it does a lot of things," Meyers says.

The platform allows the cross-matching of transaction histories with product usage to better inform the employee of a customer's potential needs. Marketers can query the system for statistics on car loans, for example, and pitch customers based on where they are in the loan cycle. Such data mining power has freed larger firms from the notion that database consolidation is required to optimize customer intelligence to boost sales.

"The old model of 'I'll build the mother of all databases' never worked," says Nair. "It's too much work. The new approach is to maintain a small set of data in a central environment, which can be accessed by various smart applications, or inform other databases, which can automatically extract or add information without knowing the data structure."

Such a services oriented architecture (SOA), as it's known, should produce accurate datasets, Nair says, like a souped up Internet search engine.

Dreyfus Services Corporation applies such a strategy via its SAS CRM solutions to head off potential withdrawals or fund transfers. The platform applies predictive analytics to customer lifecycle and investment behavior data to elicit products the Mellon Financial-owned, New York-based mutual fund distributor can preemptively offer customers to avert losing their business.

The efforts have cut asset attrition rates from over 22 percent in the late 1990s to around seven percent today, says Prasanna Dhore, evp of Dreyfus Service Corporation, which manages over $170 billion. Mellon acquired Dreyfus in 1994, creating the largest bank manager of mutual funds at the time.

Dreyfus now offers products across Mellon units by segmenting customers into groups based on demographics, transaction and scenario analysis from SAS. If clients are simply adding money to their accounts, the firm pitches an "Auto Asset Builder" on its Web site, a tool which automatically transfers money from a checking account into an investment account. Older customers can receive queries from Mellon's trust services group, whereas performance issues will trigger the firm to solicit customer interest in other of its over 140 funds, "so they don't have to leave the complex," Dhore says.

First Citizens Bank also uses SAS CRM in a proactive fashion. Douglas X. Berlon, vp of marketing at the bank, describes the power of the tool

succinctly, saying: "We satisfy our customers' needs sometimes before they realize they have (them)."

Encouraging staff to maintain vigilance, not only in collecting data, but in using it in customer interactions and then keying in results is vital, "because the tools (only) work well based on data quality," says Eduardo Agra, CIO for Banco Galicia, based in Buenos Aires.

Galicia uses Cognos Power for on-line analytical processing (Olap), which interacts with a data warehouse from Teradata, a system based on "a logical banking model" developed by NCR, the vendor's parent. The bank's direct marketing department uses the data warehouse to determine segment offerings based on responses to previous campaigns, cross-selling indexes, delinquent behavior and other customer profiles. The sector is later filtered to eliminate potential conflicts with ongoing campaigns.

Channels are then selected, the specific workflow determined, and scripts are given to officers and the campaign is launched. Each contact and response is later loaded onto the data warehouse for follow-up and management.

Galicia uses Telesoft CRM, developed by local vendor Sistemas Estrategicos, in its call center, which interfaces with the bank's custom-made system for retail banking. The main operational stores are on DB2, a widely used, SQL-based IBM relational database originally developed for mainframes. The tools push clean summaries of client information to the branch or call center. This includes credit behavior, campaigns in which the customer is included, and all of his or her products, whether active or in request.

"This allows the officer to attend the client in a highly personalized way," Agra says.

Company Names: DREYFUS SERVICE CORP
Industry Names: Applications software; Banking; Financial services; Software
Product Names: National and state commercial banks (602000); Applications software packages (737263)
Concept Terms: All market information; All product and service information; Applications; Marketing campaign
Geographic Names: North America (NOAX); United States (USA)

http://www.banktechnews.com/article.html?id=200501038111VQQU

03054886 (THIS IS THE FULLTEXT)
1st Union Profitability System Covers All Units
(First Union's new customer profitability system analyzes costs/profits of clients in each business system; quarterly reports will be broken down by segments)

TEXT:

BY MEGAN J. PTACEK
First Union Corp. raised the curtain this week on what may well be its biggest achievement yet in getting a handle on customer profitability: a system that analyzes the costs and profits of customers in every business unit.
The Charlotte, N.C., banking company said Tuesday that it has fully implemented a system to apply consistent standards of profitability and account reporting to each business line, including capital markets, capital management, and the retail bank.

The comprehensiveness of the system is a key attribute. It will gather financial information from sources throughout First Union, "and the single platform will provide consistent methodology and information throughout the organization," said Beth Gibson, senior vice president and director of profitability measurement and design.
Beginning with its first-quarter earnings report, the new profitability system will let First Union give economic and profit indicators by segment in its quarterly reports, Ms. Gibson said. She came to First Union three years ago from Chase Manhattan Bank to design, develop, and implement a profitability system that would help the bank make strategic decisions.
The next step is to begin devising and executing strategies for making customers more profitable, based on the information produced by the system, known as Compas, for "cost measurement and profitability analysis system."
"I don't think I or my group came here only to build a financial information platform," Ms. Gibson said. "The really exciting part is to employ it."
The system, which replaces multiple platforms and vendors, took about 24 months to implement, she said.
Although technology was not a problem during the integration, communication was. "One of the challenges you are faced with in a large organization is communication," Ms. Gibson said.
To overcome the communication obstacles, First Union created a steering

community composed of the chief financial officers of all of the business units. They were charged with communicating the new methodology to their respective units.

First Union built the profitability system on top of Oracle Corp.'s financial services application for analyzing profitability, which includes a performance analyzer and a price transfer feature to calculate margins for individual accounts.

Redwood Shores, Calif.-based Oracle said its financial services application is deployed all over the world and most institutions are using it throughout the bank. Sales of the Oracle system have increased, said Tony Fernicola, vice president of Oracle financial services.

Company Names: FIRST UNION CORP
Industry Names: Banking; Financial services
Product Names: National and state commercial banks (602000)
Concept Terms: All company; Corporate strategy; Financial data
Geographic Names: North America (NOAX); United States (USA)

<mark>Royal Bank of Canada Topples Walls to Boost Customer Profitability</mark>
(Royal Bank of Canada has reorganized to eliminate barriers between personal and
commercial banking divisions, while eliminating redundancies, cutting costs 25%)

TEXT:

By CHRIS COSTANZO
Royal Bank of Canada has put organizational muscle behind an effort to
focus employees on customers, not products.
A reorganization completed late last year has broken down barriers between
the retail bank's personal and commercial banking divisions and eliminated
redundancies, said James T. Rager, vice chairman of Toronto-based Royal
Bank.
Besides saving money, he said, the revamp has increased collaboration among
marketers, salespeople, and product managers.
Before, "everyone had the spirit, but the organization got in the way," Mr.
Rager said.
The handling of people who own small farms illustrates the benefits, he
said. These are unprofitable customers for the commercial banking
division, whose employees would probably would suggest lower-cost delivery
channels, Mr. Rager said. But many small farms are owned by wealthy people
who run them as hobbies -- attractive prospects to a retail banker.
With the reorganization, retail and commercial bankers now work together on
strategies for improving the customers' profitability, Mr. Rager said.
"A lot of business banking customers are potential retail customers," he
said in an interview last week after a speech at an American Banker
conference in Phoenix on retail delivery.
Product managers have been most affected by the realignment, Mr. Rager
said. They must cooperate with salespeople and marketers to ensure that
consumers get only appropriate product offers.
"It's a collaborative approach that's working," Mr. Rager said.
Trimming sales and marketing functions has reduced costs in the product
group by 25%, he said. Those cuts are part of a program aimed at
eliminating $400 million of costs. By next year, Royal Bank wants a 54%
efficiency ratio in its personal and commercial banking divisions. The
ratio has already been whittled down to 57%, from 63% in the quarter that
ended Jan. 31, Mr. Rager said.
Royal Bank is working to make every customer relationship profitable. Only

half are profitable now, but programs such as its retail banking package are intended to change that.

The flat-rate $9.50 a month package, which covers 50 transactions a month, was offered about a year ago to selected high-value customers and to those with potential high value. The bank says it has earned $21 million in new revenue from people who signed up for the package. The product has also increased the bank's ability to retain these high-value customers, because they now have more ties to Royal Bank.

In the past two years, Royal Bank has increased the number of profitable customers by almost 14%, Mr. Rager said. He added that improving profitability customer by customer is a long, tough process.

"You need the organization configured right, the silos need to come down, and you need to check the egos at the door," he said. "It's a multiyear change."

Company Names: ROYAL BANK OF CANADA
Industry Names: Banking; Financial services
Product Names: National and state commercial banks (602000)
Concept Terms: All company; Corporate strategy
Geographic Names: Canada (CDA); Canada (CDAX); North America (NOAX)

Looking for Ms./Mr. right: could your marketing and branch managers pick out your most profitable customers? And if they could, then what?(Customer Profitability)

Text:
  How banks answer the above questions varies widely, but thanks to increasingly sophisticated technology and a rekindled interest in customer profitability measurement, a respectable number of banks would be able to answer "yes" to the first question. However, if you asked those same banks whether or not they have programs in place to hold onto those profitable customers, find more customers like them, and increase the profitability of their less-than-stellar contributors, very few could answer "yes."

  Customer profitability has been bandied about for more than a decade as a way for banks to increase revenues, and although many banks have gotten pretty good at measuring customer profitability, they often fall short on effectively managing what they've measured.

  "The lion's share of banks have the ability to know who their profitable customers are, but they don't always go through the exercise of identifying them by name because they are not sure what they would do with the data once they got it," explains consultant Margaret Kane, president and CEO of Kane Bank Services, Sacramento, Calif., and a former Wells Fargo retail banking executive.

  "The profitability IQ of banks has risen significantly in the last five years," adds Robert Hall, EnAct group executive at Carreker Corp., Dallas. "The remaining challenge is to translate that into effort at the front line in an informed way."

  But not everyone agrees that banks should get an "A" for customer profitability measurement. There is a right wav and a wrong way to measure, and many banks are not looking at customer profitability in the right way, contends Phil Hudson, president and CEO, Aspen Consulting Group, Salt Lake City. instead, they measure customer profitability by looking at lee income, deposits, and loan balances instead of at a holistic picture of the customer.

  Customer profitability is not any more complex than measuring product profitability, contends Hudson, although it does require more effort as you gather data from multiple systems housing siloed products

such as deposits and loans. But the effort is worth it, he believes, because unlike product profitability, customer profitability measurement provides "intelligently actionable information."

For example, although product profitability data can inform you that a product is marginally profitable and spur you to raise lees, he explains, it does not calculate the ripple effect of a profitable customer leaving the bank because she won't pay $12 per year for a previously free debit card. Armed with customer profitability data, you know not to charge those types of fees to valuable customers.

How important is perfection?

Measuring customer profitability is not an exact science and the results tend to be a "constant moving target," says Kane, driven by a large number of diverse and ever-changing factors such as how and where customers perform transactions.

Transaction data is critical to measuring customer profitability, agrees Christopher "Kip" Fowler, president of the Easton, Penn.-based consultancy Blue Mountain Group. "If you are not capturing raw transaction data, then you don't have a full picture of customer profitability. For example, if you lump all your fee income together, you will negatively impact the effectiveness of your profit model."

>From a technology standpoint, systems are available that allocate costs for each transaction and then map every customer account and its profitability back to the general ledger. Integrating the G/L with customer data allows the bank to accurately assess how well each account contributes to the G/L, explains Rich Weissman, president and CEO of Database Marketing Agency, Portland, Ore., whose Integrated Database Marketing System does just that.

Weissman believes this level of detail makes a huge difference in customer profitability measurement, and is easily doable by most institutions.

But do you need to get customer profitability measurement down to the penny? You should try to come close, but this is not an area where perfection will reap huge rewards. And it is that desire for perfection that makes some banks abandon their customer profitability measurements. "A perfect measurement (of each customer) is not that important," says Hudson, and it's unwise to spend too much time trying to determine whether a teller transaction "costs $2.00 or $2.08."

And even if you could get to a perfect number, you would not want to use that number as the sole basis for decision-making, advises Fowler, because customer profitability numbers are--at best--directionally accurate. A customer who makes you a profit of $300 year, for example, is not four times as profitable as a customer who loses you $100 a year.

Chico, Calif.-based Tri Counties Bank ($1.46 billion) focuses less on the perfection of the customer profitability numbers and more on how to use relative profitability numbers to drive results. "You're better off investing money in training your employees to do the fundamentals

correctly, armed with basic information," says Andrew Mastorakis, executive vice-president, sales and service. "You will always do better than if you have costly technology programs that front line people have a hard time using,"

Broadway National Bank, San Antonio, is another institution that agrees with that approach. "You don't have to buy something that is going to take you to the moon and back to measure relative profitability," says James C. Allen, executive vice-president and director of the retail banking division. The key is that you need to include all products and services that a customer has with your bank into a customer profitability calculation. Armed with those less-than-perfect figures, "it's the strategy, the understanding, the communication and the activities," says Allen, which are most important to achieving results.

Manage, not measure

Because technology for measuring customer profitability has become readily available, banks began measuring without understanding the business problem they wanted to solve and how they would manage this newly-found information, suggests Kane.

Broadway Bank has carefully considered how to best use customer profitability data based on its growth strategies and bank culture. Allen explains, for example, how Broadway segments its customer base into five tiers, with tier one being the most profitable and tier five the least profitable--information the bank used when they decided how to communicate a systems change to customers. Understanding that the overhaul would have some impact on customers, such as changing the menu options on the telephone banking system, Broadway determined the most cost effective method of communicating the changes by tier--notifying tier 3, 4 and 5 customers by mail and assigning a personal banker to tier 1 and 2 customers to help them through the change.

Another example of proactively using customer profitability information is during an acquisition. By determining the most profitable customers of the bank you are acquiring, says Allen, you can put on kid gloves and create a game plan of how to introduce your bank to these customers prior to the acquisition being completed.

Don't throw out the baby

Once you find your most profitable customers, "do everything you can to keep them," says Aspen's Phil Hudson. That can be as simple as "preventing them from stepping on all the landmines that a product management mentality creates."

But while it's obvious that banks should work hard to keep the profitable customers, what about those unprofitable customers? Shouldn't you try to get rid of them? Or at least make it less pleasant to do business with your bank in the hopes that they will jump ship and become a drain on your competitor's balance sheet?

In addition to creating bad will that can have a ripple effect throughout the community, moving unprofitable customers out of your bank

only distributes your fixed costs over a smaller group of customers, says Weissman. The key, he believes, is to spread profitability over a greater number of customers by working on making unprofitable and marginally profitable customers more profitable and thereby reducing "profit risk"--the risk of profitable customers leaving your bank. He cites one financial institution that increased earnings by 40% by decreasing their profit risk by 19%. He suggests taking baby steps such as focusing on moving 5% of your customers from slightly unprofitable to profitable each year. "That can be a significant impact to the bottom line," Weissman believes.

Another reason to focus on unprofitable customers and try to move them up the profitability food chain, is that your profitable customers are extremely vulnerable to competing offers from other institutions, says Alan Grant, CEO, Exchange Solutions, Waltham, Mass. Yes, you want to protect your valuable customers, but the reason they are so valuable is probably because you are not giving them any deals.

Exchange provides outsourced customer profitability data based on the value of an individual's total financial holdings.

Out to the front line

For many banks, part of the challenge of how to use customer profitability data is whether to provide that information to their front-line, customer-facing employees.

Broadway Bank has so far chosen not to provide profitability data to its tellers, says Allen, adding that a robust training and education program needs to be in place first. The question then arises, would you train your employees to treat less profitable customers differently? "We try to treat everyone with excellent service, believing that it causes people to want to bank with you," says Allen.

Grant also believes that the front line is ill-equipped to wisely use customer profitability information. "An employee may make a decision that may seem like the right decision given the information in front of them, but may not be the right decision over the long run," he says. "Without an incredible amount of training, I'd rather treat every customer the right way than try to treat customers differently."

Developing appropriate programs for using customer profitability at the front line can be very difficult, agrees Kane, and often the information is better used for centralized marketing programs such as direct mail to persuade less profitable customers to use lower cost transaction channels.

But while you may not want to provide individual profitability data to the front line, you can use such data to identify your most profitable customers and define rules around how those customers should be treated. For example, you may train employees to provide problem follow-up for "MVPs."

Less is more

Since the 1990s, banks have worked hard to develop a sales culture

where cross-selling was seen as a panacea to all ills. The assumption was that the more products and services a customer has with your bank, the more profitable they are. While that may be true in some cases, more often than not banks were surprised at the results of their customer profitability calculations. "Smart cross-selling increases customer profitability but stupid cross-selling decreases customer profit," says Kane.

Weissman likens cross-selling to cholesterol--there is good cross-selling and there is bad cross-selling.

In fact, some of the most unprofitable customers at a bank can have the most number of products. When Tri Counties looked closely at customer profitability, it found that its most profitable customers tended to have home equity loans or lines of credit--as did their most unprofitable customers. The difference in profitability wasn't in the product per se, but in the use of the products.

Based on this information, Tri Counties has "been able to tactically change what we do to become more profitable," says Mastorakis, including training employees not to indiscriminately sell home equity products, as well as educating customers how to benefit from using them.

The rule of thumb, says Hudson, is that cross-selling profitable of marginally profitable customers will probably make them more profitable, but cross-selling unprofitable customers typically makes them more unprofitable. It's not that you don't want to sell unprofitable customers products, but you want to focus on selling them the right products that will increase their profitability, he adds.

Unfortunately, banks often load their customers up on products such as a free checking account, free savings account, a credit card with a $500 credit limit, and an ATM card, each of which is unprofitable by itself, and become even more unprofitable as a combination. However, toss in a home equity line with a drawn-down balance and a mortgage and an automobile loan, and the profitability of the customer changes dramatically.

Even as banks refine how they manage customer profitability and what they do with that information, they are realizing that this data is just one ingredient in the recipe for a successful institution.

"If you take profitability as gospel, no one would ever sell a DDA because you inherently lose money on it," says Fowler, warning: "You're in danger of losing sight of what you are in the business of doing--providing financial services."

By Lisa Valentine, a freelance business writer based in Middle Grove, N. Y.

Event Names: *200 (Management dynamics); 240 (Marketing procedures)
Geographic Names: *1USA (United States)
Product Names: *9914380 (Customer Relations)
Industry Names: BANK (Banking, Finance and Accounting); BUSN (Any type of business)
SIC Codes: 6020 (Commercial Banks)

<mark>Bank of Ireland Implements Customer Profitability Solution.</mark>
PR Newswire , p NA
April 26 , 2004
Language: English   Record Type: Fulltext
Document Type: Newswire ; Trade
Word Count: 987

Text:
  BURLINGTON, Massachusetts, April 26 /PRNewswire/ --

  - Cognos and Fidelity Information Services partner to provide solution to
improve customer profitability -
     The Bank of Ireland, Retail Division, has partnered with Cognos
(Nasdaq: COGN; TSX: CSN), the world leader in corporate performance
management solutions, and Cognos' strategic OEM partner, Fidelity
Information Services, a division of Fidelity National Financial (NYSE:
FNF), to gain increased insight into customer and product profitability.
The Bank of Ireland has implemented PMG System's TruPROFIT solution suite,
which integrates Cognos Enterprise Business Intelligence Series and Cognos
ReportNet. PMG Systems is a division of Fidelity Information Services.
     For the Bank of Ireland, understanding customer profitability means
aggregating customer data collected across multiple touch points, including
deposits, retail loans, mortgages, and credit cards. With PMG's
TruCUSTOMER(TM) and TruANALYTICS(TM) solutions, components of the
TruPROFIT
suite, customer account profitability information is created and the
account level information is aggregated and pushed out to Bank of
Ireland's customer relationship managers, enabling them to segment the
customer base and understand and measure growth in their portfolios. In a
later phase, this level of detailed information will be used to focus
sales and marketing efforts toward their most profitable customer
segments.
     "Understanding what drives customer profitability is the Holy Grail
in retail banking, and implementing the TruPROFIT solution suite brings us
much closer to that goal," said Eugene McCarthy, Head of Profitability
Measurement in Bank of Ireland's Retail Division. "We now have increased
understanding of our customer base, across all product businesses, as well
as the ability to provide our customer relationship managers with
meaningful, actionable information that impacts their decision-making
process. With Cognos and PMG, customer data is much more consumable and
therefore, much more strategic to our organisation."
     "The combined functionality of PMG's profitability applications with
Cognos Enterprise Business Intelligence Series delivers a rapid return on

investment, enabling our clients to have immediate impact on improving profitability and retention," said Frank McKeon, managing director, PMG Systems, a division of Fidelity Information Services. "TruPROFIT enables customers like the Bank of Ireland to understand the value of their customers and more importantly what the key drivers are influencing customer value, thus enabling them to more effectively establish strategy to enhance this value long term."

"Our strategic OEM partnership with Fidelity National Financial enables us to expand our global reach and help our mutual clients understand and improve customer productivity. Understanding the profitability of products, sales channels and customers and how that relates to overall business performance is key to corporate success," said Leo Tucker, director, banking solutions, Cognos.

About PMG Systems:

PMG Systems, a division of Fidelity Information Services, has been recognised as a premier provider of profitability measurement solutions for the financial services industry throughout the past two decades. PMG Systems supports financial institutions worldwide with an integrated profitability solution that provides the knowledge and tools that has enabled those institutions to better understand and manage their business, their products, and their customers via improved product pricing, customer relationship management, resource utilisation, channel management, expense reductions and cost management. With the TruPROFIT suite from PMG Systems, financial institutions can achieve sustained profitability and growth with the only technology and methodology in the industry that provides "the true measure of profitability(TM)."

About Fidelity National Financial:

Fidelity National Financial, Inc., number 262 on the Fortune 500, is a provider of products and outsourced services and solutions to financial institutions and the real estate industry. The Company had total revenue of more than $7.7 billion and earned more than $860 million in 2003, with cash flow from operations of nearly $1.3 billion for that same period. FNF is one of the world's largest providers of information-based technology solutions and processing services to financial institutions and the mortgage and financial services industries through its subsidiary Fidelity Information Services, Inc. Fidelity Information Services processes nearly 50 percent of all U. S. residential mortgages, with balances exceeding $2.5 trillion, has processing and technology relationships with 46 of the top 50 U. S. banks and has clients in more than 50 countries who rely on its processing and outsourcing products and services. Additionally, FNF is the nation's largest title insurance company and also provides other real estate-related services such as escrow, flood and tax certifications with life of loan monitoring, merged credit reporting, property valuations and appraisals, default management, relocation services, flood, homeowners and home warranty insurance, exchange intermediary services, mortgage loan aggregation and fulfillment, multiple listing services software, mortgage

loan origination software, collateral scoring analytics and real property data. More information about the FNF family of companies can be found at www.fnf.com and www.fidelityinfoservices.com.

About Cognos

Cognos is the world leader in corporate performance management solutions, which combine business intelligence reporting, analysis, and metrics management with enterprise planning software to serve each customer's decision-making and performance management requirements. The unmatched breadth of the Cognos performance management software suite gives customers a foundation of consistent information for measuring and managing performance across their entire enterprise.

Founded in 1969, Cognos serves more than 22,000 customers in over 135 countries, selling its solutions and services directly to the world's largest organisations in every major industry. Cognos solutions and services are also available from more than 3,000 worldwide partners and resellers.

Media Contacts:
Brooke Somers
Cognos, +1-613-738-1440
Kristen Orfanos
LP&P, +1-781-782-5852

Investor Relations:
John Lawlor
Cognos, +1-613-738-3503

Web site: http://www.cognos.com

CONTACT: Media: Brooke Somers of Cognos, +1-613-738-1440; or Kristen Orfanos of LP&P, +1-781-782-5852; or Investor Relations: John Lawlor of Cognos, +1-613-738-3503; Company News On-Call: http://www.prnewswire.com/comp/107867.html

Publisher Name: PR Newswire Association, Inc.
Company Names: *Fidelity National Financial Inc.
Descriptors: *Insurance industry
Geographic Names: *1USA (United States)
Industry Names: BUS (Business, General); BUSN (Any type of business)
Ticker Symbols: FNF

Text:
  FIERCE COMPETITION IN THE financial services sector for customer
share is not a new concept.

  Today, customers have more visibility and access to information and
services, and their switching costs from one provider to another is
negligible.

    They have everything to gain and nothing to lose. Preventing
customer churn is important, but equally so is making sure the customer
relationship is a profitable one.

    TARGETING SPEND WHERE THERE'S PROFIT

    Customer portfolio management is a concept which is driving the
world's financial services companies to better understand their customers,
and better manage them relative to how much that customer costs the
provider, and how profitable they are--so the bank or insurer can hone its
spend to where it's more likely to get a better return. Sounds harsh on the
customer that's not spending big--but the reality is that those customers
with a lower profitability, once identified, are much better served through
other low cost channels and services.

    How it works is that companies use a CRM solution--such as
PeopleSoft Enterprise CRM with Customer Portfolio Management capabilities,
to gain better visibility into customer profitability. They can then use
this insight to segment their customers into 'portfolios', which in turn
will help them man age and optimise their customer relationships more
effectively.

    BALANCING THE PROFITABILITY EQUATION

    Sounds simple enough, but the real key is making sure that you can
link the two halves of the customer portfolio management equation.

    The first half involves understanding how to treat each customer,
based on their perceived lifetime value and other characteristics.

    The second half requires driving this knowledge into every customer
touchpoint and business process.

    The net is being able to assess the value and overall profitability
of your customers based on their total contribution--including their actual
value today, their total potential value and the cost to service the

customer

Once customer portfolios are established, companies can then develop specific strategies around each level of customer.

For example, one portfolio might comprise customers who have high actual and potential value, coupled with a relatively low cost to service.

A strategy for that portfolio might be to establish business rules that escalate service issues.

The strategy might also call for creating account plans to increase customer loyalty and growth the customer base.

Another portfolio might comprise customers who are currently unprofitable.

A strategy in response may be to establish business rules that will increase the value of the customer by reducing the cost to service them, through self-service or automated response services.

Once the customer portfolios are established, strategies can be formed and rules made that are enforced through business processes.

THE FLEXIBILITY TO ADJUSTING THE STRATEGY ON THE GO

Understanding and managing customer profitability proactively means that Australia's financial services companies will be able to track performance at a glance and make modifications to strategies for a particular portfolio in real time to improve performance.

All brought to life by a Customer Relationship Management that's fast to implement, easy to use and enables smart business processes.

PeopleSoft

--providing flexible and adaptable solutions for the financial services industry.

Predicting lifetime value.(Customer Value)(most banks calculating current customer profitability, but not lifetime potential)
Bank Marketing International , n 155 , p 5(1)
July , 2003
ISSN: ISSN: 0791-2765
Language: English   Record Type: Fulltext
Document Type: Newsletter ; Trade
Word Count: 581

Text:
  CURRENT CUSTOMER value calculated using transactional detail and activity-based costing can tell banks how profitable customers are today, but does not provide any insight into lifetime potential, according to a survey by Gartner G2.

  Most US financial services providers are calculating current customer profitability, led by the large banks, to provide tiered servicing to customers, its research showed (see chart).
     But using just this information can seriously impact the future relationship with the customer, particularly if it is used to provide lower service or make unprofitable customers mad. Some of these unprofitable or low-value customers may, in fact, be highly profitable customers tomorrow. An understanding of lifetime value is crucial to being able to develop effective marketing, sales and service strategies that will enable firms to improve their bottom line--not just by retaining revenue of profitable customers but by identifying revenue growth opportunities. Yet this difficulty means few providers calculate lifetime value on current and future relationships, or even understand the future value a customer might bring based on existing relationships, Gartner reckoned.
     * By understanding both current value and lifetime potential, providers can make more strategic decisions about customers and customer segments.
     * If customers are low on both current and lifetime value, then improve cost of service, Gartner analysts suggest.
     * Getting rid of unprofitable customers can also impact the profitability of other customers as fixed costs are distributed over a smaller customer base.
     * Don't "fire" these customers but don't expend resources to "salvage" them if they turn up on the likely to attrition list. Instead, allow them to quietly leave by not giving any special breaks or pricing.
     * If customers are high on current value but have low lifetime value, try to maintain these segments by offering services that still keep them profitable, but don't expend a lot of effort on marketing and sales.

This will increase marketing and sales efficiency through cost reduction by not targeting a base of customers who are unlikely to buy. These customers should receive secondary prioritisation for attrition efforts, leveraging moderate-impact channels such as the call/contact center to reach out to customers in this segment at risk of leaving.

* If customers are low value today but have high lifetime value, work to establish trust and loyalty from which they can build the relationship, managing profitability levels as best as possible during the current period.

* This segment represents the best opportunity for new revenue growth. Identify appropriate marketing and sales strategies, and execute these in a timely fashion to capture the upside potential as opportunities present themselves.

* If customers are high on both current and lifetime value, look to enhance products and services to build loyalty and trust to maximise long-term profitability, Gartner recommended. In addition, closely monitor upsell opportunities to deliver timely and relevant messages about new products and services. Also consider developing and migrating this group to a "premium financial services" offering. Put this group as the highest priority on the list of available resources when customer attrition is likely, leveraging high-touch channels (e.g., branch, agent, broker, relationship manger, financial adviser) to reach out to them as soon as possible.

FIRMS CALCULATING LIFETIME VALUE AND PROFITABILITY

	Customer profitability	Lifetime value
Banks greater than $4 bn in deposits	82%	27%
Banks $1 bn to $4 bn in Deposits	56%	8%
Credit card companies	58%	22%
Insurance companies	39%	8%
Total	57%	14%

Base: 97 financial services providers

Source: Gartner G2, May 2003

Note: table made from bar graph.

Publisher Name: Lafferty Group
Company Names: *Gartner Group Inc._Surveys
Descriptors: *Marketing research firms; Activity-based costing; Financial services industry
Event Names: *240 (Marketing procedures); 200 (Management dynamics)
Geographic Names: *1USA (United States)
Product Names: *7392100 (Market Research Services); 6000000 (Financial Services)
Industry Names: BANK (Banking, Finance and Accounting); BUSN (Any type of business); INTL (Business, International)
SIC Codes: 8732 (Commercial nonphysical research)
NAICS Codes: 54191 (Marketing Research and Public Opinion Polling); 52 (Finance and Insurance)

<mark>Achieving the impossible: analysing customer and channel profitability is no easy task, but a division of the Royal Bank of Scotland has implemented a software solution to ease the pain. (Customer Profitability).</mark>

Text:
  ACCORDING TO research undertaken by GartnerG2, through 2005 fewer than half of all financial services providers will have accurate calculations of customer profitability, of which greater than 75 percent will make marketing, sales and service decisions that decrease, rather than increase, profitability.

  Activity based costing is one way of alleviating the problem faced by practically all financial services companies, although in the past, ABC was often perceived as being complicated and time consuming, involving collecting and collating disparate data from across an organisation. However, the introduction of new software solutions has made the task seem less daunting and much easier to implement.

   Kieran Grimley, activity based cost accountant at Own Brand Businesses (OBB), part of the Royal Bank of Scotland's retail direct division, says his company has got to grips with customer and channel profitability using a web-based software system supplied by ALG. The company ran a pilot model for a division of the company, Lombard Direct, which receives 40 percent of its loan applications via the Internet. Altogether, OBB receives 2 million calls every day.

   "It is widely recognised that traditional costing techniques are flawed and may lead to misleading product costs," said Grimley, "but ABC allows you to identify the true cost of your products, customers and channels. It recognises that individual products, channels and customers consume different levels of activity in varying cost dynamics through tracking and tracing resources as they flow through the organisation to individual customers and channels."

   Grimley admitted that before OBB decided to adopt the ABC approach, "there was insufficient cost data for the business to take informed pricing decisions. It was very much a case of we thought we knew, but we didn't know for sure," he said. He also claimed that, "our existing costing systems couldn't provide management information needed to respond to

changes in the external and internal business environments, for example, the development of new channels." The company also wanted to assess the effectiveness of its "rate for risk" pricing strategy.

Outlining the project

According to Grimley, the project was announced in August 2002 and was completed in November 2002, "completely on time and under budget--quite unique for financial services providers!." The scope of the project was to, "identify the product, channel and customer costs for loans, insurance, credit cards and savings products. We also wanted to identify the acquisition, set up, managing and business sustaining costs by product, channel and customer and analyse channel costs between the Internet and the telephone."

He continued, "the project also made us look at issues such as core activities, mainly processing loan applications: how much time would be spent on this and establishing our objectives in terms of a multi-dimensional risk bank--for example, was the customer new or repeat and this is how we looked at customers and costings on different channels."

Activity drivers involved in the project, said Grimley, included analysing data highlighting the number of customer accounts in default; number of customer complaints; number of bank reconciliations completed and the number of in and outbound telephone calls made. "This list is endless, but it depends on the individual company's productivity analysis and it's also important to examine how exactly the data will be used," he said. "The longest job of all is usually collecting driver data which includes interviewing, system reporting, manual analysis of paperwork and sampling."

Once the hard work has been completed, said Grimley, the rewards are evident: "ABC has enabled us to access more accurate product, channel and customer cost data and as a result, more meaningful profitability analysis. The project has also generated a greater appetite within the business to learn more about customer profitability," he said.

Secrets of success

As in most successful projects within financial services companies, management buy-in is crucial said Grimley: "The financial director was the key project sponsor in our project, which made a real difference," he said. "it's also important that you have a clear vision of what you are trying to achieve, with clear and tangible objectives. We found this to be really important as ABC means different things to different people, so it's important for everyone to be working towards the same goal."

Another important factor for success, said Grimley, was to deliver a model within 3-4 months of the project starting. "It's a true saying that a picture paints a thousand words--when we showed people how we were progressing in terms of how it helped them in their function we could see the light bulbs going on and there was real recognition of what was being achieved."

Moving forward in 2003, Grimley claimed that OBB plans to roll out ABC to other parts of the business, including Direct Line Financial

Services. "We also plan to move from quarterly to monthly ABC reporting and embed it into the fabric of the organisation. We will also revise and update existing ABC models and work with the business to develop new customer profitability models."

Although Grimley claimed the project presented several challenges, including reporting, generating management information and how to allocate marketing spend, he is confident that OBB's apparent success can be replicated in other organisations: "customer and channel profitability is an achievable goal and the process is only as complicated as people make it," he said.

Facts and figures: RBS Own Brand Businesses
* Established January 2001
* Part of the Royal Bank of Scotland (retail direct division)
* Umbrella company for Lombard Direct, Lombard Banking Services and Direct Line Financial Services
* Provides a wide range of products including unsecured loans, savings, mortgages and credit cards
* Products sold directly to customers through call centres or the Internet
* Employs over 950 staff in London, Glasgow and Rotherham

SAS Only Vendor to Provide Accurate Measure of Customer Profitability.
Business Wire , p 2411
June 13 , 2002
Language: English   Record Type: Fulltext
Document Type: Newswire ; Trade
Word Count: 597

Text:
  Business Editors/High Tech Writers

  PARIS--(BUSINESS WIRE)--June 13, 2002
    Addition of activity-based costing to customer intelligence
    gives true picture of customer revenue versus cost of service
    Market leading business intelligence software vendor SAS today
announced the addition of activity-based costing functionality to its
existing customer intelligence solutions, enabling organizations to gain a
complete and accurate picture of customer profitability for the first time.
    The announcement follows the acquisition of ABC Technologies by SAS
in March 2002.
    Customer profitability is an equation of revenue generated minus
cost of service. SAS provides the strongest analytical and forecasting
capabilities in the market for determining existing and predicting future
customer revenue. With the addition of activity-based costing, companies
are now able to get an accurate picture of the cost of servicing their
customers and are able to measure customer profitability accurately.
Equally important, they are also able to better assess the cost
implications of activities undertaken to increase customer profitability.
    For example, a company can plan and execute a marketing campaign in
SAS and build check-points early into the campaign to predict customer
response during the rest of the campaign. Using SAS optimisation
capabilities, the company can then model scenarios for improving the
campaign return. If at the check-point the company identifies that a
particular customer segment is not responding to a catalogue campaign, the
company can model the costs and predicted return of switching that segment
to a Web-based campaign. The ability to correctly attribute cost of service
to a particular channel is particularly powerful because the relationship
between channel preference and profitability is not intuitive or linear. A
number of SAS customers have found, for example, that customers using three
channels are in fact five times more profitable than customers using only
one. Therefore, the cost of servicing the customer through all three
channels is more than offset by the increase in revenue.
    "Our customers are using SAS software to get deeper intelligent
insight into their customer base," said Chris Pieper, vice president of

SAS' performance management group. "But we discovered that if they don't have true profit information derived from mapping the cost back to the actual activities they do, then the information they are basing their decisions on is less than accurate. SAS is integrating all of the functionality of activity-based costing into all our offerings so that our customers get quality information about profit from everything they do."

About SAS

SAS is the market leader in providing a new generation of business intelligence software and services that create true enterprise intelligence. SAS solutions are used at more than 38,000 sites - including 99 of the top 100 businesses on the Fortune 500 - to develop more profitable relationships with customers and suppliers; to enable better, more accurate and informed decisions; and to drive organizations forward. SAS is the only vendor that completely integrates leading data warehousing, analytics and traditional BI applications to create intelligence from massive amounts of data. For 25 years, SAS has been giving customers around the world The Power to Know(TM). Visit us at www.sas.com.

SAS and all other SAS Institute Inc. product or service names are registered trademarks or trademarks of SAS Institute Inc. in the USA and other countries.(R) indicates USA registration. Other brand and product names are trademarks of their respective companies. Copyright(c)2002 SAS Institute Inc. Cary, NC, USA. All rights reserved.

09674784   Supplier Number: 84210825 (THIS IS THE FULLTEXT)

Customer profitability -- is it enough? (News).
Franchitto, Max
Australian Banking & Finance , v 11 , n 4 , p 10(1)
March 15 , 2002
ISSN: 1325-1228
Language: English   Record Type: Fulltext
Document Type: Magazine/Journal ; Trade
Word Count: 985

Text:
  CUSTOMER RELATIONSHIP MANAGEMENT demands that you understand which
customers create profits and those that destroy it. However this is just
not enough if you want stay in business in the long term.

  Historic profitability measures just don't measure profitability -
financial accounting systems fail the test. You need something to replace
them that can actually support the business and the business decisions that
must be made.
    Every product and services provider wants to know if they are
profitable or not and financial reporting systems tell them this.
    But they also want to know who and what makes that so and here the
financial accounting systems fail them.
    What also makes sense is to know who are the customers that create
and destroy your profits so you can identify who you don't want to keep or
those you really want to attract.
    So more and more organisations are asking questions about just what
makes up individual customer profitability.
    Initially managers have asked simple questions that reflect simple
needs.
    Simple because few managers have been able to do very much with
highly aggregated and untrustworthy profitability information even when
they could actually tease it out of their financial accounting systems.
    Yet the question of customer profitability is one of the most
important questions that any customer centric organisation can ask.
    They are beginning to ask the more important questions: If I know
who the customers are, can someone tell me why they are profitable, can
they identify or profile others that could become profitable and then tell
me how I can do all this? Information is an asset!
    CUSTOMER RELATIONSHIP MANAGEMENT
    The customer's actions and transactions drives the business - no
customer no business.
    Today the term Customer Relationship Management (CRM) is banded
about by consultants and the press as if the mere chanting of the term can

change the way organisations have done business for decades.

The term is misused for sales purposes by those marketing call centres, sales automation software, Enterprise Resource Planning systems (ERP's) and other systems that will change the way business is to be carried out "tomorrow" - yes well!? Claims made by vendors, sates people and consultants are sometimes true but the success of CRM rests on both technology and organisational change.

This change should start with understanding the profitability of each customer at a granular level and then actions can be planned to make use of the other wondrous technologies and change management practices available.

CRM is a vision founded on customer profitability as its centrepiece. By taking an enterprise-wide focus CRM identifies the customer as the driver of all the business.

CRM IS HOLISTIC

The power of the CRM vision is that it pervades the whole of the enterprise and is founded on the concept of a strategic information repository a scaleable data warehouse (SDW). Information soft and hard is captured from all points of contact: phone, branch, retail counter, call-centre, internet, Value added reseller (VAR).

This information is assimilated into "one version of the truth" that enables decision makers and customer service representatives to make the right decisions and take the right actions that build relationships and enhance profits.

One of the major reasons for this drive to undertake the CRM journey is that it is good for profits and survival.

You may have read about the benefits to be derived from the move from simplistic data-base marketing to critical event driven marketing as a move from push tactics to a customer putt strategy.

The foundation however of any strategy is an understanding of what drives customer profitability and as an exercise in addition what actually drives overall profitability.

CAN YOU USE THE PROFITABILITY SYSTEM?

A good profitability system is more than a tool for measuring.

There is also a problem facing many organisations in how to actually use the profitability system once implemented.

It is not just a financial or management accounting system it is an input for creating a more profitable business.

And as such must be planned for across business units with a clear vision that it has a multiplicity of uses.

It will be an organisational wide solution that supports many business units and this in itself will require a plan for change management that will be supported by senior management. Profitability solutions must be implemented that incorporate multi-dimensional views that see the profits of the organisation as a whore, it is products, channel, business groups, and specifically customers.

THE ROAD TO CUSTOMER PROFITABILITY

On the road to customer profitability many organisations began by attempting to carry out product profitability.

Initially we could see this attempt at product profitability and hence better costing as a manifestation of an organisations' fixation on being product driven as opposed to customer focused.

However even this approach was difficult to implement as a product's profitability was often managed only vertically, from development through sales, with no measurement of costs borne horizontally through an organisation administrative and back-office expenses.

Some manufacturing companies had overcome this problem but the Services industry had found it difficult because of the many attributes their products had.

A television may have many working parts but it performs one function and does not have a range of service or risk elements attached to it. This junction where cost accounting meets CRM profitability is an issue that most service organisations have yet to manage efficiently. This often leads to serious cost-benefit doubts being cast over CRM initiatives within organisations, which in fact may not be justified.

Max Franchitto is managing director of MGF Consulting, advisers in strategic marketing and customer growth and retention through CRM strategies.

08964546   Supplier Number: 77758116 (THIS IS THE FULLTEXT)

Making 'Customer profitability' Mark.
Sutherland, Kim
Bank Marketing , v 33 , n 6 , p 81
July , 2001
ISSN: 0888-3149
Language: English   Record Type: Fulltext
Document Type: Magazine/Journal ; Trade
Word Count: 2458

Text:
  Customer Profitability. Much has been written about this
financial-services industry issue over the past five to 10 years. Many
myths exist about both the process and the uses of the results. Despite all
this discussion, however, efficient execution of account and customer
profitability is certainly not yet a standard in the banking industry.

  We do know that the issue is important. Institutions that prevail and
focus on the appropriate process steps and translate the output into
strategies and initiatives for their sales forces can achieve as much as a
30 percent improvement in average relationship value in a 12-month period.
     This article's purpose is to provide some guidelines about what is
considered to be important in an account and customer profitability
valuation. Your bank can use these guidelines to compare its efforts to
date. And, the guidelines can serve as a template for the bank's next
steps.
     Although there are still more institutions talking about customer
profitability than actually have it, more and more banks are moving in the
direction of obtaining this information. Unfortunately many institutions
have spent millions of dollars in their quest, only to be unsatisfied with
the results.
     Obtaining accurate profitability information is harder than it seems
at first. Here are some of the major barriers to getting this data:
     Not knowing what components truly drive better profitability
valuations. This means you don't know where you can make compromises
without diluting the value of the output.
     Partnering with an inexperienced vendor. Some of them don't have
many customers actively using their profitability modules--let alone
clients that are pleased with the process and outcomes.
     Lock of commitment within the organization to get to the "right"
data. The devil is truly in the details. It's worth spending a little time
to "get it right."
     Thinking you can make a list of fields needed to calculate
profitability and be done with it. Every institution is dealing with its

own universe of available information. It's far more productive to start with what you have than to ask for something that might not exist.

Understanding that it is a "process" and an ongoing effort and not a onetime project. This impacts not only the full-time employees within the organization necessary to support such an endeavor, but also the amount of support you can count on from other areas of the bank that will be affected.

Thinking you can simply publish the information and that it will find its way into the sales efforts of contact staff. There's no point in sharing the information unless you are prepared to answer questions and to instruct people in how they should be using it.

The important thing in beginning this process is to gather as much information at the account level as you can. Every distinction you can make, instead of allocating things in an ordinal fashion across groups of accounts, will enhance your ability to make better distinctions at the account level. The table (this page) details some key items you want to gather into your database/data warehouse for input into the profitability valuation.

It is also important to understand how you might use the information. The best way to maximize the uses of the information is to include fields by which you will review the profitability output--"slice and dice" fields--if you will. Listed in the second table (opposite page) are basic data elements you would also want to include in your database/data warehouse to facilitate analysis.

Banks that have begun this process know that gathering the information is not necessarily a guarantee of success. To assist you with avoiding some of the barriers discussed earlier and to support your efforts, here is a template for the successful implementation of account and customer profitability.

Team approach and sponsorship. The project must have a champion This may not necessarily be the CEO, but it should involve at least the head of retail or commercial banking. Additionally, there must be someone within the organization whose primary job will be the successful completion of your first conversion as well as the monitoring of ongoing efforts. The team should include representatives from the area where the output information will reside, as well as finance, systems, line management and marketing.

Data manipulation. There are several components to data manipulation. These components include but are not limited to: data sources, data extracts, data quality review, formula development, formula maintenance, default values and output needs--both electronic and hard copy. As valuations become more sophisticated, the number of data feeds and extracts increases, as does the expertise required to manage the data. There are no easy answers here--but focus on data-quality testing improves the process.

Transaction files. Most state-of-the art valuations today include

transaction files for both assets and liabilities. While the asset transactions have been less important until recent years, they are extremely important as a source of fee income and the use of various channels for payments. Additionally, they provide much more detailed information for the creation of a higher level valuation for mortgage customers. It is also important to know the source of each transaction in addition to the account that has the transaction. In this manner, branches that service more customers than others can be identified.

Most institutions also mine this transaction data to discern key customer behaviors. Most often transaction data is also used to support efforts in finance. This provides a high degree of synergy whereby the volumes captured by the profitability project can be used to support finance, and the unit costs developed in finance can support the profitability project.

Account-level data assumptions. The best valuations today include the following all executed at the account level: marginal maintenance or servicing costs, transaction costs by channel, fees and fee reversals, funds transfer pricing assignment, opening/origination costs, multiple levels of risk (interest rate, credit and operating), capital and liquidity assignments, fixed costs, and overhead. This should translate into having multiple "levels" of profitability available for use. This is important because different types of post-calculation projects require different views of profitability. At a minimum, your valuation should include:

Net Contribution. This level of profitability includes spread income, fee income and marginal expenses. It may or may not include the cost of opening an account. Banks treat account opening differently--some exclude it, some amortize it, others front-load the expenses. You will also have to make this decision in keeping with your organizations philosophy.

Net Income Before Taxes (NIBT). This is basically net contribution less fixed expenses.

Net Income After Taxes (NIAT). This is NIBT less taxes.

There are other levels of profitability that also subtract overhead expenses and/or capital allocations, but this article will limit discussion to the three mentioned above.

Data quality and reconciliation. State-of-the art projects include multiple data quality review checkpoints. It's far easier to check the data being supplied to the valuations than it is to find the anomalies after profitability has been calculated. It is not unusual for as much as 15 percent of the data elements to "shift" in a given month. Most of these shifts necessitate formula revisions in the current month, as well as returning formulas to their original state for the next valuation. Most anomalies are not permanent; however, most anomalies do not involve the same fields from month to month.

Additionally, the valuation must reconcile to the known institution financials. Most institutions set an acceptable target with a plus (+) or minus (-) range. If the output of basic number of account, balance, income

and expense information falls within this range, the valuation is considered to be reconciled.

This does not obviate you from testing outbound account and relationship values. While many items look OK "in total" there may be quite a bit of distortion at the account level. Due diligence must be done on this output, especially if you are sharing account level output with customer contact areas.

Smoothing information. It is important that account and customer profitability information be "smoothed" for more than one time period before it is used. Several years ago, and even today, many consulting firms support a 12-month period as being the best. However, this time period is too long to support a useful understanding of customer relationship values. Especially in the case of deterioration, the customer is long gone before the institution has the opportunity to re-establish the previous relationship. Today most progressive institutions smooth the information over a three-month period. They may then utilize four three-month periods at the account level--providing them with the same 12-month view, but allowing them to capture and respond to relationship shifts in a timely fashion.

Most importantly you should understand that a revenue model, such as rate times balance, risks misclassifying customers by 40 percent to 50 percent--nearly a random event!

The net contribution score

Most banks today score their customers at a level that best meets the needs of the intended users. If you are going to send customer scores to sales people, calling centers and relationship managers, most banks score the customer base at the net contribution level. This doesn't overburden the customers with fixed expenses or overhead. This does not prevent you from using NIBT or NIAT at a product level for product design and pricing decisions. This allows you to use different levels of profitability for different purposes.

So now, you have a profit value assigned to every account and customer and you have a score associated with every customer as well. Most U.S. banks are not passing actual dollars of profitability to their sales staff-but rather a score 1, 2, 3 . . . or A, B, C. . . . That means you have to decide how many customer groups you will divide your base into.

Selecting a scoring scheme

In the past, many banks chose to divide their customer bases into deciles. Conventional thought now is that this distinction is not meaningful. It falls short for the following seasons:

* It's a mathematical distinction, nothing more.
* Ten levels of distinction imply that you're going to differentiate actions (pricing, sales contact, etc.) 10 different ways. Ten is too many.
* Ten levels of distinction are difficult to communicate to a sales force i.e. what's the difference between a 6 and an 8 for example.
* Shifts in a customer score are not directly related to customer

behavior.

For these reasons, most banks are now dividing their customer bases into three to five groups. Let's look at a five-group scenario with group 1 being the most profitable and group 5 being the least profitable. Once you know what your average relationship value is, you can arrange the groups. Group 3 is typically those customers whose profitability is above zero but less than average. Group 2 customers are above average but below some level you designate as "wildly" profitable. Groups 4 and 5 are both unprofitable--with 5s being worse than 4s. It is not unusual for the group 1 customers to be four or five times more profitable than average.

Using the information

The fastest way to gain acceptance for this information within the organization is to know how you intend to use it. Many will be waiting with great anticipation to incorporate customer profitability into their initiatives--others however, will not be so receptive. It is important to not only understand the "personality" of your organization but also to understand the "perceptions" of your potential audiences. Relationship managers and loan officers will love having more accurate ways to evaluate the pricing of current and future bank relationships, but only if they believe the value includes "everything."

Product managers will have access to better information than they've ever had, but it has to be timely and easy to get to. Call centers and branch personnel will be more likely to use the information if it's kept simple and straightforward. Additionally, they will need to understand how they can use the information if it is to be helpful to them. Don't give incentives for volume increases or cross-sell, for example, if what you really want is increased relationship profitability.

Aggressive integration into strategic initiatives

Most institutions have two to three immediate applications of customer profitability information. These initiatives typically include:

* Product realignment evaluations (especially in organizations growing through acquisition).

* Product design or retooling.

* Relationship product development and relationship pricing efforts.

* Preferential customer efforts.

* Segmentation and target marketing.

* Direct mail target selection.

* Promotional review (comparing new business to the overall portfolio).

* Line of business or customer segment evaluations (small business, middle market, etc.).

* Branch closing and opening analyses.

Account and customer profitability didn't receive much attention until the late 1980s and early 1990s with the advent of customer databases, formerly known as MCIF (marketing customer information file) systems. The notion that some customers were contributing more than others to the bottom

line (perhaps regardless of their balances) seemed intuitively correct. Additionally, the desire to target marketing to households rather than to individuals supported the notion

However, the ability to accurately create information at the account and customer level that could be supported by bank financials has lagged far behind the desire to have such information.

Hopefully, some of the concepts covered in this article will help you launch or improve the profitability efforts at your own institution.

This is the first of two articles on the topic of customer profitability. The second, which will discuss bow to use profitability information to make better marketing decisions, will appear in the September 2001 issue.

Kim Sutherland is director and chief operating officer for Market Line Associates (MLA) of Atlanta. MLA is a consulting firm specializing in profitability, costing, customer relationship management and risk management.

Sample Account-Level Data Elements

Income Related	Cost Related	Product Specific Characteristics
Balances	Transaction Counts	Statements by Channel
Fees by Category	Maturity Dates	Maturity Dates
Service Charges	Level of Delinquency	Delinquency Notices
Interest Received	Open and Close Dates	Open and Close Dates
Interest Rates	Account Status	Renewal Dates
		Term

Sample Account-Level Analysis Elements

Type of Analysis	Type of Data Element
By Product	Account Type, Product Type
By Branch Trade Area or Region	Branch Numbers, Trade Areas Codes and Region Numbers
By Segement	Segement Codes
By Officer	Officer Numbers
By Cost Center	Cost Center Distinctions

Risk of Inaccurate Valuation
Customers Misclassified

Account-Level Transaction Data	26% - 28%
Smoothed Value	20% - 22%
Account-Level FTP Assignment	18% - 20%

Product Names: *6010000 (Banking Institutions); 9915100 (Financial Management)
Industry Names: ADV (Advertising, Marketing and Public Relations); BANK (Banking, Finance and Accounting); BUS (Business, General); BUSN (Any type of business)
SIC Codes: 6000 (DEPOSITORY INSTITUTIONS)
NAICS Codes: 5221 (Depository Credit Intermediation)
Special Features: INDUSTRY

eLoyalty Helps GMAC Residential Drive Customer Profitability.
PR Newswire , p NA
Nov 6 , 2000
Language: English   Record Type: Fulltext
Document Type: Newswire ; Trade
Word Count: 590

Text:
  Loyalty Value Added Methodology Tools Enable Company to Track and
Measure

 Return on eCRM Initiatives
    LAKE FOREST, Ill., Nov. 6 /PRNewswire/ --
    eLoyalty, a leading eCRM services company (Nasdaq: ELOY), today
announced an additional project at GMAC Residential, a wholly owned
subsidiary of General Motors Corporation that offers mortgages and real
estate services. GMAC Residential is currently implementing a significant
customer relationship management project across multiple business units
that will streamline business processes, build a common technology and
delivery infrastructure, increase customer service levels and strengthen
lifetime customer relationships. As a first step of this project, GMAC
Residential is using eLoyalty's Loyalty Valued Added(TM) (LVA) methodology
to quantify the tangible, economic benefits of each of its planned customer
loyalty initiatives.
    "With eLoyalty's Loyalty Value Added methodology, we are able to
estimate and measure the financial returns on our eCRM initiatives by
customer segment using specific customer-centric metrics, such as revenue
per customer, acquisition costs and customer retention probability," said
Lisa Charney, senior vice president of GMAC Residential. "As a result, we
are able to tie the lifetime value of our relationships with our customers
to concrete financial and operating metrics and positively impact our
bottom-line results."
    Realizing the need to focus on customer loyalty for strategic
business advantage, GMAC Residential engaged eLoyalty to prioritize its
proposed eCRM initiatives and forecast the impact of these initiatives on
the profitability of each of its customer segments. As GMAC Residential
moves to deploy each initiative, eLoyalty's LVA methodology also provides a
critical means to measure the success of each project against forecasted
benchmarks. In the past, this measurement capability has been the "missing
link" of eCRM initiatives.
    "Customer loyalty has long been viewed as a vital component to a
company's success, but to date no one has been able to track and measure
the impact of customer loyalty on the bottom line," said Kelly Conway, CEO

and president of eLoyalty. "eLoyalty's Loyalty Value Added methodology enables companies like GMAC Residential to effectively define customer value and evaluate its impact on corporate and organizational performance by translating customer-centric operating metrics into quantifiable customer and shareholder economic value."

With today's announcement, eLoyalty also rounds out a full-suite of Loyalty Valuation methodologies. The LVA methodology encompasses both risk-return analysis and the tracking of benefits stemming from identified initiatives. These new enhancements are available immediately.

About Loyalty Value Added

Loyalty Value Added is a systematic measurement methodology and toolkit designed to measure the financial returns from customer loyalty and electronic customer relationship management (eCRM) programs. Loyalty Risk Return Analysis links project and financial management to provide a real-time estimate of the risk-adjusted return of an eCRM initiative. The Loyalty Benefits Tracking methodology provides for a means to track and record the benefits that result once the project is completed and actually produces results, thus providing the overall return on investment and profitability for customer loyalty initiatives.

About eLoyalty

eLoyalty (Nasdaq: ELOY) is a leading management consulting and systems integration organization focused exclusively on building customer loyalty. With nearly 1000 professionals in offices throughout North America, Europe and Australia, eLoyalty's broad range of electronic Customer Relationship Management (eCRM) related services include creating a business strategy, defining a technical architecture, selecting, implementing and integrating best-of-breed eCRM software applications, and providing on-going support for the multi-vendor systems. The combination of eLoyalty's methodologies and technical expertise enable eLoyalty to deliver the tangible economic benefits of customer loyalty for our Fortune 1000 clients. For more information, please go to the company's web site at www.eloyaltyco.com or call 877-2- ELOYAL.

Abstract:
With its 1996 creation following a merger, Suncorp became Australia's
sixth-largest bank and second-largest insurer. In order to optimize use of
its resources, Suncorp moved its focus towards improving the profitability
of its customer base. Although the post-merger Suncorp - a combination of
Suncorp Insurance and Finance Ltd., Metway Bank and Queensland Industry
Development Commission - utilized point solutions that collected customer
privacy indicators, this wasn't enough. In March 2000 it was decided a
change needed to be made. In September 2001 the team began its search for
the sales effectiveness component. It required that the solution be mature
operationally. As the team embarked upon the Onyx product's implementation,
it focused on the goal of making it easy for employees to cross-sell.

Text:
Onyx's Employee Portal helps Australia's second-largest insurer and
sixth-largest bank assemble customer info in one place.
With its 1996 creation following a merger, Suncorp (Brisbane, Australia,
AUD $35.5 billion) became Australia's sixth-largest bank and second-largest
insurer. In order to optimize use of its resources, Suncorp moved its focus
towards improving the profitability of its customer base.
"Suncorp finds that customers with more than five products across two
business lines are much more profitable than other customers and are more
likely to be retained," says Mark Hocknell, senior manager for Allfinanz,
technology and sales effectiveness, Suncorp. Allfinanz is the name of
Suncorp's strategy aimed at growing profitability within the customer
franchise. In order to maximize profitability, the institution needed to
attain a single customer view. This is a daunting task for any insurer, but
for Suncorp-a company faced with 14 disparate banking and insurance product
systems and two million customers-the job was especially difficult.
Although the post-merger Suncorp-a combination of Suncorp Insurance and
Finance Ltd., Metway Bank and Queensland Industry Development
Commission-utilized point solutions that collected customer privacy
indicators, this wasn't enough. In March 2000 it was decided a change

needed to be made. "Four years after the merger, Suncorp realized it was not getting enough progress to support the business model," says Hocknell. At this time the Allfinanz strategy became more heavily enforced. Hocknell was the business owner of the Allfinanz team, which was composed of technology and business professionals. As its investigation began, the team sought a holistic CRM solution. "We didn't find anything that really suited our business model," explains Hocknell. "We needed to 'chunk' down CRM into five critical components"-sales effectiveness tools, marketing tools, a customer information system that could index customer information across the organization, activity-based costing and profitability modeling and analytics tools.

In September 2001 the team began its search for the sales effectiveness component. It required that the solution be mature operationally. "We looked at quite a few CRM vendors that had core competency in other areas," says Hocknell. Among the products Suncorp investigated were offerings from Siebel Systems (San Mateo, CA) and Onyx (Bellevue, WA). According to Hocknell, the team concluded Onyx's Employee Portal-a Web-based CRM solution that consolidates customer information and enables a single customer view-was the most mature operational system.

As the team embarked upon the Onyx product's implements tion, it focused on the goal of making it easy for employees to cross-sell. Instead of the traditional strategy of releasing a lot of functionality to a small group of users, Suncorp chose a different route. "We delivered a lower level of functionality quickly so it would reach all customer touch-points," says Hocknell.

Out-Of-The-Box Functionality

In the first phase of implementation, which took place in October 2001, the team developed functional specifications for customization of the tool "Suncorp focused on using as much as we could out of the box so that we could have a lot of confidence when we went live that the system could work across 5,000 users," Hocknell reports.

Suncorp was able to use the Onyx tool's lead management and sales tracking system out of the box. Aside from its intended purposes, "Suncorp also used the system to collect complaints, marketing indicators and competitor product information," says Hocknell.

Following some fine tuning, the system went live on April 29, 2002. Today, Suncorp's CRM system includes Epiphany Real-time Marketing software. Also, with the help of Infosys (Bangalore, India), Suncorp built its own customer information system. Now, activitybased costing and analytic tools are being developed with other vendors.

Case Study Closeup

Case Study Closeup

COMPANY

Suncorp, Brisbane, Australia, AUD $35.5 billion in assets.

LINES OF BUSINESS:

Life, P&C, banking, wealth management.

VENDOR/TECHNOLOGY:
Onyx (Bellevue, WA) Employee Portal; e.Piphany (San Mateo, CA) Real-time
Marketing software; Infosys (Bangalore, India).
CHALLENGE:
Achieve a consolidated view of millions of customers.
by Julie Gallagher
jgallagher@cmp.com

THIS IS THE FULL-TEXT.
Copyright CMP Media LLC Jan 2003

Company Names:
Suncorp-Metway (NAICS:524126; 522110)
Onyx Software Corp (NAICS:511210)
Geographic Names: Australia

Descriptors: Insurance companies; Banks; Case studies; Customer relationship
management; Information systems; Cross selling
Classification Codes: 9179 (CN=Asia & the Pacific); 9110 (CN=Company specific);
8200 (CN=Insurance industry); 8100 (CN=Financial services industry); 5220
(CN=Information technology management); 7300 (CN=Sales & selling)
Print Media ID: 15652

02834412   774284691
Profits one customer at a time

Compton, Jason
Customer Relationship Management   v9n1 pp: 32-35
Jan 2005
Document Type: Periodical; Cover Story Language: English Record Type: Fulltext
Length: 4 Pages
Word Count: 2038

Abstract:
Company performance is bolstered or weakened one customer at a time, which
is why it is no surprise that CRM theorists and practitioners often speak
of the importance of measuring and acting on the profitability of each
individual customer. An individual customer's profitability could be as
simple as a black or red number in a spreadsheet cell, but quite often
companies use proxies. Airlines, for example, establish service tiers based
on miles flown or flight legs completed. Once there is an understanding of
how value will be measured and how much confidence can be placed in that
measurement, look for tactical applications for that information, such as
reducing costs to serve the customer or making interactions more
profitable. The choice has as much to do with the company's goals as with
any one customer's profitability figure.

Text:
CRM strategists often speak of improving company performance by boosting
revenue on a per-customer basis. CRM magazine cuts through the hype to
examine what individual customer profitability canand cannot-do for your
business
Quarterly profit and loss is ultimately just an abstract aggregate of
countless customer interactions. But company performance is bolstered or
weakened one customer at a time, which is why it is no surprise that CRM
theorists and practitioners often speak of the importance of measuring and
acting on the profitability of each individual customer.
"It's the top of the playbook in terms of CRM strategies to understand
customer profitability and segmenting, using that to drive the behavior of
sales and marketing," says Robb Eklund, vice president of CRM product
marketing for Oracle. Yet in practice it is not immediately clear what,
exactly, it means to attempt to capture the net value of an individual
client. Nor is it immediately clear how challenging it can be. And even
capturing that individual net value with a high degree of accuracy does not
solve every customer profitability problem that is on the table.
Return to Revenue

Individual customer-profitability measures fell out of favor in some organizations in recent years because cost-cutting was so widespread it rarely seemed worthwhile to consider the impact of any given client. "When you get solidly into (economic) recovery mode, the issue changes to, 'How do I maximize my revenues?', and in that context people are looking for how to maximize the profitability of customers," says Robert Kugel, vice president of Ventana Research.

Attempting to be granular with profitability readings raises a question that in almost any B2B environment has no easy answer: Who, exactly, is the customer? Is it the enterprise itself, the division using the products, or the individual purchasing agent? Even in the home, questions about the decision-maker and the impact of the next generation of customer come into play. Often, the nuances of the importance of the individual behind each purchase are not even readily available between partners on the supply side.

Gartner divides the individual profitability measurement discipline into eight distinct value categories, ranging from accumulated value from prior interactions, to a current reading ranging from a span of a few months to several years (depending on the product life cycle), to measuring some level of value as a marketing and research resource. The measure of a customer's total market value provides perspective on the entire worth of the customer to the market segment in which a company competes. This value can also be used to derive share-of-wallet.

"The ideal situation is being able to reach all the way to the end consumer" to measure profitability, says Todd Bixby, managing director of consumer, industrial, and technology CRM at BearingPoint. "Banking and insurance are probably the leaders in generating those kinds of numbers; retailers are probably laggards. The data exists, it's just not shared through the value chain."

What is clear is that making sense of individual customer profitability is nearly impossible without coordination. "You have to think about data comprehensively across the organization, not just (for)the transaction at hand," Oracle's Eklund says. "It may make sense to think about (offering) a loss-leader if in fact there is a larger opportunity with that customer somewhere else in the organization," but without collaboration, those judgments cannot be made. When customer performance is treated as an enterprisewide responsibility, rather than a profit-and-loss concern for each division or product line, such decisions become easier to make.

What's in a Number?

An individual customer's profitability could be as simple as a black or red number in a spreadsheet cell, but quite often companies use proxies. They are easier to measure than finding the proper mix of fixed and variable costs to factor against a customer's revenue. Airlines are a prime example: Typically, they establish service tiers based on miles flown or flight legs completed, working on assumptions about their own cost structure that above a certain level of consumption, clients will have attained a solidly

profitable standing.

One proxy some companies use is loyalty. However, Wendy Close, a Gartner research director, warns that loyalty can be a dangerously misleading value proxy, because longevity and profitability are not necessarily one and the same. "If they are emotionally loyal, they stay with you because they love your business and will advocate new business," she says. "If it is rational loyalty, they stay with you because they know how to work your system."

Fixed costs in particular pose a problem for proper profitability measurement: They tend to more closely map to the company's choices, not the customer's. Marketing expenses also skew the measurement of profitability, because any sort of mass marketing will inevitably pay to reach out to a potentially unprofitable customer, perhaps even one that the firm has opted to cut ties with.

The challenges make reaching the goal of a single, clear-cut item in each client's ledger entry a difficult proposition at best. It is with those challenges in mind that companies that have been successful with value measurement make decisions about what they will and will not attempt to measure.

"We have shied away from absolute (measures), because there are too many pitfalls that lead to potentially dangerous assumptions being made in your organization where the finance folks start to believe these are hard numbers and roll forward predictions about corporate profitability," says Steve Elioff, senior vice president of CRM for investment firm AGF Management. By focusing on a relative scoring model, AGF learned to measure the value of its broker partners on a more refined scale than simple revenue size, and shifted support resources as a result. Whereas previously one quarter of the company's most profitable partners received no sales support, AGF has dropped that figure to just 5 percent.

"The best you can do (today)-and maybe it's not the final answer-is to optimize the marketing mix in the sense of what costs and expenses you can control, and get the biggest bang for your buck," says Ray Pettit, vice president of marketing services firm Longwoods International. Except in very coordinated direct marketing campaigns, "you can't really get to the individual level and save a lot of money by not marketing to (certain) people because you know they're not going to be profitable."

Applying Value Measures

Once you understand how you will measure value and how much confidence can be placed in your measurement, look for tactical applications for that information. Many companies' instinctual reaction to customer profitability data is to throw support and retention resources at clients with high present value. A smaller relationship, however, may have a huge future upside that would be missed if the customer's potential lifetime value is not measured. "You may find that in fact, their contribution to margin per unit sold is substantially higher than when selling to your volume customers," Kugel says.

A fraction of accumulated value-that is, the profitability of the customer

in the pastcan be placed in a sort of internal escrow and budgeted to front-line customer service staff to resolve minor disputes. The same policy can be extended to measures of future value, but doing so is more risky.

Ultimately, the choice has as much to do with the company's goals and flexibility as with the magnitude of any one customer's profitability figure. "What's the best way to raise the value of customers? Reducing the cost to serve the customer? Improving wallet share with the customer? Making interactions more profitable? There's a lot of different dimensions," says Gareth Herschel, a Gartner research director.

North Shore Credit Union is an example of one organization using multiple value measures in tandem. Unlike many financial institutions that simply measure the worth of a customer by the number of products in her portfolio, North Shore Credit Union integrated Pivotal across 10 lines of business to score profitability on the full context of the relationship. "In the past we just looked at the treasury view-what they have done and what they have spent. Now it is much broader," says Fred Cook, North Shore CIO. In a competitive marketplace, North Shore is learning that not all customers rate the same consideration. Although not keen to be seen as "firing" customers, the institution has started to take serious note of customer profitability.

"We're not everything to everybody as a community credit union," Cook says. "We expect the relationship to be mutually beneficial." That can mean giving little credence to customer requests from those who consistently run the credit union red or deciding not to pursue a particular customer for further business. "For people who are rate-shopping (or) if all you want is an ATM card, then maybe we're not the right institution for you-and our staff cannot be afraid to make that decision, but it has to be an informed decision," he says.

Since the credit union reoriented its business around a profitability-minded yet customer-centric approach, profitability rose 40 percent and assets more than doubled, with just a 2 percent increase in membership.

Gartner's Herschel warns that cutting customers with low current values without making other changes to the business is unlikely to provide any relief, since the fixed costs will be spread across the remaining customer base. Many companies will still need time to build a customer to profitability, lest banks start turning away all teenagers and losing decades of adulthood profit potential.

Think of individual profitability as a lever for creativity rather than as a hammer. Chris Selland, vice president of sell-side research for Aberdeen Group, relates an example of a large mutual fund company that found its phone lines jammed by investors seeking updated prices at the close of the stock market. The demographics of the customers did not call for diverting all of them to the Web site-and by time the customers placed those calls it was already too late. Rather than boost staffing for just a few hours or

risk alienating customers, the firm instituted an automated service that customers could call to hear prices-a solution that cost less per interaction than handling an inbound inquiry. "That's the kind of situation where understanding the cost of revenue and how to make allocations (to individual customers) leads to improvement," Selland says.

Above all else, be prepared to be specific about what customer profitability does and does not represent. It can be a powerful tool for market planning far beyond the individual campaign or service center policy level, as long as everyone understands the implications. "If you want to walk into the CFO's office with credibility," Selland says, "you ultimately want to be making an apples-to-apples comparison on (profit) return from customers, margin-per-transaction, lower-cost-of-serving, or a higher loyalty factor."

Value is what you make of it

"You have to recognize that customer profitability is a model, it's not a real numberm," says Chris Selland, vice president of sell-side research for Aberdeen Group. "Anybody who comes in and says they can tell you what customer profitability is,

We believe in relative value, so the only thing that becomes important is that we are using the same measuring stick to apply to everyone," says Steve Elioff, senior vice president of CRM for investment firm AGF Management. With the help of PeopleSoft, AGF measures the individual profitability of the indirect agents who recommend and sell its financial products to end investors, scoring them on their entire book of business, their propensity to deal with AGF, and the company's ability to convert more of their investor

Any valuation that looks to purchases that have not yet occurred can only be modeled, such as future or lifetime value, because the customer could behave unexpectedly and terminate the relationship-switching to a competitor, exiting the market, even dying. As a result, even more important than the profitability number the model spits out is the confidence you have in the model itself. And no predictor of

"You can make decisions based on a model, as long as you understand that it is a model," Selland says. -J.C.

"You ultimately want to be making an apples-to-apples comparison on (profit) return from customers, margin-per-transaction, lower-cost-of-serving, or a higher loyalty factor. "

Contact Executive Editor Jason Compton at jcompton@destinationCRM.com

THIS IS THE FULL-TEXT.

Geographic Names: United States; US

Descriptors: Profitability; Customers; Customer relationship management; Measurement techniques; Market planning
Classification Codes: 9190 (CN=United States); 7000 (CN=Marketing); 3100 (CN=Capital & debt management)
Print Media ID: 59452

02642110   395378751

Customer Relationship Management Keeping Customers Loyal - Case studies show the way We all know that competitive companies have a strong customer focus

Bland, Vikki

Abstract:
Despite the hype around the technologies, and the many mistakes made by
companies on a customer relationship management (CRM) learning curve,
research shows CRM planning, strategies and initiatives remain high on the
wish list of many sizeable companies. And small-to-medium-sized businesses
are catching on fast. True CRM is perhaps best defined as: the bundling of
customer strategies and processes, supported by relevant software, for the
purpose of improving customer loyalty and eventual profitability. It has
been noted by CRM specialists that effective CRM starts with good
old-fashioned segmentation analysis. This article presents three case
studies of New Zealand businesses which have managed to get their CRM
strategies and projects right: 1. UBix, 2. Kiwibank, and 3. Air New
Zealand.

Text:
Customer relationship management (CRM) is big business. It is if you're a
software marketer specialising in CRM software, but it's also big for,
well, bigger businesses.
Despite the hype around the technologies, and the many mistakes made by
companies on a CRM learning curve, research shows CRM planning, strategies
and initiatives remain high on the wish list of many sizeable companies.
And small-to-medium-sized (SME) businesses are catching on fast.
For example, a customer study by SME software specialist JD Edwards reveals
that although less than five percent of SME customers have implemented CRM
systems, nearly 30 percent will consider it over the next two years.
Quite simply, CRM strategies and technologies can provide a competitive
edge. If you can manage your customer relationships better than your
competitors, you'll not only keep your own customers, you'll probably start
to win some of theirs as well.
Further, CRM initiatives which have been properly strategised and coupled
with careful internal change management almost always increase internal job
satisfaction and company profitability.
Of course, achieving all of this is hardly about buying the right computer

equipment and software. Companies that previously believed CRM was about smart software, preferably lots of it, have learnt the hard way. True CRM is perhaps best defined as: the bundling of customer strategies and processes, supported by relevant software, for the purpose of improving customer loyalty and eventual profitability.

Note the phrase "supported by". Software is often essential to the success of an ongoing CRM strategy, but it's not where a CRM strategy should start. It has been noted by CRM specialists that effective CRM starts with good old-fashioned segmentation analysis. In other words, knowing what you want to achieve, identifying which customers are important and what they want from your business, and then working out strategies to refine all internal business processes to meet and exceed those expectations.

The remainder of this article provides three case studies of New Zealand businesses which have managed to get their CRM strategies and projects right. This is no mean feat, with confusion surrounding CRM still high. How these companies achieved CRM success, and the things they learned along the way, make valuable reading for any business interested in catching the CRM wave and ensuring its positive impact for customers and internal profitability into the future.

UBix: Early movers

In June 2001, document-imaging specialists UBix (a brand division of the company Onesource) decided radical changes to its call centre and service dispatch areas were required.

Tony Day, general manager of services for Onesource, says jobs were logged, queued and then dispatched by voice, one at a time. The average amount of time it took for a technician to get to a customer was between four and five hours.

"That's a long time when you are standing over a machine fuming," he says. The old system was also highly error prone. Not only would UBix technicians record customers' names incorrectly and so incorrectly address the customer, 14-character part numbers were frequently confused between the technician and call centre staff. Information was handled up to three times before reaching UBix's central database, which made it less reliable.

UBix began an overall CRM strategy by implementing business process changes in tandem with technologies. These included management discussions at which technicians were asked how they wanted to work, what would enable them to better service customers, and the information technology tools they thought would help.

UBix also talked to key customers ("Pick your toughest customer," advises Day) then assigned each technician a specific set of customers, thereby transferring the responsibility for customers to the technicians themselves.

"We needed a dramatic improvement in performance for the sake of the company, its customers and for our employees. The technology we ended up employing, while quite bleeding edge at the time, was only a small part of the overall strategy."

UBix's technology choices were certainly bleeding edge for 2001. The company purchased automated call dispatch management software from Econz and had it customised to automatically assign jobs to technicians (and re-route jobs belonging to sick or absent technicians). Technicians received the jobs via Compaq iPaq PDAs, which had wireless mobile JetStream connections to the UBix system.

Yet in 2001, mobile JetStream provider Telecom had not made its wireless data service commercially available or even worked out how it would be charged. Subsequently, UBix New Zealand was one of the earliest companies to trial wireless data services in the world.

"There was no one we could talk to. We initially trialled the system with just six technicians and were quite surprised when it worked. It was a crazy project at the time, it had a high risk of failure," says Day.

He says UBix's entire CRM strategy initially cost around $750,000. But in addition to halving customer service response times to 2.3 hours, the technology and process changes produced a return on investment within 12 months.

"There are measurable savings, like improved productivity, reduced mobile phone costs, fewer dispatches, and putting people in different roles. But there are many more benefits that can't be measured," says Day.

He says change management is an important part of any CRM success.

"If you give people the absolute end-to-end ownership of customer issues, they step up to the job tremendously."

UBix also made changes to its call centre process and technology.

Day says UBix was one of the first "criminals" in New Zealand to use a front-end automated call attendant 13 years ago.

"People didn't like it. So now human beings answer the phones. Sometimes you get peak load and you need technology to give the customer options. But if they leave a voice message, the technology doesn't let it sit; it puts it in a queue with other calls. If you're going to use technology, you have to build a trust in that technology."

Kiwibank: small steady steps

New Zealand's newest bank, Kiwibank, is not surprisingly in growth mode. So when Jo Allison, manager of Telecom Advanced Solutions (TAS), began working with the bank on a telephone banking and call centre system 12 months ago, she found an organisation seeking CRM solutions that would grow as it grew.

"A lot of companies come to Telecom and say 'we have a 50-seat call contact centre, help us'. But Kiwibank said 'we have 50 seats, but in a few weeks' time it could be 200 seats'. Naturally, they didn't want to pay for a bigger system before they needed it. They wanted flexibility for themselves and a leading-edge telephone banking solution for their customers."

In conjunction with IT partner Cisco, TAS provided Kiwibank with a telephone banking system, PIN verification system, and computer telephony application which, following verification via PIN, links inbound customer calls with information on each customer. That information is then passed on

to the call centre before the call is answered.

Allison says Kiwibank used this technology as part of a wider CRM strategy, which involved finding out when their customers were calling, and why they were calling. A further requirement was that the phone banking system would track which telephone banking services customers were using.

"Getting that information meant Kiwibank could train their staff to better understand the kinds of things customers want to know and want to do. This helps them to tailor their marketing initiatives, which of course makes those more cost effective, and it also helps them to tailor their investments."

While Kiwibank has yet to enter the world of internet banking, Allison says the bank is intent on moving in incremental CRM steps, ensuring what they do today is done well.

"The contact centre manager said to me 'let's get the telephone centre right first, Jo, then move on from there'. For him, it wasn't about the technology, but achieving the customer experience he wanted."

Allison says while the telephone banking and call centre technologies employed by Kiwibank are commonplace in banks, Kiwibank goes to lengths to ensure those technologies match the way Kiwibank customers like to interact with the bank.

"Kiwibank's contact centre manager Chris Sturgeon recently won the TUANZ contact centre manager of the year award. That's not surprising. His number-one priority is to provide his staff with information about the customer."

Air New Zealand: anticipating customer queries

Air New Zealand owns more information technology than any other local company (as verified in the Top 100 compiled annually by MIS New Zealand.) As such, it has several CRM software partners, a fully developed CRM strategy, and several CRM projects on the go at any one time. So it has more than a little knowledge of how to get CRM systems to support wider CRM goals.

One of the airline's more recent CRM partners is the software specialist Datamail, which supplied its RightNow software. This intelligently searches Air New Zealand's internal knowledge database and provides possible answers to customer questions on the airline's website.

While this might sound a rather simple CRM application, Cathy Stephenson, business analyst for Datamail points out CRM applications should be simple; simple to implement, simple to use and have simple but effective CRM benefits.

Stephenson says Air New Zealand previously fielded a large number of queries relating to air point enquiries. In an attempt to stem the tide, it placed answers to the most commonly asked questions under the FAQ section on its website. Unfortunately, too many customers bypassed that option, either because they couldn't be bothered or because they found the FAQ section did not contain their query. They would then call or email Air New Zealand instead.

Understandably, this caused internal resource issues for Air New Zealand, and increased response times for customers.

Stephenson says Air New Zealand met this CRM challenge by installing the RightNow software. Customers can now place a question on the website, and the software will pop up to five possible answers back at them. If the answers do not help the customer, the customer is prompted to use Air New Zealand's online knowledge database or to send an email in the usual way.

Stephenson says publishing new "question and answer pairs" to a website is not difficult and can be done quickly by Air New Zealand staff outside of the IT department. This is an advantage, given companies the size of Air New Zealand often outsource their IT functions.

She says a 50 to 70 percent reduction in inbound emails and phone calls, and a 90 percent reduction in knowledge base management costs are common results for users of the technology. M

Vikki Bland is a regular technology
contributor to Management.
Email: vbland@watchdog.net.nz.

THIS IS THE FULL-TEXT.

Company Names:
Air New Zealand Ltd (Duns: 76-000-0802 NAICS:481111; 488190)
Kiwi Bank Ltd-New Zealand (NAICS:522110)
OneSource (NAICS:561310)
Geographic Names: New Zealand

Descriptors: Customer relationship management; Manycompanies; Technological planning; Software
Classification Codes: 9179 (CN=Asia & the Pacific); 5240 (CN=Software & systems); 2310 (CN=Planning); 2400 (CN=Public relations)
Print Media ID: 24529

02421787   195578531

Will this customer sink your stock?

Selden, Larry; Colvin, Geoffrey

Abstract:
Some customers are deeply unprofitable. Most managers do not understand how
their customer portfolio undermines their ultimate bottom line: the value
of the company. Until a company starts managing its highly diverse customer
portfolio, it cannot hope to maximize shareholder value. When companies
fail to understand customer profitability, they do worse than just miss big
opportunities; they can get themselves into deep trouble. Managers,
however, are not the only ones who need better knowledge of customer
profitability. Investors do too. Boards of directors will soon begin to
demand customer-profitability data and will challenge management to act on
it; investors will demand that companies report it.

Text:
Here's the newest way to grab competitive advantage: Figure out how
profitable your customers really are.
WHO ARE YOUR UNPROFITABLE customers? We recently asked that question of top
executives at one of America's biggest retailers. They responded defiantly
that they had no unprofitable customers. Understand that this company was
in trouble-it wasn't even earning enough to cover its cost of capital, Wall
Street analysts were beating it up, and its stock was performing worse than
the shares of most competitors. Yet its leaders insisted that through some
dark financial voodoo, millions of profitable customers somehow added up to
an unprofitable company.
The truth-which shocked them-was that some of their customers were deeply
unprofitable. Simply doing business with certain customers was reducing the
firm's profits and shareholder value. Other customers were fabulously
profitable-but the effect of the bad-news buyers was overwhelming them. The
retailer's managers didn't understand any of this. They didn't understand
that their customer strategy-their whole plan for acquiring, maintaining,
and developing customers-was determining their omer profitability, and
crucially, at their customer profitability was in turn determining their
share price. Because the company didn't understand these connections, it
was, among other serious errors, aiming marketing efforts at customers who

weren't profitable and probably never would be. Here's how ridiculous the situation was: This company was actually spending money to bring in customers who were reducing the value of the firm.

Get ready for a big idea that's about to sweep through most companies: managing the enterprise not as a collection of products and services, not as a group of territories, but as a portfolio of customers. Of course, managers have always known that some customers are more profitable than others. But it's amazing how many executives, like those of that big retailer, haven't the least idea just how profitable (or unprofitable) individual customers or customer segments are.

Most managers don't understand how their customer portfolio determines their ultimate bottom line: the value of the company. Believe it or not, it's entirely typical to find that just the best 20% of a company's customers generate a huge portion of its share price-in some cases, all of it. The trouble is, the worst 20% may destroy a ton of value, with the middle 60% making up the difference. Until a company starts managing its highly diverse customer portfolio, it can't hope to maximize shareholder value.

That's a critical opportunity missed, because many companies are desperate for a new competitive advantage. Today about 60% of U.S. corporations, like the retailer mentioned above, are either chronically failing to cover their capital costs or just barely doing so. They can't hope to get their stock moving until they fix that problem. Cost cutting and Six Sigma quality programs are great, but when everyone in the industry is doing the same things, you're back to even. Now, in a tough economy and a brutal stock market, the hunt is on for a new source of advantage, one that can last a long time. Companies that find it early will build huge barriers against competitors.

A number of leading firms believe they've found such a competitive advantage. These truly customer-- centric companies-including Dell Computer, Toronto-based Royal Bank of Canada, Fidelity Investments, and Canada's Hudson Bay Co.-are getting a grip on their customer portfolio and managing it to lengthen their lead over competitors. Why now? Because until recently trying to calculate the profitability of individual customers or even customer segments was too hard an infotech task for big companies to handle. Now the technology, which is getting more powerful and less expensive by the day, is finally up to the job. Here's a mind-boggling fact: Royal Bank calculates the profitability of every one of its ten million customers every month.

But infotech isn't the key. Many companies have spent millions on the needed software-including ERP (enterprise resource planning), CRM (customer relationship management), and many other applications-with little or nothing to show. That's because cashing in on customer profitability requires a deep change in corporate mindset, something no vendor can sell you. The customer portfolio needs to become the basis of how companies get organized, measured, and managed. Making this switch is tough. That's why

even small firms, which don't require giant infotech systems to analyze customer profitability, have rarely done it. Yet companies that can make the shift are discovering huge advantages from managing their customer portfolio. Financial services firms, in particular, are leading the charge. Consider Fidelity Investments, the world's largest mutual fund company. It realized that some customers were unprofitable because of the channels they used to interact with the company. When a customer who does limited business with Fidelity, and probably has limited potential, calls a service rep too frequently, the costs can easily outstrip any profits.

So a couple of years ago, when such customers called, Fidelity's reps began teaching them how to use the company's lowest-cost channels: its automated phone lines and its website. It also made its site friendlier and more enticing to use. These customers could still talk to service reps, but the phone system identified their calls and routed them into longer queues, so the most-profitable customers could be served more quickly; for the unprofitable customers, the longer wait would be a disincentive to call. Fidelity couldn't lose. If the unprofitable customers switched to lower-cost channels, they became profitable. If they didn't like the new experience and left, Fidelity became more profitable without them. But Fidelity found that 96% of those customers stayed, about the same retention rate as in the industry overall, and most of them switched to lower-- cost channels. Over time, customer satisfaction actually increased for the smaller customers as they learned how to save time and get faster service through the lower-cost channels, increasing Fidelity's operating profit within 12 months.

Note that because Fidelity could allocate resources based on customer profitability and potential, it could have its cake and eat it too: Unprofitable customers became profitable, and profitable customers got better service through shorter wait times when calling. This is typical of companies that make the kind of change Fidelity did. By contrast, when companies don't understand customer profitability, they suffer a double whammy. Resources get squandered on unprofitable customers, which means the profitable ones get short shrift and become less satisfied.

Here's another example. In late 1999, Royal Bank of Canada, the largest bank in that country, reorganized itself not around products or territories but around customer segments. This focus on customer profitability revealed a large opportunity the bank had been missing. When clients from its elderly and well-- off "wealth preserver" segment died, their assets passed to their heirs, who tended to be concentrated in one of the bank's most profitable customer segments, which it calls "builders and borrowers." But the bank wasn't satisfied with its retention of those assets; many heirs were not Royal Bank customers, and others were transferring the assets to other institutions.

So last year the bank thoroughly revised the experience it offers current and potential customers who have to settle estates. The process can involve tons of paperwork, so the bank made it easier and more efficient. Since

settling an estate is a chore that most people don't know much about, and one that can be emotionally draining, the bank offered financial advice and planning to guide them through it. In a test of the new offer, the bank increased its retention of assets from 30% to 50% and attracted new assets equal to another 25%. Rolled out nationally, the program would translate into $1.5 billion (Canadian) of net new balances. Royal Bank won't say how much extra profit that would create, but the amount is clearly substantial. Because the bank calculates each segment's economic profit-- that is, profit after a capital charge-management can figure out how much each contributes to the share price. The company is also telling stock analysts about segment profitabilityvaluable information that gives investors deeper insight into Royal Bank than they have into competing banks.

FINANCIAL SERVICES ARE one thing. But it's harder for many people to conceptualize how analyzing and acting on customer profitability might work in retailing. Retailers sometimes throw up their hands and ask, "What can I do-put a bouncer at the door to keep unprofitable customers out?"

Probably not, but retailers can do far more than they may imagine. We know a retailer that ran a loyalty program based on how much customers spent. Analyzing their profitability showed that many of the biggest spenders-the top tier in the loyalty program-were deeply unprofitable, often because they bought only sale items and made loads of returns. So the obvious first step for this retailer was to stop sending these customers announcements of big upcoming "private" sales. The company had been promoting such events heavily to its top-tier group, not realizing that actually doing less business with some of them would increase profits.

The retailer also found ways to do more business with its most profitable customers. For example, a woman who buys $10,000 of full-price dresses each year but buys no shoes is a clear opportunity-because she's probably buying a lot of shoes somewhere. So the company could promote its shoe department to her and make sure salespeople mentioned the department to her in the store. The retailer could also take steps to turn unprofitable customers into profitable ones by trying to bundle profitable products with the unprofitable ones that the customers typically buy, based on computer analysis of frequent product pairings. This is "You want fries with that?" on steroids.

If understanding customer profitability is so valuable, how could the top managers of the major retailer we mentioned earlier have felt so certain-and been so wrong-about all their customers' being profitable? These executives said that all their products had positive gross margins, and the company managed inventories well, so tons of capital weren't tied up. Thus, they reasoned, no matter what baskets of goods customers bought, they must all be profitable.

The trouble was that these managers were ignoring important costs. Start with the store's operating expenses: sales associates, rent, electricity, maintenance, and so on. If the shoe department uses 10% of those resources, it should bear 10% of the operating costs. When our retailer began to

allocate those expenses earlier this year, the company found that 25 % of its product categories were unprofitable, many very unprofitable. Applying charges for capital-inventories, plus things like store improvements-yielded what finance experts call economic profit. It turned out that more than half its product categories were generating negative economic profit!

Using credit card data and simple observation in stores, the company began to analyze baskets of goods bought by a varied sample of customers. It found that some of them chronically bought mostly unprofitable products. Those customers were unprofitable. The retailer also found that some customers made lots of returns, behavior that could make profitable baskets unprofitable; others bought only items that were on sale. Also unprofitable were customers who tied up sales associates but didn't buy anything.

WHEN COMPANIES FAIL TO UNDERSTAND CUSTOMER PROFitability, they do worse
than just miss big opportunities; they can also get themselves into deep trouble. We've observed two especially dangerous traps (for more, see "5 ways to fail").

* The growth illusion. Imagine a company that launches a big push for new customers and acquires 5,000 of them at a cost of $1,000 each. That amount is what the company spends on advertising, promotion, sales calls, and so forth to get those customers in the door. (The company might spend $100 reaching each prospect but succeed with just one in ten.) To keep things simple we'll assume that the new customers don't produce any business in the year in which they're acquired, so the company's operating profit is $5 million lower than it otherwise would have been. That is, it has invested $5 million in the hope of realizing much more than $5 million in future profits.

Suppose this company typically holds its customers for three years, and it earns profits of $300 per year from each customer. Obviously the company is losing money; it's earning $900 on customers that cost $1,000 to acquire, and that's not even discounting the future earnings to reflect the time value of money.

Yet remarkable as it may seem, the company's investors and even its managers, looking at conventional operating results rather than at customer profitability, might not know for years that anything is wrong. Why not? Suppose that in its second year the company acquires just 1,000 more customers, again at a cost of $1,000 each, or $1 million. Since the 5,000 recently acquired customers bring in a profit of $300 each for a total of $1.5 million, the company shows a profit increase of $500,000. That's a nice change from the previous year's decline and the beginning of a good-looking trend line. It gets better. Suppose that in the next year the company again acquires 1,000 new customers for $1 million. Now it has 6,000 new customers bringing in profits ($1.8 million total) and shows a profit increase of $300,000 over the previous year. Repeat the pattern once more, and profits again rise $300,000 over the previous year.

This company looks like a star. Investors are frantic to buy the stock. The directors are paying management zillions. Yet every new customer is unprofitable. The more customers the company adds, the more value it destroys.

Obviously this situation can't last forever. The 5,000 customers acquired in the big campaign, having stayed for three years, leave; if the company keeps adding 1,000 customers a year, and the cost and profit characteristics remain unchanged, it suddenly falls into a steady state of losing $100,000 a year (that's before capital charges, which would make the value destruction even worse). The stock collapses, top management gets fired, and everyone is marveling at how a company could go into the tank so fast.

Does this scenario sound familiar? Leaving aside the simplified numbers, does it suggest Gap's recent experience as it furiously acquired new customers by opening new stores on every corner, then saw its stock collapse? Or WorldCom's spectacular run-up as it offered cash incentives to attract new customers, then crashed and burned? Or cellular phone companies nationwide that did the same thing? We hasten to add that we don't know for sure whether the scenario we describe is what afflicted those companies-and we suspect they don't know either. But the circumstances are certainly suggestive.

What scares so many managers we talk to is that they have no idea whether they're facing this disaster, because they don't know how to look across their firm's products, regions, and sales channels to understand customer profitability. They don't know what it costs them to acquire customers or how long they hold customers or what it costs to maintain them, so they have no idea how much money they make (or lose) on each one.

-The illusion of averages. In our growth illustration above, we assumed for simplicity that all customers were economically the same. In reality that's never the case. The profitability of a company's customers often varies radically. For example, at Royal Bank just 17% of customers account for 93% of the bank's profits. Occasionally a company will calculate a rough measure of average customer profitability, but because profitability is so unevenly distributed, acting on an average number may do more harm than good.

To see why, consider two struggling companies, A and B. The economic profitability of the average customer at each company is the same: -$15. Yet this average figure masks two radically different customer portfolios. Suppose that at company A, every customer is yielding this same dismal economic profit of -$15. But at company B, half the customers are generating economic profit of $80 each, while the other half are yielding economic profit of -$110 each, combining to create the -$15 average.

While the averages for A and B are the same, the implications are vastly different. Company A can't earn an economic profit with any customers and thus faces a bleak future. Company B, by contrast, is tremendously successful with half its customers and performing disastrously with the

other half. If company B's managers can figure out which customers are in which group and why, and then focus on adding more great customers and doing more business with them, while converting or losing the terrible customers, they have a great story for investors. This type of customer de-averaging represents a powerful new way for companies such as B to allocate resources in ways that will turbocharge profits.

MANAGERS AREN'T THE ONLY ONES WHO NEED BETTER knowledge of customer

profitability. Investors do too. They'd love to screen their holdings with the kind of analysis outlined above, but they can't. In today's environment many companies are publishing far more data than before, but they're still excluding a few pieces of extraordinarily valuable information: customer-acquisition costs, maintenance costs, length of customer relationships, and some sense of how customer profitability is distributed. Boards of directors will soon begin to demand customer-- profitability data and will challenge management to act on it; investors will demand that companies report it. They will have to, because knowledge of customer profitability will enable them to attract investors away from competitors that don't have this knowledge. And that's an advantage that no company can safely ignore.

Until recently, trying to calculate the profitability of customers was too hard an infotech task for big companies.

Now the technology is up to the job.

5 ways to fail

Many companies try hard to be customer-centric, but their efforts don't make their shares go up. The reason: They're committing some-and frequently all-of these five sins. Are you?

Denial

Do you insist that the differences in the profitability of your customers aren't important or aren't measurable?

Do you deny that you have unprofitable customers? If you try to measure customer profitability, do you exclude some operating or capital costs?

The Growth Illusion

Are you adding lots of new customers without knowing how much they cost to acquire or how long they're likely to stay? Most important, are you clueless about the economic profit (operating profit minus a capital charge) you can expect from each new customer?

The Illusion of Averages

Do you make decisions based on average customer profitability? Are you ignorant of

how much economic profit comes from the best 20% and the worst 20% of your customers? Are you

unsure about which specific elements of customer behavior cause customers to fall into the top and bottom groups?

Failure to Act

Do you fail to make specific managers fully accountable for acting on

customer profitability? Is your strategic plan disconnected from the economic profitability of customers or customer segments?

Failure to Drive Share Price

Have you stopped short of figuring out how much each customer segment contributes to your share price and then using that knowledge to drive the price up? Have you failed to tell your board and your investors how you're using your knowledge of customer profitability?

Boards of directors will soon begin to demand customer-- profitability data from companies; investors will demand that companies report it.

LARRY SELDEN is a professor at Columbia University's business school; GEOFFREY COLVIN is FORTUNE's editorial director. The authors' book on customers and shareholder value will be published next year.

FEEDBACK gcolvin@fortunemail.com

THIS IS THE FULL-TEXT.

Geographic Names: United States; US

Descriptors: Profitability; Customers; Problems; Competitive advantage; Investment policy

Classification Codes: 9190 (CN=United States); 3400 (CN=Investment analysis & personal finance)

Print Media ID: 28296

August 2004
IntelligentCRM

Customer Profitability Is Not a Financial Metric
Demand chain perspective often accelerates resolution.
By Jack Hafeli, VP & Research Director - Customer Intelligence & Demand Chain
Performance

VentanaView™

Summary
Demand chain performance improvement initiatives with a customer-centric focus take
on additional color when built upon a customer profitability foundation. And yet there
remain barriers to the rigorous application of customer profitability at many
organizations. Ventana Research recommends that treating customer profitability as a
demand chain metric, not a financial measure, is one path to overcoming many of those
barriers. Barriers to reaching cultural and functional consensus have a different texture
with a demand chain mind-set, and the proper application of enabling technologies can
still provide the foundation for the more precise requirements of CFOs. Ventana
Research advises organizations to take an incremental approach, refusing to accept
imprecision as an excuse for inaction.

View
Performance improvement strategies built on customer profitability measurement make
so much sense that it is remarkable that they are not the norm. One barrier to adoption is
that initiatives must begin with business metrics that matter. In most organizations,
relevant data exist, though not often in the form or format needed, and clearing the
hurdles that lie in the path to understanding customer profitability often requires that the
organization accept a degree of imprecision in its measurement. Solutions often involve
estimation and judgmental allocation, which is anathema to many CFOs, particularly in
today's business climate. Ventana Research therefore recommends that companies
initially attack the tough issues outlined here as non-financial demand chain problems in
order to combat organizational inertia.

Defining "customer." The challenge of simply defining the customer dimension
confounds many organizations. Functional perspectives on the customer differ in demand
chain, finance and elsewhere, often with justifiable logic. Within silo-ed applications, an
appropriate definition of "customer" in functional context is often self-evident. It's easy to
rationalize sub-optimal solutions in deference to project deadlines and other pressures.
The result can be inconsistency across applications, even within a business area.

It is our belief that companies must reconcile these inconsistencies and address them with
a little work by a committed organization. A small group of business and IT
representatives can be chartered to conduct a requirements gap analysis and outline a
small number (three is a good choice) of options aimed at short-term resolution consistent

with best practices and organizational objectives. These options can then be brought to a cross-functional decision-making body for final arbitration.

Customer data integration. This endeavor has been known to occupy entire careers. Issues abound with respect to physical and logical integration. Much has been written about both, and a number of vendors offer solutions. The point in highlighting the topic here is simply to suggest that an elusive ideal business solution should not prevent pursuit of what is immediately doable. If nowhere else, customer data is almost always retrievable in some form from sales and order processing systems — a "bill-to" designation for instance. This can provide a jumping-off point for debate if other options don't present themselves; a catalyst for evaluation of other systems and viewpoints.

Value metrics. With some customer dimension as a reference point, relevant metric definitions on that dimension can be pursued. Two metrics commonly applied are customer lifetime value and customer profitability. Lifetime value as a concept comes from marketing, especially direct marketing circles. Customer profitability has financial roots. The latter is arguably an extension of the first, accounting for costs as well as revenue.

In simple terms, lifetime value is the discounted present value of expected revenue streams for each customer. It is derived from customer spending patterns, period-to-period customer retention rates and the organization's internal rate of return on capital. Customer lifetime value derivation calls for a disciplined approach to revenue allocation at the customer level and recognition that timing impacts the value of both money and customers. It also begins to reveal the estimation, allocation and analytical requirements of enabling technology. It's a valuable stand-alone performance metric, provides a revenue basis for calculating customer profitability, and can also serve as a temporary surrogate for the latter measure. Defining and maintaining this metric is a great incremental step that provides footing for addressing the cost side of the equation.

Assigning costs in order to bring the lifetime value equation into the realm of customer profitability is a stiff test. Collecting and managing heterogeneous cost components, data integration, and dynamic maintenance of the pieces and parts, will test an organization's cultural and technical will. Most organizations have a handle on product profitability. At the customer level, product-based unit cost and margin factors can be applied as a starting point. Allocations of cost of sales and general sales and administration (GS&A) expenses are more difficult challenges. Standard costing or activity based costing exercises are options. Process management, data capture, allocation methodologies, and, occasionally, probabilistic and judgmental modeling tools can each play a role in reaching resolution.

The process is one of incrementally building a robust profitability metric over time. In most financial circles, profit is a precise concept, with little allowance for the probabilistic estimation that is sometimes applied liberally. Thus, customer profitability is best treated as a metric in support of demand chain (marketing, sales and service) analysis and planning. Its status as a financial performance metric will come with time, after value is established and a higher level of rigor and precision is achieved.

Assessment

Customer profitability definition and measurement necessarily involves cross-functional interests that compound the obstacles encountered. Compromise is unavoidable. Ventana Research suggests that companies take four critical attitudes into this organizational negotiation:

1. Agree and understand that precision and rigor is the ultimate goal, but not necessarily an immediate requirement.

2. Focus on what is doable now, but maintain a vision of (and launch a parallel effort to achieve) the ideal solution.

3. Start from a foundation of sound, defensible business logic and apply it consistently.

4. Like in any good negotiation, expect that all parties will come away a little dissatisfied.

It is imperative that companies resist the temptation to tackle this as a one-off effort, making use of spreadsheets, for instance. As more information becomes integrated into the derivation process, the metric will change. Robust support and the dynamic use of the resulting metrics in context with all other customer information is the objective. That can only happen in the context of a consistent performance management foundation.

Jack Hafeli is VP & Research Director - Customer Intelligence & Demand Chain Performance at Ventana Research.

http://www.intelligentcrm.com/showArticle.jhtml?articleID=26806406

Customer Profitability and Demand Chain Strategies

Creating cross-functional customer value-based initiatives.

By Jack Hafeli, VP & Research Director - Customer Intelligence & Demand Chain Performance

VentanaView™

Summary

Demand chain strategies built upon customer value metrics such as profitability or lifetime value provide examples of the effective application of Ventana Research's PerformanceCycle framework for driving performance improvement. Ventana Research suggests that cross-functional marketing, sales, and service strategies that are created to engage value-based customer segments could help organizations realize impressive return on customer information assets. We further suggest that an account-management attitude toward customer relationships is an important ingredient in a successful deployment.

View

Customer value and profitability metrics provide a PerformanceCycle foundation of "understanding" in the Ventana Research performance management framework. Measurable performance improvement comes only through leveraging this understanding to optimize processes and applying technology to bring the organization into greater alignment.

Ventana Research finds that best practices in the demand chain at top performing organizations are optimized with robust applications built on a solid interpretation of cause-effect relationships. What are the determinants of customer value? What are the characteristics of profitable, marginal and unprofitable customers? What can be learned from customer attributes and behaviors? What are the relative responses to organizational actions, attitudes, and behaviors? What organizational behaviors can be identified that have influenced positive, profitable interactions with customers?

These are all straightforward examples of customer segment and market response analyses that take on new meaning when applied to customer segments defined on profitability. When organizations derive optimal strategies from a clear understanding of profitability by customer, as well as by product group and channel or vertical target market, the real value of customer value-based metrics begins to surface.

Cross-functional objective setting by profit segment is an approach that resonates with virtually any senior business management team. When the fundamentals of segmented target marketing are extended into the sales and service functions, cross-functional alignment is brought into the customer value dimension. In this scenario, all customer-facing operatives are armed with consistent knowledge and support systems that

differentiate customers and prescribe modified behaviors based on profit potential going forward.

The marketing department targets its efforts to reach and capture leads with higher profit profiles, not just higher response rates. The sales department qualifies prospects based on profitability expectations, not only revenue. Account management is goaled on migrating existing customers into more profitable segments, not just retention or cross-sell rates. Service center practices are optimized to align with value-weighted customer satisfaction scores. In these examples, each profit segment receives specialized treatment that reflects not only differentiated marketing messages and promotional offers, but also specialized sales support materials and customer service procedures and practices. This is clearly doable only with scalable applications and IT infrastructure.

This value-based strategic technique applies well in both business-to-consumer (B2C) and business-to-business (B2B) commercial environments. Ventana Research is of the opinion that adoption of an ongoing account management mind-set is the most important differentiating factor in either environment. A customer value-based account management approach is more likely to be a de facto best practice in top performing B2B organizations. A finite customer/prospect base and direct personal contact with each customer is more typical. Even without a supported value-based strategy, top performing account reps will judgmentally determine which customers are marginally more fruitful customers and prospects at a given point in time. A B2C organization's larger customer universe makes such an ad hoc approach impractical, increasing the value proposition of a software-based solution.

Assessment
Among those organizations that have established a foundation of customer value and/or customer profitability, Ventana Research asserts that such metrics should be dynamically maintained and used more often as the basis for cross-functional business initiatives. Those that have not built customer value metrics should do so. Regular assessment of enterprise and business unit P&L will drive new business initiatives, and, in a similar vein, changes in product profitability are often the basis for shifting organizational objectives. Clearly, customer profitability dynamics should drive strategies across the demand chain. We further recommend that value-based strategies best bring about performance improvement when account management processes are linked to sales management. Customer acquisition efforts and those aimed at retention are best treated as a single process continuum, defined to encompass all components of the customer-facing demand chain.

Jack Hafeli is VP & Research Director - Customer Intelligence & Demand Chain Performance at Ventana Research

http://www.intelligentperformance.com/showArticle.jhtml?articleID=29100139

Sales Effectiveness and Customer Profitability
Using planning and analysis to optimize account coverage
By Robert D. Kugel - CFA, VP & Research Director - Financial Performance
Management

VentanaView™

Summary
Enhancing sales effectiveness to increase corporate profitability is an important objective
of performance management. To achieve it, companies must measure profitability
accurately and in a timely manner, and sales objectives must be established based on
customer/account profitability. For some companies this may not be practical or even
feasible because of the nature of their business or because getting to the data is too
difficult. Nonetheless, most companies with a business-to-business selling model that do
not have complex product sets should be able to fatten their bottom line by following a
profitability-based sales management regimen. Finance departments can and should play
an important role in spearheading and managing these efforts since much of the
information exists in their IT systems. Ventana Research advises CFOs and controllers
that want to increase the strategic value of the finance organization to focus on
developing systems that optimize customer profitability.

View
While companies can (and do) work on improving customer profitability without
software, Ventana Research believes automating the process will produce consistently
better results, particularly in the case of managing how sales people allocate their time.
There are a variety of software options to facilitate the process of measuring account
profitability, using this information to establish sales targets for each account in a way
that optimizes revenue and profit objectives and monitoring sales performance.

In most business-to-business sales situations, companies (and individual sales people)
have accounts with varying size and profitability characteristics. While bigger customers
may be more profitable, they are not dependably so. Larger accounts may be attractive to
individual sales people because they produce high absolute commissions, but smaller
accounts may be more profitable after direct costs, discounts, support, and other items are
considered.

Balancing revenue and profit targets to optimize the mix of business is an important
element of sales management. In the past, managers and sales people have had to rely on
intuition rather than hard facts to make decisions on how to structure account coverage
and set objectives. Ventana Research asserts that companies in many cases can and
should apply the customer data they already have to make these decisions.

An international technology components company has deployed a system that helps it establish sales objectives to optimize revenue and profitability objectives by customer, and assess how well its sales organization executes the plan. Initially, the company deployed Hyperion Planning to (among other purposes) set its revenue goals by account and to measure how well these objectives were met by individual sales people. Later, the controller investigated the profitability of customers and discovered that, contrary to what was generally believed by the sales organization, many smaller customers were consistently much more profitable than larger ones.

Although this type of ad hoc investigative analysis is almost always done with stand-alone spreadsheets, measuring account profitability on a routine basis in any mid-size to large company with simple spreadsheets is infeasible because the data sets are too big and the customer sets too dynamic. The relatively simple prototype usually gets bogged down as additional dimensions of information are layered on, increasing obsolete data, modeling errors, and other problems. The net result is that what started as a good idea winds up being ignored and fades away because of the inability of the systems to support it.

Moreover, to gain a true appreciation of the information available (and ensure buy-in from the sales and finance organizations), Ventana Research finds it is necessary to be able to look at the data from multiple perspectives. For example, account performance may need to be examined and compared over the past 3- 6- and 12-month periods (or even longer) if, by the nature of the business, orders are irregular and infrequent. Assessing the cost of developing a new customer is another useful metric. The custom application makes it possible to allocate all operating costs using different methodologies (e.g., proportionately by revenues, by headcount, etc.). This makes it possible to work through multiple allocation approaches rapidly to deal with any objections that the numbers are wrong, while ensuring all direct and indirect expenses have been included. Theoretically this can be done with stand-alone spreadsheets, but their lack of data integrity and referential integrity quickly make them too unwieldy to be a practical tool.

Assessment
Corporations can take a variety of approaches to managing customer/account profitability, both in terms of process as well as the software that supports the effort. However, we strongly advise companies that want the effort to succeed to support these initiatives with the appropriate software packages and tools. An easy place to start in a sales effectiveness initiative is to use an existing planning/budgeting tool to manage the sales forecasting process (e.g., setting objectives by account by sales rep). In our judgment, performance management tools like Cognos and Hyperion are well suited to the financial information tracking and analysis that needs to be done to measure profitability. We strongly advise against using individual spreadsheets except in the prototyping and designing phases.

http://www.intelligentcrm.com/showArticle.jhtml?articleID=21100395

02842846   783051621

<mark>Can we predict customer lifetime value?</mark>

Malthouse, Edward C; Blattberg, Robert C

Abstract:
Relationship marketing assumes that firms can be more profitable if they
identify the most profitable customers and invest disproportionate
marketing resources in them. While intuitive, such strategies presume that
a firm can accurately predict the future profitability of customers. In
particular, we argue that the feasibility of such strategies depends on the
probabilities and costs of misclassifying customers. This paper presents a
detailed empirical evaluation of how accurately the future profitability of
customers can be estimated. We evaluate a firm's ability to estimate the
future value of customers using four data sets from different industries.
Out-of-sample estimates of predictive accuracy are provided. We examine (1)
the accuracy of predictions, (2) how accuracy depends on the length of time
over which estimates are made, and (3) the predictors of the firm's best
customers. We propose the 20-55 and 80-15 rules. Of the top 20%,
approximately 55% will be misclassified (and not receive special
treatment). Of the future bottom 80%, approximately 15% will be
misclassified (and receive special treatment). Thus, a firm cannot assume
that high-profit customers in the past will be profitable in the future nor
can they assume that historically low-profit will be low-profit customers
in the future. (PUBLICATION ABSTRACT)

Descriptors: Relationship marketing; Profitability; Predictions; Mathematical models;
Customers; Statistical analysis; Studies
Classification Codes: 7000 (CN=Marketing); 9130 (CN=Experimental/Theoretical)
Print Media ID: 12651

Building and sustaining profitable customer loyalty for the 21st century

Kumar, V; Shah, Denish

Abstract:
The concept of customer loyalty is conspicuous by its ubiquity. Therefore,
there is no surprise that it is one of the most widely studied areas by
researchers and one of the most widely implemented marketing initiatives by
practitioners. This article draws upon past research to review important
findings related to customer behavior and attitude in the context of
customer loyalty. Further, research related to linking loyalty to
profitability and forward looking metric such as the customer lifetime
value is reviewed to propose a conceptual framework for building and
sustaining loyalty and profitability simultaneously at individual customer
level. A two-tiered rewards structure is presented as a means for marketers
to operationalize the framework. The conceptual framework hopes to serve as
a platform to understand the evolving dominant logic of loyalty programs
for building and sustaining loyalty in the twenty first century as well as
induce further research in that direction. (PUBLICATION ABSTRACT)

02387415   134067241

Case study: Customer profitability and customer relationship management at RBC Financial Group

Narayanan, V G; Brem, Lisa

Abstract:
RBC Financial Group entered the tumultuous twenty-first century as Canada's leading bank. With Canada's finance industry in flux from changes in banking regulations, many smaller banks were acquired or changed their focus away from retail banking. In the early part of the new century, RBC emerged as one of Canada's few full-service, national, and international financial institutions. The seeds of a CRM program at Royal Bank were planted in 1997 as the result of several marketing projects within the Bank. The Strategic Marketing Research and Analytics group had been conducting brand research, as well as segmentation and predictive modeling using information from Royal Bank's data mart. In response to the competitive pressures nipping at its heels, Royal bank wanted to actively use the information that it had on its customers to interact with them in a more informed way.

Company Names:
RBC Financial Group (NAICS:551111)
Royal Bank of Canada (Duns: 20-524-7372 NAICS:522110)
Geographic Names: Canada

Descriptors: Case studies; Bank marketing; Statistical data; Customer relationship management
Classification Codes: 9172 (CN=Canada); 8120 (CN=Retail banking); 7100 (CN=Market research); 9140 (CN=Statistical data); 9110 (CN=Company specific)
Print Media ID: 12651

Abstract:
Most decision making research in management accounting remains focused on
cost information in a production context. Little is known on the relevance
of customer profitability analysis (CuPA) reports, which more accurately
reflect revenue and marketing support variations across customers, for
marketing decisions. This study uses an experimental design to examine the
impact of such reports on resource allocation decisions (that affect the
firm's profits) in marketing environments varying in complexity. The main
result of the experiment suggests that the value of CuPA reports depends on
the complexity of the marketing setting. Only in a highly complex marketing
setting do they enhance resource allocation decisions and resultant firm
profitability. Conversely, in the simple marketing environment, decision
makers can combine their traditional volume-based cost data with other
available types of feedback to perform as well as under a more accurate
CuPA report. These findings on complexity contrast with those of a prior
study in a production context (Gupta and King, 1997). It is argued that
improvements in the current research design, in the form of regularly
updated profitability reports and concerning accuracy, increase the
relevance of CuPA reports in a complex marketing setting. (PUBLICATION
ABSTRACT)

Linking Customer Management Effort to Customer Profitability in Business Markets

Bowman, Douglas; Narayandas, Das

Abstract:
Chain-link frameworks such as the Service-Profit Chain (SPC) are much
discussed as a means to link customer profits to operational resources
under the influence of vendor managers, though empirical testing to date
has been limited primarily to consumer services settings. In this paper,
the authors adapt the SPC framework to accommodate characteristics of
industrial markets, specifically the complex decision-making unit,
strategic supplier selection, and resource allocation at the individual
customer level. They also extend the SPC framework to allow for a richer
description of the complex linkages between vendor effort and account
profitability, namely, nonlinear linkages and differential responsiveness
occasioned by customer-specific factors such as competitive context.
Controlling for such factors illuminates, to some degree, why similar
levels of customer management effort and/or performance can yield quite
different customer profitability outcomes. An application is presented that
demonstrates how adapting and extending the SPC to industrial markets can
provide vendors with (1) insights into the process that culminates in
individual customer profitability and (2) useful guidelines for adapting
their customer management efforts at the individual account level with an
eye towards improving account profitability. The results show the
importance of accounting for decreasing returns to customer management
effort at a given account and reinforce the notion of customer delight.
(PUBLICATION ABSTRACT)

Descriptors: Profitability; Business to business commerce; Market strategy; Studies
Classification Codes: 7000 (CN=Marketing); 9130 (CN=Experimental/Theoretical)
Print Media ID: 27556

02710145   621104961
Achieving Deep Customer Focus

Vandermerwe, Sandra

Abstract:
Today's managers acknowledge the importance of customer focus. Yet the
costly customer efforts they usually implement rarely bring the promised
gains. The reason? A superficial understanding of what customer focus
really means. True customer focus involves comprehensive organizational
change. As Baxter Healthcare, LexisNexis, IBM and BP are learning, the kind
of customer focus that creates an advantage competitors have great
difficulty copying calls for companywide transformation. The author's
in-depth research over many years shows how 10 breakthroughs in thinking,
remarkably consistent across industries, improve growth and profitability
more effectively than customer-relationship-management software, loyalty
programs or satisfaction surveys. The author describes how, for example,
the manager of Baxter Healthcare Corp. Germany got employees thinking of
themselves as doing postoperative "home-recovery enhancement" instead of
merely providing postoperative nutritional products to hospitals - and how
that ultimately led to Baxter becoming indispensable to customers. When
deep customer focus gets rooted in employee behavior, people at all levels
become innovators. (PUBLICATION ABSTRACT)

Company Names:
Baxter Healthcare Corp (Duns: 00-508-3209 NAICS:339112)
LexisNexis Group (NAICS:511140; 518210)
BP PLC (NAICS:324110; 447110)
IBM Corp (Duns: 00-136-8083 Ticker: IBM NAICS:334111; 334119; 334611 ; 511210;
334413)
Descriptors: Customer relations; Organizational change; Strategic management;
Innovations; Manycompanies; International; Guidelines
Classification Codes: 9180 (CN=International); 2500 (CN=Organizational behavior);
2310 (CN=Planning); 2400 (CN=Public relations); 9150 (CN=Guidelines)
Print Media ID: 23942

Customer Profitability Studies

What is the true value of a lost customer?

Hogan, John E; Lemon, Katherine N; Libai, Barak

Abstract:
Customer profitability models have evolved into an important strategic tool
for marketers in recent years. Traditional customer profitability models
implicitly assume that customers can be valued in isolation from one
another and that social interactions can be ignored. It is shown that these
conventional models may be inappropriate for markets involving new products
or services because they fail to account for the social effects (e.g., word
of mouth and imitation) that can influence future customer acquisitions. It
is also shown how the impact of a lost customer on the profitability of the
firm depends on whether the customer defects to a competing firm or
disadopts the technology altogether, and when the customer disadopts the
technology - distinctions often overlooked in conventional models. The
results demonstrate how the value of a lost customer changes throughout the
product life cycle, showing that the loss of an early adopter costs the
firm much more than the loss of a later adopter.

Text:
Customer profitability models have evolved into an important strategic tool
for marketers in recent years. Traditional customer profitability models
implicitly assume that customers can be valued in isolation from one
another and that social interactions can be ignored. The authors show that
these conventional models may be inappropriate for markets involving new
products or services because they fail to account for the social effects
(e.g., word of mouth and imitation) that can influence future customer
acquisitions. They show how the impact of a lost customer on the
profitability of the firm depends on (a) whether the customer defects to a
competing firm or disadopts the technology altogether and (b) when the
customer disadopts the technology-distinctions often overlooked in
conventional models. The results demonstrate how the value of a lost

customer changes throughout the product life cycle, showing that the loss of an early adopter costs the firm much more than the loss of a later adopter.

Consider the following scenario. Joan has heard a lot about Web-enabled cell phones recently from friends and through magazine and television ads. After several weeks of deliberation, she decides to add the service to her existing mobile phone service to access the Web and check e-mail while away from home. After a few months, she starts to use it less and less until she eventually puts it aside and cancels her service subscription.

What is the financial impact on the seller of Joan's decision to disadopt Web-enabled cell phone service? Conventional customer profitability models would attribute the lost profit to the value of Joan's potential product upgrades, usage, service contracts, software, and accessories that she might purchase in the future. Yet such an approach would significantly underestimate Joan's value to the firm. Had Joan continued to use the service, she would have influenced potential customers to switch from basic cell phone service to Web-enabled service each time she used it in public or wondered aloud how she ever managed to live without it. In other words, focusing only on the direct effect associated with the profits from Joan's future purchases overlooks the indirect effect that Joan's word of mouth, imitation, and other social effects have on future sales. As we show in this research, the profit impact on the firm of these "lost" social effects can be substantial.

In recent years, customer profitability models have evolved into an important strategic tool for managers in a variety of markets. Although considerable research has focused on direct purchases when assessing the value of a lost customer (cf. Berger and Nasr 1998; Blattberg and Deighton 1996; Dwyer 1997; Rust, Lemon, and Zeithaml 2001), scholars have yet to develop a viable approach to assess indirect social effects. As we demonstrate in this article, focusing solely on direct purchases will understate the value of lost customers in markets where disadoptions are common. Because anecdotal evidence suggests that increasing numbers of marketers rely on individual customer profitability models to guide marketing strategy (Brady 2000), failure to include these social effects could lead to misallocation of scarce marketing resources during the critical early stages of a new product market. Given the increasing technological content of many product and customer service applications, this appears to be a pressing management issue that should be addressed by academic research.

The purpose of this article is to examine the effect of disadoptions on the value of a lost customer. We demonstrate how the value of a lost customer depends on whether the customer defects to a competing firm or disadopts the product category altogether. The impact of disadoption on customer value is explored using Monte Carlo simulations and an analysis of data

from the online banking industry. Specifically, we find that a lost customer can affect the firm through self-losses related to disadoptions by the firm's customers and through competitor-based losses related to a slowdown in the overall category-level sales due to disadoptions of competing products. We also find that the value of a lost customer changes throughout the product life cycle, with the loss of early adopters of a technology costing the firm much more than the loss of later adopters. Finally, we show a link between firm market share and individual customer profitability.

This research contributes to our understanding of the value of a customer in several ways. First, it reveals the importance of distinguishing between customers who disadopt entirely (stop purchasing from the category) and those who merely defect to a competing provider. Second, the research incorporates the cost of disadoption of competitor customers into customer profitability. Third, it provides a new link between customer retention and acquisition. Fourth, it provides a new tool to improve marketers' ability to assess customer profitability over time. Overall, the research suggests new reasons for firms to attend to postpurchase customer service strategies early in the evolution of the product market to minimize the likelihood of disadoption. The article is organized as follows. We begin by providing a conceptual background regarding disadoption and its effects on customer profitability. We then propose an approach for valuing the effect of disadoptions on the value of a lost customer. This is followed by a Monte Carlo simulation to determine the relative importance of key variables and an empirical illustration of the approach to the online banking industry. Finally, implications for marketing theory and practice and directions for future research are discussed.

CONCEPTUAL BACKGROUND

Defection Versus Disadoption

In the years since Reichheld and Sasser (1990) first demonstrated the effect of customer retention on firm profits, researchers have made substantial progress in understanding the mechanics of customer defection. Recent studies have provided insights into defection processes (Keaveney 1995), consumer profiles of switchers (Ganesh, Arnold, and Reynolds 2000; Rust and Zahorik 1993), the role of satisfaction (Oliver 1997), and ways to prevent defections (Jones, Mothersbaugh, and Beatty 2000). Although some of the claims about the link between customer retention and profitability have been challenged recently (Dowling and Uncles 1997; Reinartz and Kumar 2000), there is a general consensus that preventing customer defections is a sound business strategy (Anderson and Mittal 2000; Zeithaml 2000).

It is important to distinguish between the effects of defection and disadoption on firm profitability. Customer defection refers to a situation in which a customer leaves one firm in order to purchase from another. When a customer defects, the firm loses the direct sales that the customer would have made had he or she remained loyal to the firm. In contrast, disadoption occurs when a customer rejects an innovation and ceases

purchasing from the product category altogether. One of the differentiating characteristics of disadoption and defection is that there are two ways that disadoption can affect long-term profitability. When a customer disadopts, the firm loses not only the direct effect of customer purchases but also the indirect effect of word of mouth, imitation, and other social effects that influence future customer acquisitions of the category. Indirect social effects are integral to the diffusion process in many markets because they help potential consumers reduce the perceived risk of adoption. As prior research has demonstrated, the contribution of these indirect social effects to the rate of category growth can be substantial (Rogers 1995).

The issue of postadoption behavior, and specifically disadoption, has received considerable attention in the technology management literature regarding the implementation of information technology within organizations (Meyers, Sivakumar, and Nakata 1999). Several studies have found that the usage of new technologies such as material requirement planning systems (Cooper and Zmud 1990), computer-aided design systems (Liker, Fleischer, and Arnsdorf 1992), and object-oriented software (Fichman and Kemerer 1993, 1997) are often much lower than the number of reported adoptions. In a broader context, Rogers (1995) has observed the need for additional research on the antecedents and consequences of disadoption to more fully understand the social processes driving diffusion.

Recent research has begun to investigate the process of disadoption. Using a diffusion approach, Redmond (1996) examined the consumer process of quitting smoking and its antecedents. Unson (2000) examined the psychological determinants of the decision to disadopt certain contraceptive methods. Finally, Kleine, Kleine, and Allen (1995) found that consumers experience attachment to objects and therefore find it difficult to let go, or disadopt, such objects. Overall, this research suggests that the decision to disadopt is significantly different from the decision to defect.

The growing body of research on disadoption suggests that it may be a substantial problem for marketers, especially in markets using new technologies to manage the customer experience. It is notable, therefore, that the problem of understanding the impact of disadoption on customer profitability has not been addressed in scholarly research. One reason for this lack of research may be that most empirical studies dealing with lost customers have focused on mature markets such as insurance, credit cards, and catalog sales where customer data are readily available. Historically, disadoption has been less of a concern for these markets because of the relative lack of technological innovation. This may no longer be the case as firms in these mature industries reengineer their customer service functions using Internet and wireless technologies. These new technologies can reduce the firm's cost to serve by automating previously personalized service encounters such as transaction processing and customer service. For example, the American Bankers Association estimates that banks save

approximately $0.80 for every personalized transaction that is converted to an automated teller machine (ATM).

The economic benefits derived from such new technologies have led to a proliferation of self-service technologies such as telephone-based response systems, online response systems, and interactive kiosks that enable consumers to produce a service independently of employee involvement (Meuter et al. 2000). Not surprisingly, consumers often experience considerable pressure from firms to adopt these new service technologies. The banking industry has been particularly aggressive in pursuing self-service technologies by increasing the cost of using personalized service relative to automated technologies such as ATMs and electronic banking (Stoneman 1997).

Another reason for the lack of research investigating the impact of disadoption on customer profitability is that incorporating indirect social effects such as word of mouth into customer valuation models has been considered an intractable problem to date (Rust, Zahorik, and Keiningham 1995; Zeithaml 2000). Research indicates, however, that increased retention spending can lead to incremental customer acquisition as satisfied customers share their experience with others (Danaher and Rust 1996), suggesting the need to incorporate these effects into customer profitability models. In addition, the increasingly prominent role of technology in most product markets has increased the need for managerial tools that can account for the profit impact of disadoption on customer profitability. In the following section, we show how this can be accomplished.

DETERMINING THE EFFECT OF DISADOPTION ON THE VALUE OF A LOST CUSTOMER

Assessing the value of a lost customer requires that we distinguish between defectors and disadopters. If the relative proportion of a firm's lost customers who are disadopters is it, then the value of an average lost customer is

$$VLC = \alpha \, VLC_{disadopter} + (1 - \alpha) \, VLC_{defectors} . \quad (1)$$

In addition to being firm specific, the value of a may vary across markets as well. In some markets (typically lowtechnology markets), the value of alpha will approach 0, and the value of a lost customer can be measured with conventional customer lifetime value models for defectors (cf. Berger and Nasr 1998; Dwyer 1997; Rust, Lemon, and Zeithaml 2001). However, situations where disadoptions are common, such as for technology-intensive products, $\alpha > 0$, and therefore we must estimate $VLC_{disadopter}$ in order to calculate the value of an average lost customer. This study focuses on estimating VLC

sub disadopter

. However, the relative importance of disadoptions in shaping the total value of lost customers depends on the value of a for a specific market.1

Estimating Future Sales With a New Product Growth Model

To estimate the financial impact of disadoptions on lost customer value, we must capture the sales effect of slower customer acquisitions caused by the reduced level of word of mouth and other social effects. We use the Bass new product growth model to capture these lost social effects and to describe the typical evolution for a product market (Bass 1969; Mahajan, Muller, and Bass 1990). The model, which follows Roger's diffusion-of-innovation theory, assumes that two forms of communication influence adopters: mass media (e.g., advertising) and social influence (e.g., word of mouth). One appeal of the model is that it is flexible enough to accommodate a wide variety of marketspecific situations such as different marketing mixes and consumer purchase. Moreover, the basic model has been shown to have a good fit for a large number of products (see Mahajan, Muller, and Wind 2000 for a recent review and for an in-depth examination of the underlying assumptions of the model).

Estimating the Profit Impact of a Lost Customer

There are two possible sources of direct profit from customers. The first stems from the contribution margin generated from the initial purchase, whereas the other is derived from periodic profits generated by ongoing services or user charges. If the product is one for which there is little or no relationship with the selling firm after the sale, then the profit derived from the customer stems from the initial sale only (e.g., a digital video disk (DVD) player). If the product is a service for which there are only periodic usage charges (e.g., Internet access), then only the periodic profits matter. A product can also have both as in the case when a cellular-service provider profits from the initial equipment purchase and the monthly usage fees. These distinct sources of profit can all be handled by our approach.

Note that the profit impact of the indirect effect is due to the deceleration of the diffusion process. We illustrate this effect with an example in which a firm loses 100 customers in the 3rd year as a result of new product rejection (see Figure 1). Figure 1 illustrates how the loss slows the adoption of the product and postpones the peak of the sales curve by nearly 2 years. This deceleration of future sales creates two problems for the firm. First, it decelerates the rate of customer acquisitions, thereby reducing the value of the new technology to the firm (Srivastava, Shervani, and Fahey 1998). It also increases the probability that some competing technology will be introduced that will prevent the complete diffusion of the new product or service.

FIGURE 1

It is important to note that traditional customer profitability models implicitly assume that customers can be valued in isolation from one another and that social interactions can be ignored. In this research, we

no longer make this simplifying assumption. Although we focus on firmlevel profitability, firm profit as measured by the difference between Equations 3 and 4, when a single customer is lost, is equivalent to an individual customer profitability measure that incorporates social interactions.

Adapting Modeling Assumptions to Market-Specific Conditions

The basic version of the approach presented above includes a few assumptions that should be noted. First, as with basic Bass model modeling, diffusion parameters, p, q, and market potential, m, stay constant through the diffusion process. In addition, we assume that revenues from the product K_i and L_i stay constant with time. Finally, S_i represents the firm's share of the new adopters for the product category during the period. Although S_i could be estimated using a variety of survey or experimental techniques, a simple proxy would be to assume that the percentage of new adopters is equal to the firm's current market share in period t_i. In the basic model, we assume that S_i stays constant through the customer valuation horizon.

An appealing aspect of our approach is that it can be adapted to accommodate market-specific conditions by relaxing the basic assumptions. In fact, even the basic Bass model itself can be replaced with alternative models. For example, any of the many extensions to the Bass model that include marketing mix and other variables could be used.2 Yet, given the ability of the basic Bass model to capture the diffusion process without decision variables (see Bass, Jain, and Krishnan 2000 for a discussion of this issue) and possible estimation problems using many parameters with limited data, we believe that the basic Bass model is sufficient in many cases.

Another assumption that can easily be relaxed is the use of a constant market share to estimate S_i. This is a reasonable assumption for relatively stable markets in which the relative market shares of competitors do not change substantially during a limited time period. However, in more dynamic markets, it is possible to model S_i in Equations 3 and 4 as a function of time to reflect the actual share of losing and gaining customers. Similarly, other parameters such as the profit from initial purchase L

sub i

and profit from per period purchase K

sub i

can also be modeled as a function of time if appropriate.

The theoretical approach discussed above suggests that a lost customer may have a significant profit impact on the firm. However, it is important to examine the specific determinants of the value of a lost customer to understand the magnitude of the impact of the indirect effects on customer profitability.

THE KEY DETERMINANTS OF THE VALUE OF A LOST CUSTOMER

In this section, we conduct an industry-level analysis to identify which of the market and firm variables have the greatest impact on the value of a lost customer. The analysis employs a Monte Carlo simulation in which the key parameters (i.e., p, q, t

sub i

, and d) were varied based on previous research and commonly observed market conditions. Based on previous findings in the new product diffusion modeling literature (Parker 1994; Sultan, Farley, and Lehmann 1990), p was sampled randomly from values ranging from .0001 to .06, and q was sampled randomly from values ranging from .1 to .7 (both means correspond to the Sultan, Farley, and Lehmann 1990 means). The value of d was sampled randomly from a range of 0 to 0.15, and t, was sampled from a range of 0 up to 10 years after the innovation was launched. For each trial of the simulation, the value of a lost customer was calculated based on the input parameters and a 5-year horizon.

On the basis of the results, we conducted a regression analysis to examine the effect of each of the four variables on the value of a lost customer. We chose a log-linear formulation because of the expected exponential relationship between the independent variables and the dependent variable. The analysis employed a random sample of 120 observations, which exceeds generally accepted recommendations for generalizability (Hair et al. 1995).

Results

The results of the regression analysis in Table 1 show that the coefficients for all four variables are significant and that the independent variables explain a large portion of the variance of the dependent variable (adjusted R

sup 2

=.63).

From the standardized coefficients, we see that the time when a customer disadopts has the largest impact on the value of the lost customer. The earlier a customer disadopts, the more money the company loses. Early in the product's life, there is only a small pool of users available to affect future adopters through word of mouth and other social effects, and thus a single disadoption can have a significant effect on the rate of future customer acquisitions. This effect diminishes later when many more adopters join the pool that can influence, and thus the indirect effect of a single

adoption goes down.

We also see that the external-influence parameter p has a negative impact on the value of a lost customer. This effect can be attributed to the number of previous adopters at any time period-the slower the penetration (due to a lower p), the lower the number of previous adopters for a given time period and thus the higher value of each lost customer. In contrast, the internal-influence parameter, q, has a positive impact on penetration because a higher q means a stronger word-of-mouth effect and thus, the company loses more with each lost customer.

Finally, as expected, discount rate has a positive impact on the value of a lost customer. As the discount rate increases, current revenues become more important and, likewise, the value of a lost customer in the firm's profit stream.

THE EFFECT OF DISADOPTION ON MARKET POTENTIAL

An important assumption made in the calculation of the value of a lost customer regards the ability of the firm to reacquire lost customers after they disadopt. In the basic model, we make the assumption that a lost customer does not rejoin the pool of potential customers, at least for the customer lifetime horizon examined (e.g., 5 years). An alternative is to assume that the lost customer joins the pool of potential customers and thus may readopt the product at any time after he or she disadopts. Although the applicability of the assumption may be product specific, it is important to understand how much additional profit can be earned if the customer is not lost for good upon disadoption.

To examine this point, we conducted a Monte Carlo simulation (using 5,000 trials), using the same parameter range as in the simulation reported in Table 1. We examined a 5-year horizon for the lost customer value calculations and looked at a case in which there are only service charges, with no setup charges (to avoid the situation where a service provider makes money by charging setup cost again to a previous disadopter).

TABLE 1

We found that, on average, when the disadopter has the potential to readopt the product, the disadoption loss is reduced by nearly one half (49%). This means that, even if firms cannot avoid some disadoptions, they might be able to mitigate much of the harm done by working to keep the disadopters within the pool of potential customers.

The results of the simulation highlight the critical role that indirect effects have in determining the value of a lost customer. It is important to understand the specific ways in which the firm "loses" due to the loss of a customer. To understand the specific impact of a lost customer, we now turn to an empirical illustration of the approach.

EMPIRICAL ILLUSTRATION

We demonstrate the approach developed in the previous section by applying it to the online banking market (often called PC banking or Internet banking). With the advent of the Internet, online banking was expected to have a substantial impact on the lives of consumers. Proponents touted that

it would enable consumers to conduct financial transactions at home 24 hours a day while avoiding long lines for personal tellers (Rose 2000). In addition to consumer appeal, the technology appealed to banks because it enabled them to offer more services while reducing costs. These savings could be substantial, with some industry analysts placing the variable cost of personal service as much as a hundred times the cost of online service (Orr 1999).

The surge of Internet users in the mid-1990s created pressure for banks to move rapidly into the online banking market or risk losing customers to new "e-banks" and to traditional banks with online capabilities (Robinson 2000). In response to this competitive pressure, many banks introduced online banking prematurely with inadequate technology that failed to meet consumer expectations. For many consumers, online banking turned out to be a frustrating affair that often caused as many problems as it solved (Rose 2000). Sites frequently offered limited services that required navigating a complex and often confusing customer interface. Recent consumer surveys reveal that many of the initial users have disadopted online banking and are not inclined to try it again in the near future (Robinson 2000; Rubino 2000; Trotsky 1999). Not surprisingly, the active use of online banking even among PC owners in the end of the year 2000 was much lower than initial expectations (Johnson 2000; Robinson 2000; Rubino 2000). Banking managers have realized belatedly that improving customers' experience with online banking will require substantial capital investments (Monahan 2000). Moreover, the return on those investments can be estimated only if the bank understands the value of customers, and more important, the value of disadopters.

The Value of a Lost Online Banking Customer

Calculating the value of a lost customer in the online banking industry requires estimations for the diffusion parameters p, q, and m. We estimated these parameters on the basis of data on the penetration of online banking obtained from various issues of Online Banking Report, a leading industry trade publication. Household usage of online banking through the year 2000 is shown in Figure 2. These data were augmented with interviews from representatives of the American Bankers Association, the leading trade organization, and managers in the banking industry. On the basis of these data, we used nonlinear least squares to obtain parameter estimates: p = .008, q = 0.61, and m = 32.4 million households.

Next, we estimated the cost differential for servicing an online transaction versus a personal transaction. In general, there is no initial profit from online banking at the time of subscription and thus, the variable L in Equations 3 and 4 is 0. The periodic savings (K_i) of online banking versus a personal teller were estimated at $1.06 per transaction based on data provided by the American Bankers Association.[3] Thus, a customer conducting one transaction per week would save the bank approximately $55 per year.[4] For the purpose of the initial analysis, we

assume a discount rate of 10%, a time horizon for the customer lifetime of 5 years as suggested by Berger and Nasr (1998), and a firm market share of 100%.

FIGURE 2

On the basis of these estimates, we show in Figure 3 the value of a lost customer in the online banking industry against the time period in which the customer disadopted. The direct purchase effect is the discounted value of the $55 annual savings over 5 years, which is approximately $208. The indirect social effect changes with time; it is large if the disadoption occurs early in the product life cycle and goes down exponentially in the latter stages of the life cycle. In the case of online banking, the indirect social effect is larger than the direct purchase effect until Year 4. In general, the difference between the total effect (which includes the social effect) and the direct effect helps to explain the degree to which conventional customer lifetime value models have misstated the financial impact of lost customers.

The previous analysis examined the value of a lost customer when the firm held 100% market share. We now extend the analysis to understand how the value of a lost customer will change when the firm has a market share of less than 100%.

The Effect of Competitors' Lost Customers

In conventional models, market share has no effect on customer profitability. However, when the profitability model is extended to include social effects, the relationship between market share and customer profitability becomes apparent. As previously noted, the indirect effect of a disadoption is determined by the loss of social interactions of the customer that decelerate the growth rate of the product category. When a firm has less than 100% market share, this deceleration can occur via the disadoption of the firm's customers as well as the disadoption of its competitor's customers.

FIGURE 3

Figure 4 shows the relationship between market share and the value of a lost customer for the online banking industry after the disadoption of 10 customers from the product category 2 years after the introduction of the new technology (Figure 4a) and 5 years after introduction (Figure 4b). We again assume that the savings per year for this bank are $55. The figures demonstrate how there are actually three ways that disadoptions can affect the firm when market share is less than 100%. The first two fall under the category of self-loss that occurs when the firm loses its own customers. Self-loss includes the direct purchase effect of its own customers who disadopted and the indirect effect-the firm's share of the social effect of these customers. For example, if Firm A's market share is 10%, then Firm A would lose one customer for every 10 disadopters, on average. This would equate to losses of $208 due to the direct effect as well as 10% of the lost indirect effects from that one customer. The total self-loss amounts to about $263, as shown in Figure 4a.

The third source of financial loss stems from the effects of competitors' lost customers. When competitors' customers disadopt, the absence of their word of mouth and imitation effects slows category-level sales and thus reduces the future sales of all firms. In our example, 9 of the 10 lost customers were purchasing from Firm A's competitors. The lost indirect effects of these 9 lost customers on Firm A's future profits amounts to $494. In this case, the company loses more value from its competitors' disadoptions than from its own. This result is different when the disadoption occurs later in the product life cycle at t, = 5 (see Figure 4b). Here the self-loss is $223, and the competitor-based loss is $132 when the firm holds 10% market share.

FIGURE 4

Figure 4a:

Figure 4b:

We should recall that the above analysis reflects only the effect of disadoptions and not that of defections to competitors. In case of a defection, one can take the competitive view that defecting customers enrich competitors and give them more resources and incentive to attack, and so the firm will probably view it in a positive way. For disadoption, as we have just shown, the story is different. In a real-life application, the managerial reaction to a lost customer will be influenced by whether it is a defection or a disadoption.

Incorporating the Effect of Negative Word of Mouth

In the previous section, we examined the effect of disadoption on customer value accounting for lost positive social effects such as the customer spreading positive word of mouth. However, when consumers are highly dissatisfied, they tend to spread negative word of mouth about the product (Anderson 1998; Mahajan, Muller, and Kerin 1984), which will influence potential adopters not to purchase. We now extend the analysis to account for negative word of mouth.

Suppose that a disadopter spreads negative word of mouth about a product that convinces another would-be adopter to delay her adoption for a period of 5 years. Returning to the online banking example, we illustrate the detrimental effects of negative word of mouth on the value of a lost customer in Figure 5. As Figure 5 shows, the direct effect of disadoption is $208 as previously calculated. However, the indirect effects for a disadoption in Year 1, for example, have increased to approximately $1,200 due to lost positive word of mouth and additional negative word of mouth. Moreover, if the disadopter's negative word of mouth were to affect five customers, then cost of a lost customer soars to more than $3,000. As Figure 5 demonstrates, the relationship between the time of disadoption and the value of a lost customer is magnified significantly due to negative word of mouth. As above, this effect is exacerbated if the negative word of mouth occurs early in the life of the product.

DISCUSSION

This research investigates the effect of disadoptions on the value of a

lost customer. Although researchers have long recognized that word of mouth and other social effects are integral to determining customer value (Danaher and Rust 1996; Rust, Zahorik, and Keiningham 1995; Zeithaml 2000), our approach is among the first to show how to quantify this value. We now discuss the theoretical and managerial contributions of this research.

Theoretical Contributions

Disadoption versus defection. Satisfied customers of innovative products play an essential role in promoting future sales in the product category through word of mouth and imitation (Mahajan, Muller, and Wind 2000; Rogers 1995). When these customers defect, the firm loses their future sales but retains the positive effect these customers bring to future category-level sales. In contrast, a customer who disadopts an innovation hurts firm profitability in two ways: through the loss of direct sales and the deceleration of sales from potential adopters. We have demonstrated that the indirect loss can be substantial, often exceeding the direct loss in some markets.

An important implication of our finding is that marketers must begin to differentiate between defection and disadoption. Considerable research has focused on understanding the antecedents to defection and the financial impact of defection on the firm (cf. Lemon, White, and Winer 2002; Reichheld and Sasser 1990; Reinartz and Kumar 2000). In contrast, comparatively little research has focused on the antecedents of disadoption (Kleine, Kleine, and Allen 1995; Redmond 1996; Rogers 1995; Unson 2000), and even less research has examined its financial impact on the firm. Although understanding and incorporating defection in customer profitability models is critical, the ubiquitous use of technology in new products and in service delivery applications suggests that failing to account for disadoption could lead to substantial errors in managerial decisions.

FIGURE 5

Linking acquisition and retention. Conventional customer profitability models developed in mature service industries are based on the assumption that customer retention and acquisition are independent processes. However, marketers increasingly recognize that customer acquisition and retention processes are interrelated and that failing to account for this relationship can lead to erroneous value assessments (Thomas 2001). The valuation methodology we have proposed captures one aspect of the relationship between acquisition and retention by demonstrating how the social interactions between retained customers and potential customers can affect firm profits.

Incorporating competitive effects into the profitability calculation. This research also provides new insights into how customer profitability is affected by the actions of competitors. Even when a firm has excellent product quality and has invested appropriately in its retention efforts, it can suffer substantial losses from the disadoptions of competitors' customers. When a competitor's customers defect, this provides the firm

with an opportunity to leverage its product and service quality to acquire a portion of the defectors. In contrast, when a competitor's customers disadopt, they leave the product category altogether and act as a decelerating force on future category sales. We have shown that the magnitude of this competitive effect is inversely related to the firm's market share. Thus, the customer profitability of smaller firms may be affected substantially by the product quality of larger firms. This is an important consideration in any market dominated by a few large firms such as banking, broadband, and telecommunications. Whereas previous research examining customer profitability focused on how competitors' offerings affect the switching probability of a firm's customers in mature markets (Rust, Lemon, and Zeithaml 2001), we have identified an additional mechanism by which competitive actions affect customer profitability via the acquisition of future customers.

Change in CLV across the product life cycle. This research also informs our understanding of how customer value changes throughout the product life cycle. Customers who are acquired at the earliest stages of a product life cycle have a substantial effect on future customer acquisitions through their ability to influence potential adopters. In the online banking application, the value of a customer acquired in Year I is 80% greater than the value of the same customer in Year 4. The reason for this phenomenon relates to the number of users at each stage of the product life cycle. Initially, there is only a small pool of users available to affect future adopters through word of mouth and other social effects. Thus, a single disadoption can have a significant effect on the rate of future customer acquisitions. However, as more customers use the product, the magnitude of the indirect effect of a lost customer diminishes because there are fewer potential adopters to be influenced.

There are two interesting theoretical implications of how our model enables marketers to assess customer profitability over time. First, it allows them to quantify the value of the various adopter categories such as innovators, early adopters, early majority, late majority, and laggards as proposed by Rogers (1995). It is commonly believed that earlier adopters are worth more to the firm because of their effect on later adopters. However, we have been unable to find any empirical evidence to support this assertion. Because the value of a customer to a firm equals the profit the firm loses if the customer leaves, our approach can be used to examine the value of different adopter groups.

In Figure 6, we present the results of this calculation for the online banking industry. Using the online banking industry parameters in a Monte Carlo simulation, we determined average 5-year customer profitability for each of the adopter categories proposed by Rogers (1995). As Figure 6 shows, earlier adopters are indeed worth considerably more than later adopters. The distinction between the categories is even stronger if we recall that the total value includes the $208 direct value, which is the same for all categories. Thus, for online banking, the social value of an

innovator and an early adopter is larger than her direct value. The early majority lost customer has a social value that is about 30% of the direct value, and late majority adopters and laggards have a relatively small social value compared with their direct purchase value.

The second implication is related to the change in an individual customer's value to the firm over time. Reichheld (1996) suggested that the average value of a customer typically goes up with time. Thus, loyal customers are worth more to the firm due to factors such as the ability of the firm to cross-sell, lower service costs with time, or lower price elasticity for loyal consumers (Reichheld and Sasser 1990). Although the magnitude of these effects has been questioned (Reinartz and Kumar 2000), the idea that a customer's profitability goes up with time remains a highly quoted finding. Our results raise additional questions about the validity of Reichheld's findings by showing that the value of long-term customers may actually go down with time when indirect social effects are included in the value assessment.

Managerial Implications

Spending on customer retention. One insight derived from this research is that firms relying on conventional profitability models as a basis for allocating marketing resources may be underspending on customer retention. As an example, a recent survey among online banking managers reveals that although many appreciate the importance of retention, minimal resources are actually devoted to this goal (McAdam 2000). By underspending on retention, these marketers actually drive up their acquisition costs because the pool of potential adopters in a given year shrinks due to reduced social effects. As this pool shrinks, the number of customers acquired for each acquisition dollar spent declines as well. Our results suggest that investing additional resources early on in the product life cycle in programs designed to facilitate consumers' use and acceptance of technological innovations that have been incorporated into the product or purchase experience and investing in postpurchase customer service could lead to improvements in overall firm profitability.

Allocation of retention and acquisition spending over time. Conventional wisdom suggests that managers should initially focus on customer acquisition activities and only later focus on retention spending. Ironically, the value of retention is highest in the early stages of the product life cycle when managers are most likely to focus on acquisition of the initial pool of customers. This overemphasis on acquisition in the early stages of a market was typical of many Internet companies in the late nineties. Now defunct companies like Pets.com and Homeruns.com spent lavishly on customer acquisition through the use of expensive television ads at a time when consumers were just becoming familiar with the potential uses of the Internet. However, many of the acquired customers found the online ordering and fulfillment capabilities of these firms to be inadequate and subsequently disadopted. Moreover, the rate of new adoptions quickly declined as predicted by our approach (Reichheld and Schefter

2000). A more complete understanding of customer value provided by our approach would have supported an alternative strategy that emphasized retention and postpurchase support at the earliest stages of the life cycle.

FIGURE 6

Extended return on investment (ROI) analysis. Marketing managers are increasingly asked to justify marketing expenditures based on expected returns. Consider, for example, information technology expenditures (where senior management increasingly demands a clear forecast of how a new technology will benefit the firm (Anthes 2001)) or customer relationship management (CRM) systems (expected to be one of the largest markets for information products in the coming years (Trott 2001)). This article demonstrates that assessments of the ROI for such investments should include an analysis of the social effects of customers. Failing to account for social effects may lead companies to underestimate the actual ROI on these investments.

Managing the competitive environment. This research raises some important issues for start-ups and other small firms attempting to compete on the basis of new technologies. By virtue of their low market share, these firms are vulnerable to the way their competitors manage customerrelated technology. As we have demonstrated, overall growth of the market can slow substantially if a major competitor has inferior technology or service that causes many consumers to disadopt. This creates a conundrum for small competitors with superior offerings. Although the company's competitive advantage may stem from its superior technology, it could potentially benefit by helping competitors prevent disadoptions through shared technological enhancements of the service function. Although we would not recommend that small firms give away their technology, this research raises the possibility that small firms could benefit by helping the industry overcome disadoptions by using trade associations to monitor customer problems and solutions and conduct informational advertising to educate consumers about using new technologies.

Limitations and Future Research Directions

This research addresses the phenomenon of disadoption and shows how social processes such as word of mouth can affect the customer profitability calculation. One limitation of the approach we have developed is that it does not account for social effects that occur in mature markets. Scholars have called for models that include word-of-mouth effects in the profitability calculation (Rust and Keiningham 1995; Zeithaml 2000). Although our model partially addresses this call, additional research is needed in this important area.

We have based this research on the new product growth model first proposed by Bass (1969). The advantage of this model is that it is both flexible and robust. It has been shown to provide an accurate description of new product growth across a wide variety of industries (Mahajan, Muller, and Bass 1990). Yet there might be other models that could be usefully employed.

Additional research should also investigate alternative model specifications for the Bass model. For example, a useful extension would be to include marketing mix variables to provide a more tailored model for a particular market (see Bass, Jain, and Krishnan 2000).

Another issue relates to the ability to differentiate between the different factors that constitute a "social effect." A customer may affect others through direct word of mouth, imitation (even when the user is unaware of it), and network effects (where the utility of customers from the product is related to the existence of other users). The Bass model, and consequently our approach, captures all these effects together with a single parameter. Thus, distinguishing between the different social effects may require different modeling approaches such as that proposed by Hogan, Lemon, and Libai (2002) for measuring the incremental value of positive word of mouth.

The research identifies a single mechanism linking customer retention and acquisition. However, there are undoubtedly other links between these important variables. This is an important area for future research because conventional models implicitly assume that the two processes are independent even when prior research has shown this is not the case (Thomas 2001). The disparity between the direct and indirect customer values demonstrated in the banking example reiterates the need to better understand the complex linkages between customer acquisition and retention. Our work can be viewed in the context of social capital of individuals, a topic that has received great attention by organizational management and sociologists in recent years (e.g., Burt 1997; Coleman 1990). Students of organization and human behavior have focused on how a person's social structure and connectivity with others can create value for that individual. Future research could focus on understanding how this social capital affects the firm's marketing programs. There is a need for further research that can combine marketers' knowledge of consumer social and network-based behavior with advanced customer profitability models to examine the factors that affect social capital for different customers of the firm.

CONCLUSIONS

In this article, we have shown how the value of a lost customer depends on whether the customer defects to a competing firm or disadopts the technology altogether. In the empirical application of the model, the results from the online banking industry show how the value of lost customers is affected by the stage of the product life cycle, the firm's market share, and the rate at which competitors' customers disadopt. The approach is such that it is easily applied by managers, providing a practical tool by which they can manage customer relationships in an innovation-- intensive market. Although advances in the theory and practice of CRM have been substantial in the past few years, the discipline is far from mature. To date, researchers have focused almost exclusively on mature service industries to develop and test theories and analytic models because

of data availability. This restrictive focus is detrimental to the advancement of the discipline because it leads to models that may not be valid in the technologydriven markets that are rapidly becoming the norm. As we have shown in this article, researchers in this area should be concerned that practitioners are applying inappropriate valuation methodologies in markets where disadoptions are common. This research represents one step toward expanding the conceptual domain of customer profitability models. It is our hope that it provides a useful foundation for additional inquiry.

1. The value of a could be readily estimated using defector analysis techniques (Reichheld 1996).

2. For example, it is important to note whether a disadopter reenters the market potential, m-as a potential "readopter," or if the disadopter is assumed to be gone forever, in which case m changes to reflect the loss.

3. Note that this saving could be much higher if the bank charges a monthly fee for the service. For example, SunTrust Bank in Washington, DC, reported charging a monthly fee of $7.95 for its online bill-paying feature (Anonymous 2001).

4. There may be other benefits to having online consumers beyond reduced service costs such as retention of higher value customers and, in the case of online banks, total customer profits the bank would lose if the customer goes offline. Given the lack of a published assessment of these other lost benefits, we used the more conservative estimation of service costs after consulting with banking executives. The estimation of savings per customer affects the magnitude of the financial results but not the patterns or conclusions drawn.

REFERENCES

Anderson, Eugene W. (1998), "Customer Satisfaction and Word of Mouth," Journal of Service Research, 1 (1), 5-17.

and Vikas Mittal (2000), "Strengthening the Satisfaction-Profit Chain," Journal of Service Research, 3 (2), 107-20.

Anonymous (2001), "Is Internet Banking for You?" Association Management, March, 5-7.

Anthes, Gary H. (2001), "ROI for IT Projects Elusive but Essential," Computerworld, May 28, 20.

Bass, Frank M. (1969), "A New Product Growth Model for Consumer Durables," Management Science, 15 (January), 215-27.

Dipak Jain, and Trichy Krishnan (2000), "Modeling the Marketing Mix Influence in New Product Diffusion," in New Product Dif fusion Models, chap. 5, Vijay Mahajan, Eitan Muller, and Yoram Wind, eds. Boston: Kluwer, 128-147.

Berger, Paul D. and Nada I. Nasr (1998), "Customer Lifetime Value: Marketing Models and Applications," Journal of Interactive Marketing, 12 (1), 17-30.

Blattberg, R. and J. Deighton (1996), "Manage Marketing by the Customer Equity Test," Harvard Business Review, 74 (July-August), 136-44.

Brady, Diane (2000), "Why Service Stinks," Business Week, October 23, 118-28.

Burt, R. S. (1997), "The Contingent Value of Social Capital," Administrative Science Quarterly, 42, 339-65.

Coleman, J. S. (1990), Foundations of Social Theory. Cambridge, MA: Harvard University Press.

Cooper, R. B. and R. W. Zmud (1990), "Information Technology Implementation Research: A Technological Diffusion Approach," Management Science, 36 (2), 123-39.

Danaher, P. and Roland T. Rust (1996), "Indirect Financial Benefits from Service Quality," Quality Management Journal, 3 (2), 63-75.

Dowling, Grahame R. and Mark Uncles (1997), "Do Customer Loyalty Programs Really Work?" Sloan Management Review, 38 (4), 71-82. Dwyer, F. R. (1997), "Customer Lifetime Valuation to Support Mar

keting Decision Making," Journal of Direct Marketing, 8 (2), 73-81.

Fichman, R. G. and C. F Kemerer (1993), "Adoption of Software Engineering Process Innovations: The Case of Object Orientation," Sloan Management Review, 34 (2), 7-22.

and- (1997), "The Assimilation of Software Process Innovations: An Organizational Learning Perspective," Management Science, 43 (10), 1345-63.

Ganesh, Jaishankar, Mark J. Arnold, and Kristy E. Reynolds (2000), "Understanding the Customer Base of Service Providers: An Examination of the Differences between Switchers and Stayers," Journal of Marketing, 64 (3), 65-87.

Hair, Joseph F., Rolph E. Anderson, Ronald L. Tatham, and William C. Black (1995), Multivariate Data Analysis. Englewood Cliffs, NJ: Prentice Hall.

Hogan, John E., Katherine N. Lemon, and Barak Libai (2002), "Incorporating the Effect of Positive Word-of-Mouth into Customer Profitability Models," working paper, Boston College, Chestnut Hill, MA.

Johnson, Steve (2000), "Can Internet Marketing Reach Orbit?" New Statesman, September 18, R28.

Jones, Michael A., David L. Mothersbaugh, and Sharon E. Beatty (2000), "Switching Barriers and Repurchase Intentions in Services," Journal of Retailing, 76 (2), 259-74.

Keaveney, Susan M. (1995), "Customer Switching Behavior in Service Industries: An Exploratory Study," Journal ofMarketing, 59 (2), 71-82.

Kleine, Susan Schultz, Robert E. Kleine III, and Chris T. Allen (1995), "How Is a Possession "Me" or "Not Me"? Characterizing Types and an Antecedent of Material Possession Attachment," Journal of Consumer Research, 22 (3), 327-43.

Lemon, Katherine N., Tiffany B. White, and Russell S. Winer (2002), "Dynamic Customer Relationship Management: Incorporating Future Considerations into the Service Retention Decision," Journal of Marketing, 66 (January), 1-14.

Liken Jeffrey K., Mitchell Fleischer, and David Arnsdorf (1992), "Fulfilling the Promises of CAD," Sloan Management Review, 33 (3), 74-86.

Mahajan, Vijay, Eitan Muller, and Frank M. Bass (1990), "New Product Diffusion Models in Marketing: A Review and Directions for Research," Journal of Marketing, 54 (January), 1-26.

, and Roger A. Kerin (1984), "Introduction Strategy for New Products with Positive and Negative Word-of-Mouth," Management Science, 30 (December), 1389-1404.

and Yoram Wind (2000), New Product Diffusion Models. Boston: Kluwer.

McAdam, Paul (2000), "Internet Performance Measures Lags behind Online Initiative," Banking Strategies, 76 (Fall), 8.

Meuter, Matthew L., Amy L. Ostrom, Robert I. Roundtree, and Mary Jo Bitner (2000), "Self-Service Technologies: Understanding Customer Satisfaction with Technology-Based Service Encounters," Journal of Marketing, 64 (3), 50-64.

Meyers, Patricia W., K. Sivakumar, and Cheryl Nakata (1999), "Implementation of Industrial Process Innovations: Factors, Effects, and Marketing Implications," Journal of Product Innovation Management, 16 (3), 295-311.

Monahan, Julie (2000), "In the Out Door," Banking Strategies, 76 (November/December), 122-26.

Oliver, Richard L. (1997), Satisfaction. New York: McGraw-Hill.

Orr, Bill (1999), "E-banks or E-branches," ABA Banking Journal, 9 (July), 32-34.

Parker, P.M. (1994), "Aggregate Diffusion Models in Marketing: A Critical Review," International Journal of Forecasting, 10 (September), 353-80.

Redmond, William H. (1996), "Product Disadoption: Quitting Smoking as a Diffusion Process," Journal of Public Policy and Marketing, 15 (Spring), 87-97.

Reichheld, Fredrick (1996), The Loyalty Effect: The Hidden Force behind Growth, Profits, and Lasting Value. Boston: Harvard Business School Press.

and Earl Sassar (1990), "Zero Defections: Quality Comes to Service," Harvard Business Review, 68 (September-October), 105-11. and Phil Schefter (2000), "E-Loyalty," Harvard Business Review, 78 (July-August), 105-13.

Reinartz, Werner J. and V. Kumar (2000), "On the Profitability of LongLife Customers in a Non-Contractual Setting: An Empirical Investigation and Implications for Marketing," Journal ofMarketing, 64 (4), 17-35.

Robinson, Teri (2000), "Internet Banking: Still Not a Perfect Marriage," Informationweek, April 17 (782), 104-6.

Rogers, Everette M. (1995), The Diffusion of Innovations. New York: Free Press.

Rose, Sarah (2000), "The Truth about Online Banking," Money, 29 (April), 114-22.

Rubino, Gail (2000), "Getting and Keeping Online Customers: If You Build It, Will They Come?" Bank Marketing, 32 (3), 36-40.

Rust, Roland T., Katherine N. Lemon, and Valarie A. Zeithaml (2001), "Driving Customer Equity: Linking Customer Lifetime Value to Strategic Marketing Decisions," Working Paper No. 01-108, Marketing Science

Institute, Cambridge, MA.

and Anthony J. Zahorik (1993), "Customer Satisfaction, Customer Retention and Market Share," Journal of Retailing, 69 (Summer), 193-215.

and Timothy L. Keiningham (1995), "Return on Quality (ROQ). Making Service Quality Financially Accountable," Journal of Marketing, 59 (April), 58-70.

Srinivasan, V. and Charlotte Mason (1986), "Nonlinear Least Squares Estimation of New Product Diffusion Models," Marketing Science, 5 (Spring), 169-78.

Srivastava, K. Rajendra, Tasadduq A. Shervani, and Liam Fahey (1998), "Market Based Assets and Shareholder Value: A Framework for Analysis," Journal of Marketing, 62 (January), 2-18.

Stoneman, Bill (1997), "Banking on Customers,"American Demographics, 19 (February), 36-41.

Sultan Fareena, John U. Farley, and Donald R. Lehmann (1990), "A Meta Analysis of Applications of Diffusion Models," Journal ofMarketing Research, 27 (February), 70-77.

Thomas, Jacquelyn S. (2001), "A Methodology for Linking Customer Acquisition to Customer Retention," Journal of Marketing Research, 38 (May), 262-68.

Trotsky, Judith (1999), "One and Done," Banking Strategies, 75 (6), 16-22.

Trott, Bob (2001), "ROI Takes Center Stage," Info World, 23 (April 16), 1.

Unson, Christine G. (2000), "Psychological Determinants of Disadoption of Traditional Contraceptive Methods," Paper presented at the 128th annual meeting of the American Psychological Health Association, Center on Aging, University of Connecticut Health Center, Farmington.

Zeithaml, Valarie (2000), "Service Quality, Profitability and the Economic Worth of Customers: What We Know and What We Need to Learn,"Journal of the Academy of Marketing Science, (28) 1,67-85.

John E. Hogan Katherine N. Lemon Boston College

Barak Libal

Technion-Israel Institute of Technology

John E. Hogan is an assistant professor of marketing in the Wallace E. Carroll School of Management at Boston College. He has a B.S. in electrical engineering from Auburn University, an M.B.A. from Indiana University, and a Ph.D. in marketing from the University of North Carolina at Chapel Hill. His research interests include customer relationship management and applying advance financial modeling techniques to enable marketers to measure, quantify, and influence the value of market-based assets.

Katherine N. Lemon is an assistant professor of marketing in the Wallace E. Carroll School of Management at Boston College. She has a B.A. in philosophy from Colorado College and a Ph.D. in marketing from the University of California, Berkeley. Her research focuses on understanding the process of the development of the firm's customer asset (i.e., the antecedents and consequences of successful customer-firm relationships, and measuring, quantifying, and influencing the value of these relationships).

Barak Libai is a senior lecturer on the Davidson Faculty of Industrial

Engineering and Management at the Technion-Israel Institute of Technology
and a visiting senior lecturer, Faculty of Management, at Tel-Aviv
University. He has a B.Sc. in industrial engineering from the
Technion-Israel Institute of Technology, an M.B.A. from Tel-Aviv
University, and a Ph.D. in marketing from the University of North Carolina
at Chapel Hill. His research interests include customer valuation
management, word-of-mouth analysis, and the use of complex system methods
to analyze new product growth.

<mark>Cross-selling in the financial sector: Customer profitability is key</mark>

Jarrar, Yasar F; Neely, Andy

Abstract:
Customer relationship management (CRM) is a growing trend in banks today
and billions have already been spent on CRM systems. Financial service
providers (FSPs) are, however, recognizing the many challenges they face in
implementing an enterprise CRM business strategy. This paper provides an
overview of research work undertaken, in partnership with a major UK bank,
to assess the validity of the sales through service concept. The project
aimed at identifying the requirements for a successful cross-selling system
to provide an external input to the current initiative already underway at
the bank. The paper aims to summarize the work undertaken to present what
is believed to be a considerable gap between what CRM literature publishes
and the actual implementation in real-life organizations. It concludes with
recommendations for developing the cross-selling initiative at the bank.

Text:
Received (in revised form): 18th December, 2001
Abstract Customer relationship management (CRM) is a growing trend in banks
today and billions have already been spent on CRM systems. Financial
service providers (FSPs) are, however, recognising the many challenges they
face in implementing an enterprise CRM business strategy. This paper
provides an overview of research work undertaken, in partnership with a
major UK bank, to assess the validity of the 'sales through service'
concept. The project aimed at identifying the requirements for a successful
cross-selling system to provide an external input to the current initiative
already underway at the bank. The paper aims to summarise the work
undertaken to present what is believed to be a considerable gap between
what CRM literature publishes and the actual implementation in 'real-life'
organisations. It concludes with recommendations for developing the
cross-selling initiative at the bank.
INTRODUCTION
Customer relationship management (CRM) has become the buzzword of
e-business, and it seems that there are almost as many definitions for CRM

as there are vendors promoting products for getting closer to customers. Hence, there is little consistency on how CRM fits into an organisation, ie is it customer care, marketing, sales, all of those, others? In essence, CRM aims to increase the profitability of the customer portfolio. This may comprise many elements like customer acquisition, price, cost to serve, cross sales (further sales to the same customer), up sales (where the customer makes greater use of the same product or services) and so on. As argued in this paper, however, despite all the hype surrounding CRM in the financial services industry, as well as the solutions provided by vendors, financial service providers (FSPs) are recognising the many challenges they face in implementing an enterprise CRM business strategy.

The Centre for Business Performance undertook a study in partnership with a major UK bank to help identify the business rules for a main application of CRM, namely cross-selling financial services. This paper summarises the study undertaken in three main parts. The first part of the study comprised a literature review and intended to provide a quick overview of the literature to help understand the concept of cross-selling, and shed further light on the ability of IT to facilitate cross-selling for customers in the financial sector. The literature overview attempted to cover published experiences and case studies presented by other organisations.

The second part focused on analysing the literature (cases and theories) researched to distil the business rules and best practices for cross-selling. Case studies were analysed systemically and the findings were presented in a framework that provided a holistic view of what are seen as the key ingredients for a successful cross-selling initiative.

Finally, the third part is an overview of the status quo of the bank's systems (those related to cross-selling business rules). Based on the generic framework developed, the study attempted to identify where (and if) these ingredients are available at the bank, where the data are kept, how they are managed, by whom and to what degree they are integrated. A 'data map' was developed at the bank based on background information and personal interviews, and proposals for the way forward were recommended.

This paper provides an overview of the research undertaken, the framework of business rules developed, and the data map. Moreover, the paper explores the role of customer profitability data within the framework and thus provides the context for using such information in a value adding approach for cross-selling.

CROSS-SELLING IN THE FINANCIAL SECTOR: LEARNING FROM ORGANISATIONAL EXPERIENCE

Information technology-based CRM and cross-selling seem to be growing trends in banks today. In banks the world over, billions have already been spent on CRM systems. Attempts have varied from installing database management systems to implementing enterprise-wide CRM systems. Not surprisingly, the results have ranged from total failure to weary success

and positive future outlooks.

The attraction and retention of a firm's most valued customer is the bedrock of any CRM implementation. It is generally accepted that it costs five times more to acquire a customer than to retain an existing one. It is thus clear that one of the major principles for cultivating relationships with customers is to focus the company on increasing its 'share of the customer wallet' with each individual customer.1

Full-scale cross-selling, however, is a largely untapped marketing strategy for many financial organisations. Broad-based financial services companies are trying to provide a one-stop shopping experience for customers as a way of retaining them for life. Many banks have invested in CRM systems and are already testing this theory.

A survey of experiences in European banks2 revealed that there were limited success stories depending on the country, the type of financial institution and the type of product/service sold. There are, however, various challenges, in a worldwide basis. As much as insurers and banks would like to package insurance and banking products, the regulators and the pressures of disclosure as well as new distribution channels such as the Internet are working in the opposite direction. There is pressure towards individual products with very transparent product charges, as opposed to the packaged policies where the charges are more obscure.3

Some organisations, like PNC,4 reported implementing advanced CRM technology but no results were reported, and it was viewed as an investment to pay off in the future. A few organisations, however, did report successful cases like the Woolwich (the UK mortgage bank) which, in 1997, decided that it needed a customer rather than a productcentric proposition based upon flexibility and convenience to the customer, and embarked upon its Open Plan strategy.5 This resulted in some business benefits, including a rapid growth in customer numbers, and a reported increased share of wallet. BBVA6 had also reported similar successful outcomes. These cases demonstrated the most critical success factor for CRM: it should be a business strategy that requires a shift in focus from a product-oriented mentality to a customercentric approach. This, as demonstrated by the Woolwich, requires changes in products, structures, organisational culture and information technology (IT) systems.

Other cases, like Wells Fargo,7 have reported partial success for their cross-selling efforts which, upon studying the facts and circumstances of the cases, are arguable. These are cases where banks have merged or acquired other banks, and managed to sell some of their products to the new customer base. Such cases are heavily reliant on non-organic access to a huge customer base and can not wholly or even largely, be attributed to CRAM strategies. They are more the result of advanced new customer-product matching software/databases, and targeted marketing campaigns (tools in CRM systems, but neither holistic in nature, nor as expensive as the whole CRM strategic approach). And a lot of eyes will be watching Citigroup/Travelers to see just how successful this landmark financial holding company

becomes.8 Cross-selling was a key objective behind the merger between the Travelers Group and Citicorp in 1998, 'an objective that so far has been elusive'.9 Overall, plenty of other financial giants have taken a crack at cross-selling, mostly with little success. In fact, various surveys10 and industry experts11 seem to agree that CRM in general has not been able to show demonstrable payback.

CRM-BASED CROSS-SELLING: HOLY GRAIL OR ACHIEVABLE GOAL?

In theory, for banks that are up to the challenge, the rewards of mastering CRM-based cross-selling can be substantial. Many bankers and experts believe that 'as the various sectors of financial services gradually converge, customers will gravitate to providers who can blend financial services into one compelling value proposition'.12 Moreover, the sheer increase in Web traffic overall should boost customer contacts at bank sites. Getting those customers to consolidate their financial services with a single institution requires, however, a lot of convincing to show customers the value to them, and a seamless experience (from an IT on-line perspective).13 Managers cannot ignore any of these CRM trends and should measure customer expectations, relationship complexity, the reasons that drive customers to leave and the level of demand for mass custom-isation.14 How best to approach this task is, however, still under study. FSPs are being pressured to be more customercentric and develop enterprise CRM strategies. The promise of CRM, however, still eludes most FSPs because of a lack of definitions and technology solutions that integrate business goals.15

The main points that came through from the literature review regarding CRM-based cross-selling in FSPs were:

- most of the evidence provided in the literature is basically anecdotal referring to organisational experiences with hindsight and very few have documented any numbers to show related measures or costs (apart from the cost of IT installations)
- the concept of cross-selling, and using IT to facilitate that process, seems to still be in an embryonic stage (hardly any banks noted that they have any such initiative older than two to three years). Thus very few are able to provide any evidence of its success (or even failure). Most view it as an investment waiting to pay off
- in some instances, there is conflict between the opinions provided in the literature (for and against) reflecting different attitudes, and indeed different experiences with IT enabled cross-selling.

Overall, IT-enabled cross-selling is still a developing concept in banks (with some more advanced than others). It is very complicated and will only be beneficial if it is approached in a well-planned manner, ie it can be a successful venture, or an expensive mistake depending on how well the process is planned, managed and monitored. With today's dazzling and seductive technology, enterprises must carefully calculate and understand the benefits they will gain and must realise that CRM and e-CRM investments may not show quantifiable benefits in the short term16 - and, as CRM is a

young discipline, none have achieved long-term status yet to demonstrate the full long-term benefits. In this context, it is important for any organisation to develop a better understanding of what critical factors have to be considered when planning for CRM based cross-selling.

BUSINESS RULES FOR IT-BASED CROSS-SELLING

The objective of this part of the study was to provide a framework of business rules to guide the sales through service initiative at the bank. The inputs to this framework were mainly experiences of other organisations (case studies of leading financial institutions) and basic theories and research related to cross-selling in general and the financial sector specifically. Hence, the resulting framework can be viewed as a generic best practice approach.

The goal of the sales through service system is to understand customers so the organisation can tailor any offering to them, at a profit: what are they buying, what would they buy, what financial products are they buying from other companies, what market segments are they in, what are the purchase-behavioural characteristics of that segment, what is the composition of those households, where are they with respect to lifecycle need, how to best approach the customer (which channels, when, what to say), how to measure their reactions, how to ensure satisfaction, what skills do the workforce need, how to motivate them, what systems are required to support them?

Figure 1 provides an overview of the cornerstone ingredients that must be tackled successfully to develop such a system. What follows is an overview of these ingredients.

IT infrastructure

There are two primary design requirements to ensure that all the pieces come together at this stage: common standards for core systems (for database structure, for example) so that separate systems can be linked, and a central databank that is accessible to all.17 In this context there are two different types of technologies that support a customer relationship strategy:

Figure 1

- CRM, the customer-facing, interaction systems, such as support, campaign management and sales force automation
- customer intelligence (CI), which provides tools to capture, store, process, access, organise and analyse/model customer data. The results of this analysis are typically put into action via the CRM systems.

Clearly, this is the area where most banks do, eventually, get it right. It requires considerable investment in patching up old technology and acquiring new systems. There is no lack of CRM systems and e-CRM system vendors and consultants, and most banks do rely on them.

Predictive modelling system

Predictive modelling builds behavioural models to predict response rates, cross-sell opportunities, fraud potential, chum candidates and creditworthiness, etc.18 CRM techniques to maximise cross-selling potential

include:19
- using transactional triggers/events to deliver relevant messages to customers
- improving targeting of direct marketing campaigns through the use of behavioural propensity and segmentation models
- using contextual triggers to deliver relevant messages to customers.

A reliable predictor of future behaviour in humans is past behaviour, which is why transactional information is important. A culture must be fostered that continuously gathers customerspecific information that enhances the customer information database. Every encounter must be seen as another opportunity to find out additional information.20

There are, however, some drawbacks. The assumption that usually underlies CRM technology is that customers are rigid individuals who express 'normal' behaviour all the time. In fact, much of the predictive technology assumes a normal distribution of the market segment that has a particular behaviour and that this behaviour falls within the specified confidence interval. There is evidence that such 'normal' behaviour does not necessarily apply all the time.21 Predictive technology also assumes a direct causal relationship between two different products or among multiple products. The direction of this causality in these relationships is actually unclear.

Thus, while the predictive modelling is an important ingredient, it is not enough on its own. Much has to rely on the bank's own people who must be trained and empowered to listen and talk to the customer. The main message here, as with other areas in the study, is not to place too much reliance on IT and forget the business process and its people.

Constructing the 'cross-selling' engine

The following components were cited as essential inputs to build a successful 'cross-selling' engine:
- product/service lines knowledge: what products/services are provided, what the customer needs are, what products/services 'go together',22 what their features are, etc.
- piloting and script testing: in many organisations' experiences, banks that have taken a more modest, gradual approach - building competitive advantage in certain geographic regions or product segment by product segment, and learning by trial and error - have made considerable gains. 'Those tempted to go for the "big bang" should re-examine the rationale behind their strategy'23
- contact rules: policies must be set based on all the ingredients to the system (360 degree view of the customer and predictive modelling) to generate the 'rules of engagement' (when to talk/send to a customer, what is the content, how to approach, etc.).24 Policies, however, must only be an enabler to trained and empowered staff who are in contact with the customer as only they can assess the right time, and appropriateness of the situation
- real time: the system's goal should be to bring all of a customer's data together on demand. It must be designed to take customer information from

call centres, websites and information updates (like billing status),
create a comprehensive profile of the customer, and make it available to
anyone who might need it. Compaq modelled a system with one billion
transactions providing real-time updates to a simulated 40,000
representatives25
- consistency: 'The key to realizing the potential value of a cross-selling
program, no matter what approach you follow, is consistency of effort'.26
The more advanced systems track the offers a bank has already made, and
provide consistency, control and coordination over all sales channels.27

Sales skills and attitudes

The key to a successful cross-selling system, which is forgotten by some
banks, is the ability and motivation of their sales force. Technology is
only an enabler for CRM. After all, it is the people who will use the
system, implement the plans and talk to the customers. Many CRM systems
fail due to failure to adopt the new system, and many did not achieve good
results because of untrained staff.28 'Skills development/transfer is the
key issue, not IT'.29

The following have been identified as best practice in this area:
- know the sales force: their product knowledge, their sales skills, their
knowledge of customers, and especially their attitudes and preferences
- train staff when to go for sales opportunity: training needed covers a
range of skills including sales and listening and account rounding
- make cross-selling a priority: commit the necessary resources and instil
disciplined management supervision. Managers need to work with
customer-service representatives in integrating cross-selling into their
daily work process
- customer-service representatives have to know cross-selling is part of
their job. They need discipline to discuss the benefits of full account
coverage with one agency proactively
- staff must take ownership of the customer.30 Representatives in best
practice companies maintain contact with the customer throughout the
process to ensure that their question or issue is ultimately resolved
- quality assurance: this can be done via random monitoring to ensure
compliance with using the script correctly, positive reinforcement of
positive habits (eg catch the sales representative doing something right),
and listening to the customer recommendations to the bank31
- reward and recognition: it is critical for everyone in the organisation
to benefit from the programme. Agents and customer-service representatives
should be compensated for their roles in the process.32 Sales are usually
rated on salesmanship, customer relationships, compliance and technical
skills.33

An integrated view of the customer

The objective of the information to be integrated here is to have an entire
financial/personal snapshot of a customer on one engine (360-degree view).
The data that should be integrated in this engine include the following.
1. Customer satisfaction - main ingredients include satisfaction surveys,

customer feedback (usually in the form of voluntary feedback, eg completing prepared cards in branches), and customer awareness surveys (can be incorporated in other surveys, mainly to understand how familiar customers are with the bank's products, processes and their willingness to recommend it).

2. Customer needs - mainly identified through surveys (postal, interview based, over the phone, over the Internet (website)).

3. Customer complaints - problems reported via all channels and the responses provided. These data are essential in preparing contact plans (both content and timing) and should drive or suppress sales actions.

4. Customer loyalty (retention analysis) - usually measured by studying customer behaviour in respect to transactions. Customer loyalty can be demonstrated if they take part in cross-buying, up-buying, repeat purchases and persistency in the relationship with the bank. Other measures of loyalty can be inferred from customer satisfaction surveys and customer awareness surveys. This type of information should be mainly used to manage communications with customers, manage promotions and evaluate investments.

5. Customer personal profile - the importance of updating customer files is paramount. If companies want to cross-sell effectively, one of the first things they need to do is focus on updating the demographic information about their customers.34 Best practice contact centres house a wealth of customer information in their databases, which allows representatives to talk with the customer on a more personal level.35,36

6. Customer financial profile -- including items like risk scores, credit scores, etc., to create a risk profile showing the risk profile of individuals/households for each product and on an aggregated basis, so as to indicate which products should be offered to which customers.

Figure 2

7. Customer holdings - including product range held by customer and purchasing profile.

8. Customer contact history - details of when the organisation was in touch with the customer including marketing campaigns, and other contacts (organisation or customer initiated) and the customer responses to these contacts across all touch points.

9. Customer segmentation - once a single view of the customer base and their potential profitability is in place it is possible to identify and segment the target market. Segmentation of future target groups can be based on customer need, behaviour and value.37

10. Customer profitability - among many others, Gartner Group research38 has illustrated that customer profitability analysis can form the cornerstone of successful CRM. It has been argued that cross-selling can actually be detrimental to an institution unless it is tied in closely to customer profitability analysis. In other words, selling more products to an unprofitable customer may simply make that customer even more unprofitable.39 'Knowing one's customers vary in value allows the organisation to concentrate on the types of customers who are more likely

to generate meaningful profits for the business'.40 Research revealed that 20 to 30 per cent of customers produce the most profit for a bank. Another 20 to 30 per cent are typically moderately to wildly unprofitable customers. The remaining customers are around the break-even to moderately profitable point.41,42 Applying broad strategies, such as shedding all unprofitable customers or trying to increase the number of products per person, are unlikely to increase the bottom line.43 Different profitability categorisations require different emphasis on retention, cross-sell and service modifications. Figure 2 shows current customer profitability (white bars), and the potential (black bars) at a UK building society.44 By showing the opportunity lost, and the potential profit, the figure clearly reveals the need to re-design the marketing and targeting plans based on customer profitability measures.

Organisations that decide on major investment in CRM technology should pause and ask themselves whether the customers are worth it. A US-based survey45 reported that just over half the national sample (52.2 per cent) report they do not measure customer profitability. Of those banks that do measure it, half do not take any action based on the data. As for the other half, 29.9 per cent use the system to target unprofitable customers for increased cross-selling; 12.3 per cent use pricing to encourage them to go elsewhere; and 8.7 per cent attempt to guide them towards cheaper, more automated options.

Banks must close the loop and measure the effectiveness of their CRM initiatives on bottom-line contributions. Failure to do so will result in ignorance about how marketing, sales and service decisions are affecting overall profitability and the lack of a mechanism for refining initiatives to increase customer value. Gartner Group46 estimates that by 2004, more than 60 per cent of banks will not know if these decisions are significantly increasing their bottom lines because they will fail to measure the effectiveness of their CRM initiatives based on profitability contribution.

Therefore, to be sure that their CRM initiatives are increasing profitability, banks must close the loop and measure the results of their CRM efforts based on profitability. Many banks measure marketing, sales and service initiatives, but few measure them based on profitability.47 Research indicates that banks have been slow to use profitability analysis as a measure of success for marketing campaigns and cross-selling. According to a survey48 of more than 200 US banks, most banks measured their 1999 marketing campaigns based on the number of sales, the dollar value of sales or response rates. Less than 35 per cent of the responding banks measured the results based on the profitability contribution to sales overall or the contribution of sales to individual customer profitability. For cross-sell campaigns, banks predominately measured results based on the number of cross-sells. Less than one quarter measured cross-sell effectiveness based on the contribution of cross-sell to overall profitability or to individual profitability.

Calculations of current customer profitability, however, are not trivial and because banks face competing priorities, these calculations will be difficult to develop. In trying to understand customer profitability many organisations attempt to use proxies (account balances, multiple accounts, particular product used, sociodemographics, visits to facilities)49 instead of 'actual' costs as a basis due to difficulty in measuring actual costs. There are more detailed methodologies that should be followed to provide a clearer picture50 to attempt to understand the actual customer cost and profitability over the relationship timeframe (long-term value, LTV). An example was presented by NCR. Sitting atop NCR's Teradata data warehouses, 'value analyzer' measures profit at a very granular level by rating individual customer accounts based on five factors of income, expense and risk. These include net interest revenue, fee-based and other revenues, direct expenses (such as those related to transaction processing), indirect expenses and the anticipated risk associated with each account (based on NCR's risk-provisioning module); plus, to customise the system, the bank has also added a sixth factor: cost of capital. Value analyzer generates a score for each of these measures to develop an overall score for each account. Value Analyzer's primary purpose is to measure profitability as part of a bank's CRM strategy. The software supplies information about what customers are doing today plus supports the bank's projections about customer relationships five years down the road.51

DATA MAPPING

This final part of the study overviewed the status quo at the bank, regarding the sales through service initiative. The bank was already implementing a pilot at one of its branches, and this section of the report provides an assessment of the current systems and infrastructure against the identified best practice business rules and components. The main objective is not to provide a 'yes/no' answer, but to provide some thoughts on areas for potential improvements, and highlight some issues that need further attention.

Figure 3

This stage was based on a best practice standard template of 'data mapping' to collect this information from known keepers. The proposed data mapping template is shown in Figure 3.

The data mapping process had to rely on the research team's involvement in interviews and discussion with various parties to get a realistic picture. It was planned that the map would be constructed along the same lines as the best practice business rules for cross-selling to identify whether the required information and components were in place, integrated and clear. The project team conducted in-depth interviews with personnel from all units of the bank and from various levels covering: business banking, personal banking, IT and research and development. Moreover, having constructed the data map, it was important to validate its contents from various sources. A list of key people were sent the final draft to gain their approval and feedback, including original interviewees and additional

sources like the data protection officer and several users.

The data map was finalised and studied. Due to its confidential nature, Figure 4 demonstrates an illustrative example only (selected parts of the map with sample information). The map highlighted several key points:

- the bank already had in place systems to gather all the components noted in the best practice business rules
- the data gathered differed in sophistication and depth for each component and in many areas there are several opportunities for improvement of the type of data, method of collection and use

Figure 4

- the data gathered are not integrated and this is the main obstacle revealed so far
- in many areas there were pilots for improvement and these, if well coordinated, can form the base line for future integration
- some areas need to be revisited with questions in mind like 'are we asking the right questions' and 'do we have the right measures in place'.

Moreover, the bank had undertaken a pilot to assess the effectiveness of the sales through services concept. It was a controlled experiment in one branch and the staff involved were those who volunteered. The pilot revealed several issues:

- the cross-selling scripts were adhered to 100 per cent for regulatory requirements. Due, however, to the mechanistic nature of the process, agents had to sell a product even if they felt it inappropriate (due to targeting measurement in the system)
- there were some flaws in the performance measurement system for the whole process as no data were held on how successful sales were. Data captured related to the number of leaflets etc. sent out and not actual conversions
- pilot saw staff being offered the opportunity to volunteer for the pilot, the staff taking up the offer were those already disposed to sell and should have a greater disposition toward sales.

The implications of this pilot were that although the initiative resulted in good results in successful cross-sells, it was felt that these were mostly due to staff ability to understand customer needs and discuss potential requirements and had little to do with the IT system that supported the process. In fact, the IT system that highlighted 'propensity' and 'likeliness to buy' and provided sales scripts was seen by some staff as a hindrance rather than help.

ISSUES FOR FUTURE CONSIDERATION

Having reviewed the experience of other organisations at implementing cross-selling, and having assessed the current approach and system at the bank, the following issues and gaps have been noted, and are listed here as areas to think about and improve where appropriate. These issues should be seen as potential problems that can occur, areas for future/immediate improvement, or areas that require further investigation. Although these resulted from a case application at the bank, they can be seen as generic issues that potentially affect various organisations in similar positions.

1. Capacity plans - when all the multichannel initiatives are up and running, and the sales through service is fully deployed, can the back office support this? Capacity plans and outlooks for the bank for the future 'currently' should focus on this capability and capacity building to provide the ability to deal with a possible large influx of customers. 'Cross-selling is not a big technology problem unless your organisation faces scale issues' says an IT executive at Chase Manhattan.

2. Customer relationships - the bank might jeopardise customer relationships by excessive and or repetitive (duplicated) contacts with a customer. Due to the lack of IT integration, there is the risk of offering the customer the same offer via two different channels in a short time period.

3. Sales force compensation and training - it is critical for everyone in the organisation to benefit from the cross-selling programme. Agents and customer service representatives should be compensated for their roles in the process. 'We made cross-selling part of the corporate culture. We told our employees this was the reason we were in business. We put incentives to cross sell into the compensation programme, said Mr Pulmeri, Citibank's Retail Branches and Credit Cards Director.52 Moreover, it is critical to provide the appropriate training for customer-facing sales force, both in terms of selling skills and product and service knowledge. Such training will require investment in time and money, and will require clear planning to decide on the mix of skills to be acquired (specialist versus generalist). Such decisions will be part of the overall CRM strategy.

4. Product re-design - without a clear, compelling value proposition, the power of marketing is limited. What, for example, is the point of building a marketing database or developing attractive promotional and enrolment materials if the product is a high-load, unbranded product or service that no one wants?53 The Canadian Imperial Bank of Commerce's VP credited the success of a campaign to a 'combination of targeting the right customers, being able to predict their responses, and having a very good offer'.54 In the UK, a recent government investigation found little differences between the current accounts offered by the big banks.55

5. IT investment and integration -- 'The biggest post-Y2K IT expenditure for financial institutions will be investment in better platforms for mining customer intelligence. The reason is simple obsolescence. In many cases, data warehouses built three to five years ago do not support finely targeted marketing and cross-selling over multiple channels. At the same time, the channels themselves are creating more challenges, as online financial services divert rich sources of customer intelligence outside the purview of the institutions'.56

6. Customer profitability analysis -- some have argued that cross-selling can actually be detrimental to an institution unless it is tied closely to customer profitability analysis. In other words, selling more products to an unprofitable customer may simply make that customer even more unprofitable. Moreover, once an efficient system is in place to understand

customer profitability, the bank will face issues regarding what to do with unprofitable customers, and how to focus on profitable ones. Issues in this area will include channels of contact, products and service mixes delivered, charges, etc. In discussing customer profitability analysis (CPA) and long-term value (LTV), there needs to be recognition of the fact that an organisation's selling and marketing expenses are themselves major components of CPA and LTV, and the equation is interactive. The goal is to maximise customer LTV by investing the right amount and type of sales and marketing effort for each customer. Some customers should receive a lot and some should receive none. Some customers might even be encouraged to deal elsewhere if they cannot be made profitable and offer no other benefit to the organisation.

CONCLUSION

The business buzzword of the new millennium is CRM, with many firms displaying the same 'implement it quick' thinking as was applied to earlier management fads and fashions such as business process re-engineering (BPR) and enterprise resource planning (ERP), without appraising the real business benefits and linkages to future strategy. The potential danger is that retail banks see CRM as a panacea to future success. 'Merely by implementing a customer management software package the business can at a stroke improve customer retention ratios, increase cross-selling and reduce costs. Such aspirations are misplaced and often fuelled by a blind belief in the technology.'57

CRM as a whole is an embryonic concept and many organisations have already invested a lot of money in it. Most believe it will pay back. So far, however, and from the published experiences, there is no evidence to show any paybacks to justify such investments. 'The rewards of selling several financial products in one package can be spectacular. But few companies have attained this goal.'58

Companies have been building and maintaining customer relationships and cross-selling products effectively for decades without today's expensive technology. In fact, it may be today's emphasis on technology and the huge investment involved that have contributed to low return on CRM investment and perceived lack of success by diverting management attention from fundamental marketing and service issues.

'The strategy [cross-selling] is going to be appropriate for many firms (not all), but the tactical and operational considerations will separate the winners from the losers.'59 It is not a technology issue. Cross-selling is all about culture and real-time support. The key is to have a well-trained and motivated sales force, who can talk to the customer supported by a real-time (or as close as possible) information system, that is centred around individual customer profitability, to help staff understand all they need about the customer.

It is clear that customer profitability analysis can be used to drive customer relationship management initiatives. Yet, CRM initiatives should not just start with customer profitability analysis, they should end with

it as well.

References

1 Anonymous (2001a) 'CRM in a downturn economy', a Peppers & Rogers Group White Paper.
2 Howard, L. (2000) 'European banks find cross-selling difficult', National Underwriter, Chicago, 17th April.
3 Ibid.
4 Clark, P. (2000) 'Bank commences cross-selling', B to B, Chicago, 25th September.
5 Maughan, S. and Gentle, C. (2001) 'What determines the winners among Europe's retail banks? - How CRM can provide the silver bullet for the future', Goldman Sachs and KPMG Consulting.
6 Ibid.
7 Roosevelt, P (1999) 'King of the cross-sell', Barron's, Chicopee, 11 th October.
8 Johnson, T. (2000) 'The multiple product approach', LIMRA's Market Facts, Hartford, June.
9 Milligan, J. (2000) 'Sandy strikes again', US Banker, New York, October.
10 Cocheo, S. (2000) 'Sales culture: A long way to go', ABA Banking Journal.
11 Anonymous (2001b) 'Tips from the CRM trenches', CRM Forum.
12 Engen, J. (2000) 'E-brokerage's integration challenge', Banking Strategies, Chicago, May/June.
13 Ibid.
14 Thompson, E. (2000) 'CEO and CIO update: The top CRM trends for 2001 - Plus one', Close, Gartner Group.
15 Collins and Harris (2001) 'In search of the elusive promise of financial services CRM', Gartner Research. SPA-13-0295.
16 Close, C. and Eisenfeld, B. (2000) 'Benefits to be gained from e-CRM', Gartner Group.
17 Adolf, R., Grant-Thompson, S., Harrington, W and Singer, M. (2000) 'What leading banks are learning about big databases and marketing', McKinsey Quarterly.
18 Angel, B. (2000) 'CRM: The upgrade', Canadian Banker, Third Quarter, Vol. 107, No. 3.
19 Forsyth, R. (1998) 'Customer retention and CRM techniques', CRM Forum, www.crm-forum.com 20 Meltzer, M. (1999) 'Using the data warehouse effectively for channel management', January, NCR Corporation, www.rm-forum.com
21 Young, K. (2000) 'CRM lives on', The Banker. Vol. 150, No. 895, September.
22 Johnson (2000) op. cit.
23 Adolf et al. (2000) op. cit.
24 Martocci, R. (2000) 'Teleservices creates multifaceted relationships with banking customers', Call Center Solutions, Norwalk.
25 Groenfeldt, T. (2000) 'Customer data, right here, right now', US Banker,

Vol. 110, No. 5.

26 Bellenoit, R. (2000) 'Crossing the sales divide', Best's Review, Vol. 101, No. 5, p. 86, September.

27 Groenfeldt (2000) op cit. 28 Anonymous (2001b) op. cit. 29 Forsyth (1998) op. cit.

30 Anonymous (2000c) 'Intimacy in the contact centre', American Productivity and Quality Centre (APQC) White paper.

31 Martocci (2000) op. cit. 32 Bellenoit (2000) op. cit. 33 Martocci (2000) op. cit.

34 Curley, B. (2000) 'Royal Bank unearths profitability solution', Bank Systems & Technology, April.

35 Ratcliff, P. (2000) 'Managing deeper relationships', Mortgage Banking. Vol. 60, Iss. 6, p. 94.

36 Hamblen, M. (2000) 'Instant customer data gives bank sales force an edge', Computerworld, 15th May. 36 Maughan and Gentle (2001) op. cit. 38 Ratcliff (2000) op. cit.

39 Cline, K. (2000) 'No magic bullet', Banking Strategies, November/December.

40 Anonymous (2001d) 'CRM in a down turn economy', A Peppers & Rogers Group White Paper 6.

41 Keltner, B. (1999) 'Growing sales from existing customers', Sales and Marketing Management, Vol. 151, Iss. 11, p. 135.

42 Collins, K. (2000) 'Managing customer relationships for increased profitability', Gartner Group (FSCI SPA-12-5880), December.

43 Ibid.

44 Forsyth (1998) op. cit.

45 Cocheo (2000) op. cit.

46 Collins, K. (2000) 'Measuring CRaM success based on profitability', Gartner Group.

47 Ibid. 48 Ibid.

49 Meltzer, M. (2000) 'Customer profitability information just isn't enough', CRM Forum Resources, www.crm-forum.com

50 Ibid.

51 Curley (2000) on cit.

52 Authers, J. (1998) 'Cross-selling's elusive charms', Financial Times, 16th November. 53 Adolf et al. (2000) op. cit.

54 Coyle, T. (1999) 'Finding your best customers', America's Community Banker, September.

55 Anonymous (2001e) 'Switching accounts to be made easier', The Sunday Times (money section).

56 Coyle, T. (1999) 'Surveys and trends', America's Community Banker, October.

57 Clark (2000) op. cit. 58 Authers (1998) op. cit. 59 Johnson (2000) op. cit.

Yasar F. Jarrar
is Research Fellow at the Centre for Business Performance, Cranfield School

of Management and an Honorary Visiting Fellow in Total Quality Management
at the European Centre for Total Quality Management, Bradford School of
Management, UK. He has published numerous papers in the areas of
performance measurement and management, and has worked as a consultant for
various national and international organisations.

Andy Neely
is Professor of Operations Strategy and Performance. Andy has been
researching and teaching in the field of business performance measurement
since the late 1980s. He chaired the first and second international
academic conferences on performance measurement in July, 1998 and July,
2000 respectively and has authored over 100 books and articles on the
subject, including 'Measuring business performance', which was published by
The Economist. He has consulted to and worked with numerous organisations.
Dr Yasar F. Jarrar
Centre for Business Performance, Cranfield School of Management, Cranfield
MK43 0AL, UK.
Tel: +44 (0) 1234 75 1122;
Fax: +44 (0) 1234 75 7409;
e-mail: Yasar.Jarrar@ cranfield.ac.uk

THIS IS THE FULL-TEXT.

Geographic Names: United Kingdom; UK

Descriptors: Customer relationship management; Financial services; Cross selling; Data
base management
Classification Codes: 5240 (CN=Software & systems); 2400 (CN=Public relations); 8100
(CN=Financial services industry); 9175 (CN=Western Europe)
Print Media ID: 49312

Gurau, Calin; Ranchhod, Ashok

Abstract:
In most industries, companies are facing an ever-incresing level and intensity of competition, as well as a rapid evolution of the market environment. Under these conditions, the analysis and management of customer profitability becomes a key issue in securing the long-term success of the business. This paper proposes a model for calculating, predicting and increasing customer profitability, based on the measurement of customer satisfaction in real market conditions. The methodology brings together, in a coherent framework, a number of concepts that have proliferated in the marketing world, including customer lifetime value, customer segmentation, customer loyalty and data mining. The paper explorers also the necessity of designing and implementing effective marketing-mix strategies targeted to the high-value, loyal customers, and the implications of this approach at managerial and organizational work.

Text:
Received (in revised form): 30th November, 2001
Abstract In most industries, companies are facing an ever-increasing level and intensity of competition, as well as a rapid evolution of the market environment. Under these conditions, the analysis and management of customer profitability becomes a key issue in securing the long-term success of the business. This paper proposes a model for calculating, predicting and increasing customer profitability, based on the measurement of customer satisfaction in real market conditions. The methodology brings together, in a coherent framework, a number of concepts that have proliferated in the marketing world, including customer lifetime value, customer segmentation, customer loyalty and data mining. The paper explores also the necessity of designing and implementing effective marketing-mix strategies targeted to the high-value, loyal customers, and the implications of this approach at managerial and organisational level.
INTRODUCTION

In the present economic environment, characterised by technological dynamism and intensive competition, the problems of customer retention and customer profitability have become paramount for the success of any business. As organisations in every industry have reached out to grow their business through the use of advanced processes and technology, they have shifted their focus from being 'productcentric' to being 'customercentric'.1 Understanding customer behaviour and profitability and leveraging this information to manage customers more effectively is the key to creating a competitive advantage in the new economy.

In a number of industry sectors, companies are facing rapidly changing business environments. If not recognised and responded to effectively, this may result in increased pressure of work, lost revenue opportunities, increased costs and, ultimately, in increased levels of customer dissatisfaction, relative to the competition.2 When customer dissatisfaction sets in, and the competition catches up, the nature of the trading relationship between buyer and seller needs to change before it collapses.

As a result of promoting change for the benefit of both parties, the power base in the company-customer relationship will inevitably change. The customer can no longer be considered as simple prey for the powerful multinational corporations, but rather as a partner in a long-term relationship characterised by a win:win situation.

The companies which move most urgently towards customer profitability management are those which recognise that there is a misalignment between customer needs and wants and what the seller wants to do, or is able to do, at an acceptable price. Some companies proactively respond to manage the impact of this situation but others only react when the conflict or crisis has arisen. In reality the crisis catalyst is only a matter of time if the customer interface and its satisfaction levels are not being managed effectively.

THE RELATIONSHIP BETWEEN CUSTOMER SATISFACTION AND CUSTOMER PROFITABILITY

The relationship between customer satisfaction and business profitability was extensively investigated and described in the specialised business literature. Both service management and marketing literature propose that customer satisfaction influences customer loyalty, which in turn affects profitability.3-17 Statistically-driven examination of the links between satisfaction, loyalty and profitability has been initiated by Nelson et al.18 who demonstrated the relationship of customer satisfaction to profitability among hospitals, and Rust and Zahorik,19 who examine the relationship of customer satisfaction to customer retention in retail banking. The Bank Administration Institute has also explored these ideas, in particular Roth and van der Velde.20,21

The specialists argue that customer satisfaction is the result of a customer's perception of the value received in a transaction or relationship - where value equals perceived service quality relative to

price and customer acquisition costs22,23 - relative to the value expected from transactions or relationships with competing vendors.24 Loyalty creates increased profit through enhanced revenues, reduced costs to acquire customers, lower price sensitivity, and decreased costs to serve customers familiar with a firm's service delivery system.25

Taking these studies into consideration, it can be assumed that:
- customer satisfaction measurement can provide a good basis for calculating, predicting and improving customer profitability
- customer satisfaction has to be investigated and evaluated in a real-life situation, considering the competitive offers on the market; this analysis is as important for the acquisition of new customers, as for the retention of the existing ones.

In spite of the increasing evidence regarding the positive relation between customer satisfaction and business results,26 no clear models have been proposed for the evaluation of this influence at microeconomic level. A study conducted by the Juran Institute 27 has shown that only 2 per cent of the surveyed managers are able to measure and stress the financial impact resulting from increased customer satisfaction levels. This paper attempts to introduce and describe a possible method for calculating customer profitability in relation to the level of perceived satisfaction in a competitive market environment.

Figure 1

CUSTOMER LIFETIME VALUE

In calculating customer profitability, most methods start from customer lifetime value. Customer lifetime value (CLV) is a controversial concept among business specialists. Some consider it 'an elaborate fiction of presumed precision',28 while other analysts declare that companies should abandon lifetime value theories and take care of customers now.29

In mathematical terms, CLV consists in taking into account the total financial contribution, ie revenues minus costs, over the entire life of a customer's business relationship with a company. Despite its simplicity, the measurement of CLV requires great care. All cash flows involved in the process have to be identified and measured on a very detailed level, and allocated precisely to each customer or type of customer. Figure 1 represents a concise seven-step approach to measuring CLV.30

Translating Figure 1 into mathematical formulae:

where CLV = customer lifetime value (profitability); RR = recurring revenues; Y = lifespan of a customer, or number of transactions; RC = recurring costs; AC = acquisition costs; P = total profits; C = number of customers.

The mathematical expression of the CLV can represent a sound basis for analysing the existing situation, and for identifying possible strategies to increase customer profitability. Analysing formula (3), five levers of customer value creation can be identified.32 These strategies represent only the starting point of a company-wide operational effort. Table 1

Table 1:

shows the complexity of implementing customer-oriented strategies based on the analysis of the CLV.

PROBLEMS IN CALCULATING CUSTOMER LIFETIME VALUE

The calculation of the CLV is not problem free. Most of these problems, however, can be successfully solved if two main issues are taken into consideration:

- the company applying this method has to define clearly from the beginning the purpose of using CLV analysis and the expected benefits
- the problems raised by the CLV analysis are often industry and company specific, as a result the company has to select the most appropriate way to apply this concept in its particular situation.

Defining a 'customer'

The first challenge is to define the customer unit.33 Is it an individual, an account, a household or a business address? A second challenge is linking customer information into a single customer record when they leave and return multiple times during their lifetime.

The answer to these questions is industry specific. The business organisation has to identify the characteristics of its customer relationship, and, on this basis, to define the customer unit and the customer lifetime cycle. In the present marketplace, a company can be confronted with the situations

Table 2:

characterised in Table 2.

Table 2 shows the 27 possible combinations of customer relationship characteristics which differ between industrial sectors and even between companies within the same industry. For example, a company with a small number of customers, which makes a small number of transactions that require a high level of company-customer involvement, will probably define the customer unit as being single customers (individuals or organisations), and the customer lifecycle as depending on the business cycles specific for the industry (production cycle, investment cycles, consumption cycles). On the other hand, for a company dealing with a large number of clients, with large number of transactions and low involvement, it might be more appropriate to aggregate individual customers into particular segments with homogeneous profiles and behaviour. On the basis of these considerations proposition 1 can be formulated:

Proposition (1): The calculation of customer profitability is industry specific.

Evaluating costs

The measurement of cost to the customer level poses the greatest challenge to customer lifetime value measurement.34 While revenue can usually be collected by customer from the appropriate billing system, cost information is aggregated into general ledger departments and accounts and requires a good deal of analysis and disaggregation before it can meaningfully be attached to individual customers or customer segments. The indirect costs are especially difficult to be divided and allocated. In solving these

problems, three key costing principles should be applied:35
- customer costs must be related to the revenues they generate
- not all costs within the organisation should be attributed down to a customer level
- it should be made absolutely clear who can influence different types of cost and revenues.

Proposition (2): The evaluation and distribution of costs should be made in connection with the level of profitability of different customer segments.

Evaluating the duration of customer loyalty

The duration of customer-business relationships is difficult to measure in the present economic environment, characterised as it is by unpredictability and rapid change.36 Many companies are using as the main predictive tool the analysis of historical data about the past behaviour of their customers, identifying specific segments and extrapolating the behaviour of these segments into the future. This method can be used successfully only in relatively stable market environments because it assumes that:
- customers will repeat their past behaviour in the fiture
- market conditions will not change significantly.

The method is, however, completely useless in dynamic, fast-changing environments, such as the high-technology industries. In such sectors, customers' needs and perceptions change fast, competition is intense and market conditions fluctuate widely.37

It is therefore important to connect these predictions with the external market environment. Many CLV/profitability models neglect the external environment of the firm, and concentrate only on the relation between the organisation and its customers.38-41 It is, however, dangerous to forget that this relation does not take place in a marketing void. Market conditions might, and indeed do, change over time, impacting on organisations' policies and on customer needs and perceptions.

Proposition (3): Customer Lifetime Value has to be calculated taking into consideration the real conditions of the market environment. The duration and intensity of customers' loyalty is determined and influenced by customer satisfaction.42-46 It can be assumed that as long as a company's offer satisfies a customer's need, that customer will be loyal to the firm. The measurement of customer satisfaction can therefore provide a platform for calculating, predicting and increasing customer profitability.

Proposition (4): The duration and intensity of customers' loyalty is determined and influenced by customers' level of satisfaction.

Measuring customer satisfaction: a possible solution for calculating, predicting and increasing customer profitability

Evaluating the perceived satisfaction of customers in relation to different existing offers, it can be considered that the acquisition of new customers is successful when:

In order to predict the revenues obtained by the company, the relationship between cost, revenues and customer satisfaction can be further represented

graphically (see Figure 3). This method can help companies predict the necessary costs for obtaining a certain level of revenue, and finally, the profitability of a particular segment of customers (with a specific satisfaction profile).

Figure 2

Figure 3 is only an arbitrary example. In reality, the graphical representation of the relationship between cost, revenue and satisfaction can be very different. For example, it is possible that, in the case of some clients/customer segments, the costs to achieve a necessary level of customer satisfaction are larger than the potential revenues. In such a case that particular client/customer segment would be considered unprofitable and eliminated from the company's target market (see Figure 4).

In this way, the organisation can significantly simplify the research process, focusing on the correlation between cost, revenue and perceived satisfaction (both in relation to its own offer and to competitors' offers). The research costs will represent a part of the total cost represented in the graph.

The authors consider customer profitability to be a more accurate concept than customer lifetime value. The lifetime expression creates pressure to predict the duration of the entire company-customer relationship, which is almost impossible considering market dynamics. The only possibility is to extrapolate the results of historical data, which sometimes are non-existent and sometimes inaccurate because they refer to past market conditions. In these conditions, most companies use a three to five-year interval as a prediction horizon.48

The measurement of customer profitability focuses on the level of satisfaction of specific segments of existing or potential customers. The concept is more accurate and complex because it takes into consideration the dynamics of the market environment and its influence on customers' needs and perceptions. The company-customer relationship can be considered to last as long as the existing customer is more satisfied with the company's offer than with competitors' offers. The same holds for potential customers becoming customers of the organisation. Evaluating exiting market conditions (general characteristics, the structure of customer needs and the intensity of competition), as well as existing trends, simulation models can be created to predict the future situation in terms of cost, revenue, customer segments and customer satisfaction.

Figure 3

POSSIBLE CRITICISMS OF THE SATISFACTION-PROFITABILITY MODEL

Defection of satisfied customers

There is empirical evidence that even satisfied customers defect,49-51 for a number of different reasons.52 In order to understand the real danger of this tendency it is important to analyse and differentiate among (1) different categories of customers and (2) different industrial sectors. Hughes53 differentiates between two categories of customers:

- transaction buyers: focused on price, low loyalty level
- relationship buyers: focused on trustful, long-term business relationship, high loyalty level.

Understanding the differences between these two categories of customers, coupled with an accurate market segmentation, can provide the company with a powerful competitive strategy. The company can either choose to concentrate on only one of these customer groups, implementing a focused marketing-mix strategy, or to take advantage of both segments, differentiating its offer and marketing operations accordingly.

On the other hand, the size and the occurrence of these two customer categories is probably sector specific. Considering the possible combinations of customer relationships presented in Table 2, the industries characterised by a large number of customer, doing a large number of transactions and requiring a low level of involvement will have a higher propensity to have a large proportion of transaction customers than the sectors with a concentrated (small number of customers), highly relational (high involvement) market. The fact that the paper identifying the main reasons for customer disloyalty analyses the situation in the retail grocery sector is extremely relevant.54

Figure 4

Even in industries characterised by a high customer turnover, the satisfaction profitability model can be successfully applied because it takes into consideration not only customer retention, but also customer acquisition. If the perceived satisfaction of the customer in relation to the company's offer is higher than the perceived satisfaction in relation to a competitors' offer, high customer turnover is likely to be in favour of the company. It is possible that even defecting customers will return, when the effect of random preferences dissipates.

Another possible source of error is the way satisfaction and a satisfied customer are defined by the firm. If the company is not aware of customers' real needs and wants, the criteria for measuring satisfaction will be biased from the start.55

Satisfied customers are not always profitable

Some specialists argue that a growing number of companies have discovered that improved satisfaction scores do not necessarily translate into increased profits, bottom-line results have even deteriorated. A direct relationship between satisfaction and sales could not be proven in all cases.56

Considering Figures 3 and 4 once more and the relation between cost, revenue and satisfaction, it is quite possible to induce increased satisfaction without obtaining higher profits, or indeed any profit at all. Cost-revenue-- satisfaction profiles have to be built for each targeted customer segment. The main objectives of the organisation are not only to increase customer satisfaction, but also the more efficient use of funds, the costs being an essential element in the calculation of customer profitability.

Difficult/costly measurement of satisfaction levels
Both the service management and the marketing literatures suggest that
there is a strong theoretical underpinning for an empirical exploration of
the linkages between customer satisfaction, customer loyalty and
profitability.57 The relatively small quantity of empirical research
performed on these relationships58 is probably the result of the paucity of
organisations measuring 'soft' issues, eg customer satisfaction and
customer loyalty, in meaningful ways. These problems have determined a
trend towards the formalisation of customer satisfaction.59 There is a
broad technical literature concerned with such issues as:
- developing different concepts of customer satisfaction which can be
evaluated60
- designing effective customer satisfaction data collection and reporting
systems, varying in sophistication61
- adopting methods for institutionalising customer satisfaction measurement
into organisational control systems62
- developing systems for responding effectively to customer dissatisfaction
and customer complaints.63
Customer satisfaction is a multidimensional subject.64 Normally a diverse
set of criteria called 'quality drivers' is used to explain customers'
satisfaction or dissatisfaction in multiattribute measurement approaches.
The measurement and comparison of customers' satisfaction was considered so
important that national or international organisations have tried to define
and apply standardised customer satisfaction barometers. There are national
indices in the USA (the American customer satisfaction index, ACSI),65
established in 1994; in Sweden (the Swedish customer satisfaction index,
SCSI),66 established in 1989; and in Germany (Deutsche Kundenbarometer,
DK),67 established in 1991. A European Customer Satisfaction Index was
implemented at the beginning of 1999, aggregating a number of national
customer satisfaction indexes.68 These measurement methodologies are highly
complex and sophisticated, analysing both the general perceptions customers
have about a company, product or service, as well as their attitudes
towards diverse analytical components of the object under investigation.
The competitive/ comparative dimension is also included in these scales,
though a number of questions remain regarding the intention to switch to a
competitor, or about the comparison of the existing company with an ideal
organisation.69
As can be seen, companies wishing to measure their customers' satisfaction
can choose from a variety of analytical models. In countries that have
implemented a standardised customer satisfaction index it might even be
possible to access official statistics permitting direct comparisons with
competitors.
Finally, companies concerned about the costs of such investigations, can
use a general satisfaction index, asking respondents to evaluate the degree
of satisfaction in relation to a specific product/service. This index will
be accurate enough as long as it is also applied to non-customers, and

includes customer satisfaction relative to competitors, offering a base for comparisons.

Difficulty and cost of measuring and predicting the relation between customer satisfaction and costs/revenues for a particular product or service

Both the evaluation of costs and selling prices in relation to a new product or service represent standard research procedures for many companies.71 The additional element, customer satisfaction, can be easily integrated into these studies. Nor does the measurement of customer satisfaction regarding a competitive offer raise any difficult issues, comparative marketing tests being used intensively to identify and assess the competitive position of different products or services in the market. The main problem is with the capacity to predict the future level of customer satisfaction. This is not necessarily a disadvantage however. In comparison with customer lifetime value, the concept of customer profitability takes into consideration the competitive evolution of the market. A company would therefore have to invest in market research projects, studying its customers, their needs and wants, the competition, existing offers and the perceptions and attitudes of the general public.72 Even if these research projects could be realised at specific moments in time, the firm's information systems would have to be permanently engaged in scanning the competitive environment, identifying trends and predicting sectorial evolution. This would improve the firm's knowledge base, allowing for a more accurate and faster decision-making process, and consequently, increasing the strategic competitive advantage of the firm, as well as its capacity to correctly identify and react to the changing market environment.

Probably the most appropriate form of market research that can be used to collect data regarding the connection between customer satisfaction and profitability is the panel.73 Using a panel, comparative data from the sampling units can be collected on several occasions. The panels can be made up of individuals, households or firms. Continuous research services, however, demand considerable investment in back-up facilities such as specialised staff, computers and database management, and because of this the retail audits and panels are usually organised and conducted by large research organisations. Typical organisations are ACNielsen (Homescan) and Taylor Nelson Sofres (Superpanel and Family Food Panel).74 Other market research agencies are specialised in panels designed for a particular market (children's market, agricultural market, motorists, etc.).

USING CUSTOMER SEGMENTATION AND SATISFACTION MEASUREMENT TO IMPLEMENT
SUCCESSFUL MARKETING MIX STRATEGIES

The key to understanding the profitability of a specific customer and to applying the most appropriate customer management strategy is segmentation.75 Business organisations should aim at adopting a simple and operational segmentation methodology that can be readily used by

operational managers and that can discriminate sufficiently by customer value.[76] The selected segmentation dimensions should discriminate either on the revenue side (eg usage intensity and behaviour), or on the cost side (eg products purchased, channel used, intensity of customer care usage and service levels. This way the company can have a complete mapping of the 'wells' of value creation and 'pits' of value destruction of the business and an understanding of why they are such.

Figure 5

Making clear connections between customer behaviour and customer demographic profiles is critical for a company interested in keeping customers and increasing their profitability. The implementation of an efficient profiling/segmentation methodology has to address the following issues:[77,78]

- robust transaction data, properly collected and updated
- data warehousing capabilities for capturing and storing the data (databases)
- an associated retrieval and data delivery system
- data mining tools that reflect the unique nature of the business
- detailed costing information, including the process cost, as well as the physical product or service cost
- a meaningful business model that represents clearly the company-customer interaction and the fluctuation of customers' and businesses' lifecycles.

The satisfaction measurement has to be specific for each targeted customer segment of the company. The needs and wants of different customer segments are usually different, as are the quality standards regarding the offered products and services.

Not only do organisations need to benchmark their results after the completion of the customer survey, but they also have to evaluate the process they used to obtain these results. Such data must be as accurate as possible, especially if staff bonuses or other incentives are triggered by achieving satisfaction improvement targets.[79] It is also important to disseminate the results of customer satisfaction measurement to all organisational levels. Little action will be taken to improve customer satisfaction if employees do not know enough about these results or their implications.[80] In addition, the extent of feedback provided to employees will also send messages about how important the customer survey is to the organisation.

A thorough research of the specific sources of customer satisfaction/dissatisfaction and of the importance allocated to them by customers, will indicate the areas of excellence/necessary improvement in company's strategy (Figure 5). On the basis of this research, a marketing mix strategy targeted at specific customer segments can be designed and implemented.

As companies shift from a traditional product focus to a customer focus, customer relationship management represents a fundamental change which affects virtually every aspect of an organisation. This includes its

business strategies and operating processes, application and technology infrastructure, management and organisational structures, and sometimes even its culture. To achieve successful customer relationship management, organisations must foster behaviours and implement processes and technologies that support coordinated customer interactions throughout every customer touch point. This process often includes new ways of
- marketing to and caring for customers
- establishing sales channels tailored appropriately to customers
- establishing a partner community centred around common customers
- fostering innovation and collaboration with the aim of improving customer service and loyalty
- investing in the creation, capture and dissemination of customer knowledge within the organisation, among partners, and potentially with customers
- leveraging information technology to enable the transformed practices mentioned above.

Customer profitability provides a sound basis for decision making regarding investments and strategies for each of these. Through the ability to understand and segment customers based on value, companies will be better equipped to develop customer management strategies that focus on:
- directing marketing and sales resources toward those customers who create the greatest value
- enhancing loyalty programmes that help retain high-value customers
- modifying customer service activities for low-value customers
- increasing customer service activities for high-value customers
- developing service pricing distinct from product pricing.

The main effects of these operations of better segmentation, targeting and customer relationship management will be the improvement of customer satisfaction, a better focus of company's resources and an increase in customer loyalty and profitability.

CONCLUDING REMARKS

This paper proposes a simple model of connecting customer profitability management with the real situation of competitive markets, through customer satisfaction measurement. This model has value particularly for highly dynamic industrial sectors, in which the use of historical data for predicting future customer behaviour is inaccurate. Four propositions have also been formulated in connection with the application of the proposed model of customer profitability:
- Proposition (1): the calculation of customer profitability is industry specific
- Proposition (2): the evaluation and distribution of costs should be made in connection with the level of profitability of different customer segments
- Proposition (3): the customer lifetime value has to be calculated taking into consideration the real conditions of the market environment
- Proposition (4): the duration and intensity of customers' loyalty is

determined and influenced by customers' level of satisfaction.

The application of this model is far from easy. Careful and continuous customer research and market scanning are necessary for its successful implementation as well as an accurate evaluation of the organisational structure and processes. In today's economy, the key marketing skills are still necessary and valid; they must, however be complemented and supplemented in a number of important areas. These complementary key skills include:

- customer profitability modelling: it is necessary to understand the key drivers of customer profitability and the likely impact on customer value of changes in the marketing mix
- prediction: using techniques such as CHAID and regression, the strength and nature of relationships between events and customer attributes can be identified in order to predict behaviours such as purchase, referral, renewal, lapsing, etc.
- clustering: cluster analysis can be used to group customers, or prospects, with similar characteristics or attitudes. This enables significant segments of customers to be identified for which relevant propositions and communications can then be developed
- measurement and monitoring systems: in order to develop profitable new customer propositions for different customer segments, it is essential that the means to monitor their effectiveness are established. This requires the design of appropriate measures, including the return on investment, and systems necessary to deliver timely and accurate information
- design and analysis of tests: ideally, a new idea should be tested on a sample of the customer or prospect base before implementing it. Therefore, the design of statistically valid tests and the development of appropriate analytical tools to aid their interpretation is yet another critical skill.

From the managerial perspective it is extremely important to implement within the organisation an effective system of segmenting the market, evaluating the profitability of different segments of customers, and measuring the relationship between satisfaction, profitability and loyalty on a regular basis. Research studies such as panel surveys should either be organised by the company, or carried out by specialised market research agencies. On the basis of the research findings, the company has to design and implement well-targeted marketing mix strategies, differentiating between high-profitability, loyal customers, and low-value, opportunistic clients. These operations should change fundamentally the company focus, from a product and distribution approach to a customer-centred approach. The design of a complex customer relationship management model has to take into consideration, and to modify, all aspects of the organisation, including the organisational culture, structure and operations.

Customer profitability analysis, if managed effectively, can deliver improved profitability and a greater return on investment by:

- targeting acquisition activities at those prospects with the greatest potential lifetime value

- developing stronger and more profitable relationships with existing customers
- ensuring that scarce financial and staff resources are allocated to those customers with proven value or potential.

References

1 Harper, D. and Schmarzo, W (1999) 'Making every customer relationship count: Exploring the business drivers and technology enablers of customer relationship management', www. crm-forum.com/crm_vp/mecrc/sld01.htm.

2 Connolly, T. and Ashworth, G. (1994) 'Managing customers for profit', Management Accounting, Vol. 72, No. 4, pp. 34-40.

3 Anderson, E. W and Fornell, C. (1994) 'A customer satisfaction research prospectus', in Rust, R. T. and Oliver, R. (eds), 'Service quality: New directions in theory and practice', Sage Publications, Thousand Oaks, CA, pp. 241-268.

4 Edvarsson, B., Johnson, M. D., Gustafson, A. and Strandvik, T. (2000) 'The effects of satisfaction and loyalty on profits and growth: Product versus services', Total Quality Management, Vol. 11, No. 7, pp. 917-928.

5 Gummesson, E. (1993) 'Quality management in service organizations: An interpretation of the service quality phenomenon and a synthesis of international research', International Service Quality Association, Karlstad, Sweden.

6 Hallowell, R. (1996) 'The relationships of customer satisfaction, customer loyalty, and profitability: An empirical study', International Journal of Service Industry Management, Vol. 7, No. 4, pp. 27-42.

7 Heskett, J. L., Sasser, W E. and Hart, C. W L. (1990) 'Breakthrough Service', The Free Press, New York, NY

8 Heskett, J. L., Jones, T. O., Loveman, G. W, Sasser, W E. Jr. and Schlesinger, L. A. (1994) 'Putting the service profit chain to work', Harvard Business Review, March-April, pp. 105-111.

9 Page, M., Pill, L. and Berthon, P (1996) 'Analysing and reducing customer defections', Long Range Planning, Vol. 29, No. 6, pp. 821-834.

10 Reichheld, E F and Sasser, W E. Jr (1990) 'Zero defections comes to services', Harvard Business Review, September-October, pp. 105-111.

11 Reichheld, E E, Markey, R. G. Jr. and Hopton, C. (2000) 'The loyalty effect - the relationship between loyalty and profits', European Business Journal, Vol. 12, No. 3, pp. 134-141.

12 Rust, R. T., Zahorik, A. J. and Keiningham, T. L. (1995) 'Return on quality (ROQ): Making service quality financially accountable', Journal of Marketing, Vol. 59, No. 2, pp. 58-70.

13 Schneider, B. and Bowen, D. E. (1995) 'Winning the service game', HBS Press, Boston, MA.

14 Soderlund, M. and Vilgon, M. (1999) 'Customer satisfaction and links to customer profitability: An empirical examination of the association between attitudes and behavior, SEE/EFI Working Paper Series in Business Administration, No. 1, January, http://swoba.hhs.se/hastba/abs/hastba1999_001.htm.

15 Storbacka, K., Strandvik, T. and Gronroos, C. (1994) 'Managing customer relationships for profit: the dynamics of relationship quality', International Journal of Service Industry Management, Vol. 5, No. 5, pp. 21-38.

16 Yi, Y (1990) 'A critical review of consumer satisfaction', in Zeithaml, V (ed.), 'Review of marketing, 1990', American Marketing Association, Chicago, IL, pp. 68-123.

17 Zeithaml, V, Parasuraman, A. and Berry, L. L. (1990) 'Delivering quality service', The Free Press, New York, NY.

18 Nelson, E., Rust, R. T., Zahorik, A. J., Rose, R., Batalden, P. and Siemanski, B. A. (1992) 'Do patient perceptions of quality relate to hospital financial performance', Journal of Health Care Marketing, December, pp. 42-49.

19 Rust, R. T. and Zahorik, A. J. (1991) 'The value of customer satisfaction', Working Paper, Vanderbilt University.

20 Roth, A. and van der Velde, M. (1990) 'Retail banking strategies: Opportunities for the 1990s', Bank Administration Institute, Chicago, IL.

21 Roth, A. and van der Velde, M. (1991) 'Customer perceived quality drives retail banking in the 1990s', Bank Management, November, pp. 29-35.

22 Heskett, Sasser and Hart (1990) op. cit.

23 Blanchard, lK. E and Galloway, R. L. (1994) 'Quality in retail banking', International Journal of Service Industry Management, Vol. 5, No. 4, pp. 5-23.

24 Zeithaml, Parasuraman and Berry (1990) op. cit. 25 Reichheld and Sasser (1990) op. cit.

26 Chambers, J. (2000) 'Customer satisfaction at Cisco Systems', www.tdmktg.com/resources.html.

27 Juran Institute (1995) 'Can't get no satisfaction? Perhaps you should stop trying', Wilton, Juran Institute.

28 Jackson, D. R. (1992) 'In quest of the Grail: Breaking the barriers to customer valuation', Direct Marketing, Vol. 54, No. 11, p. 44-48.

29 Ambler, T. (2001) 'Abandon lifetime value theories and take care of customers now', Marketing, 12th July, p. 18.

30 Bacuvier, G., Peladeau, P, Trichet, A. and Zerbib, P. (2001) 'Customer lifetime value: Powerful insights into a company's business and activities', http://www.bah.com/viewpoints /insights/cmt clv-2.html. 31 Ibid. 32 Ibid.

33 Ness, J. A., Schroeck, M. J., Letendre, R. A. and Douglas, W J. (2001) 'The role of ABM in measuring customer value', www.mamag.com/strategicfinance/2001/03f htm.

34 Smith, M. and Dikolli, S. (1995) 'Customer profitability analysis: An activity-based costing approach', Managerial Auditing Journal, Vol. 10, No. 7, pp. 3-7.

35 Connolly and Ashworth (1994) op. cit.

36 Forsyth, R. (2001) Re-evaluating CRM cliches: Customer lifetime value', CRM-Forum, www.crm-forum.com.

37 Andre, M. M. and Saraiva, P. M. (2000) 'Approaches of Portuguese companies for relating customer satisfaction with business results', Total Quality Management, Vol. 11, No. 7, pp. 929-940.

38 Cody, D. (2000) 'Analytical CRM: Increasing lifetime customer value through prediction', www. serverworldmagazine.com/sunserver/2000/12/analytical.shtml.

39 Howard, S. (2001) 'How customer lifetime value can drive your marketing efforts', www. receptive.com/only/taurus/dm/plan/dmb-articles/lifetimevalue.html.

40 Hughes, A. M. (2001a) 'Building successful retail strategies using customer lifetime value', www.dbmarketing.com/articles/Artl 81.htm.

41 Strategic Database Marketing (1994) 'Augmenting customer lifetime value', www.bradyco.com/cre5html.

42 Hallowell (1996) op. cit.

43 Reichheld, Markey and Hopton (2000) op. cit. 44 Andre and Saraiva (2000) op.cit.

45 Reichheld, F F (1996) 'The loyalty effect', Harvard Business School Press, Harvard.

46 Scharitzer, D. and Kollarits, H. C. (2000) Satisfied customers: profitable customer relationships: pharmaceutical marketing: how pharmaceutical sales representatives can achieve economic success through relationship management with settled general practitioners-an empirical study', Total Quality Management, Vol. 11, No. 7, pp. 955-966.

47 Jones, M. A., Mothersbaugh, D. L. and Sharon E. B. (2000) 'Switching barriers and repurchase intentions in services', Journal of Retailing, Vol. 76, No. 2, pp. 259-274.

48 Forsyth (2001) op. cit.

49 Juran Institute (1995) op. cit.

50 Andre and Saraiva (2000) op. cit.

51 Scharitzer and Kollarits (2000) op. cit.

52 McGoldrick, P. J. and Andre, E. (1997) 'Consumer misbehaviour: Promiscuity or loyalty in grocery shopping', Journal of Retailing and Customer Service, Vol. 4, No. 2, pp. 73-81.

53 Hughes, A. M. (2001b) 'Why customers leave, and what you can do about it', www.dbmarketing.com/articles/Artl 42.htm.

54 McGoldrick and Andre (1997) op. cit.

55 Hill, N. (2001) 'Customer satisfaction measurement', www.leadershipfactor.com/forum/csmnh/csm4.htm. 56 Scharitzer and Kollarits (2000) op cit.

57 Hallowell (1996) op. cit.

58 Storbacka, Strandvik and Gronroos (1994) op. cit. 59 Piercy, N. E (1996) 'The effects of customer satisfaction measurement: The internal market versus the external market', Marketing Intelligence Fr Planning, Vol. 14, No. 4, pp. 9-16.

60 Griffin, A. and Hauser, J. R. (1992) 'The voice of the customer', Marketing Science Institute, Cambridge, MA.

61 McQuance, E. and McIntyre, S. (1992) 'The customer visit: An emerging practice in business-to-business marketing', Marketing Science Institute, Cambridge, MA.

62 Lele, M. M. and Sheth, J. (1988) 'The four fundamentals of customer satisfaction', Business Marketing, June, pp. 80-94.

63 Richins, M. L. (1987) 'Negative word-of-mouth by disatisfied customers: A pilot study', Journal of Marketing, Vol. 47, No. 1, pp. 68-78.

64 Scharitzer and Kollarits (2000) op. cit.

65 Forell, C., Johnson, M. D., Anderson, E. W, Cha, J. and Everitt Bryant, B. (1996) 'The American customer satisfaction index: Nature, purpose, and findings', Journal of Marketing, Vol. 60, pp. 7-18.

66 Fornell, C. (1992) 'A national customer satisfaction barometer: The Swedish experience', Journal of Marketing, Vol. 56, pp. 6-21.

67 Meyer, A. and Domach, F (1995) 'Nationale Barometer zur Messung von Qualitat and Kundenzufiedenheit bei Dienstleistungen', in Bruhn, M. and Strauss, B. (eds) Dienstleistungsqualitat (Wiesbaden), pp. 429-453.

68 Eklof, J. A., Hackl, P. and Westlund, A. (1999) 'On measuring interactions between customer satisfaction and financial results', Total Quality Management, July, pp. 514-523.

69 Gronholdt, L., Martensen, A. and Kristensen, K. (2000) The relationship between customer satisfaction and loyalty: Cross-industry differences', Total Quality Management, 11th July, pp. 509-515.

70 SMART (2001) 'Customer satisfaction measurement', www.s-m-a-r-t.com/exp_csm.htm.

71 Chisnall, P. (2001) 'Marketing research', Sixth edition, McGraw-Hill, Maidenhead.

72 SMART (2001) op. cit. 73 Chisnall (2001) op. cit. 74 Ibid.

75 Bacuvier et al. (2001) op. cit.

76 Doyle, P. (2000) 'Value-based marketing', John Wiley & Sons, Chichester.

77 Thearling, K. (1999) 'Increasing customer value by integrating data mining and campaign management software', http://www3primushost.com/-kht/text/integration/integration.htm.

78 Wundermann, C. J. (2001) 'Unlocking the true value of customer relationship management', http://www.crm-forum.com/crm_vp/utv/sld01.htm. 79 Chambers (2000) op. cit.

80 Hill (2001) op. cit.

Calin Gurau

is lecturer in marketing in the School of Management, Heriot-Watt University, Edinburgh. He is a Junior Fellow of the World Academy of Art and Science, Minneapolis, USA. He worked as marketing manager in two Romanian companies and he has received degrees and distinctions for studies and research from University of Triest, Italy, University of Vienna, Austria, Duke University, USA, University of Angers, France and Oxford University, UK. His present research interest focuses on the marketing

strategy of biotechnology firms and marketing strategies on the Internet.

Ashok Ranchhod
is Professor and Head of Marketing at Southampton Business School, UK and a
Visiting Professor in Marketing at the University of Angers in France. He
has also worked at the Nottingham, Sheffield and Open University Business
Schools. Before working in academia, he ran a plant biotechnology company.
He is now the Senior Examiner at the Chartered Institute of Marketing for
the case study paper (analysis and decision). He has run senior manager
programmes for several multinational companies and published widely on
marketing subjects in various journals such as The International Journal of
Advertising, The Journal of Information Technology and The Journal of
Global Information Technology. His current interests surround marketing
strategies for biotechnology companies and effective market orientation
with the use of technology.
Calin Gurau
Lecturer in Marketing, School of Management, Heriot-Watt University,
Riccarton, Edinburgh, EH14 4AS, UK.
Tel: +44 (0)131 451 3587; Fax: +44 (0)131 451 3296; e-mail:
c.gurau@hw.ac.uk

Abstract:
Understanding the financial contribution customers make to their
organisations is an initial step in customer relationship management. Set
in the banking industry, this paper examines the strength of 'share of
wallet' as a proxy variable for measuring customer profitability. Data from
a study of 1,100 personal retail banking customers of a New Zealand
regional bank were used in combination with the bank's own customer
contribution data for each of those respondents. Results indicate that
although share of wallet might be used as a proxy for customer contribution
at a macro level of customer classification, details of specific financial
relationships customers have with their main bank are still necessary.
Nevertheless, share of wallet ought to become a standard entry in a bank's
customer database. (PUBLICATION ABSTRACT)

Text:
Abstract Understanding the financial contribution customers make to their
organisations is an initial step in customer relationship management. Set
in the banking industry, this paper examines the strength of 'share of
wallet' as a proxy variable for measuring customer profitability. Data from
a study of 1,100 personal retail banking customers of a New Zealand
regional bank were used in combination with the bank's own customer
contribution data for each of those respondents. Results indicate that
although share of wallet might be used as a proxy for customer contribution
at a macro level of customer classification, details of specific financial
relationships customers have with their main bank are still necessary.
Nevertheless, share of wallet ought to become a standard entry in a bank's
customer database.
Keywords Share of wallet, customer profitability, retail banking
INTRODUCTION
Relationships between customers and their service providers have been at
the forefront of marketing enquiry for decades. Measuring the value
(usually in financial terms such as profitability) of enduring long-term

relationships has been a recurring theme to such an extent in recent services marketing research that Gummesson[1] began calling for a 'return-on-relationship' (ROR) measure. Such a measure was mooted somewhat earlier, again from within the Nordic School of researchers, by Storbacka.[2] Working in a personal retail banking context, he coined this measure, 'customer relationship profitability' (CRP). Although not stated as such, each of these commentators seemed to advocate customer lifetime value analysis (which compares revenue generated against costs incurred over time, including forecasted revenue and costs at net present value) although each acknowledged such analysis is far from easy in personal retail banking.

Until the 1990s, relating individual customers' contributions to bank profitability had been handicapped by an inability to allocate transaction costs to individual customers. Now modern activity-based accounting procedures make it possible to allocate these costs and trace individual contributions, but it is by no means easy or cheap to do so. Indeed, 'management accounting systems (still) provide data that treat the costs of marketing and customer service as marmalade overheads to be spread evenly over the top . . . it is simply not true that customers buying the same amount of goods or services need the same amount of time and attention'.[3] Customer service costs tend to grow and can make the difference between profitable and unprofitable customers, at least in the short term. While Ryals[3] points out the limitations of single-period customer profitability analysis, she acknowledges the difficulties in obtaining data for lifetime value analysis.

LITERATURE REVIEW

Calculating customer profitability in personal retail banking

Two recent (2002) special issues on customer profitability and customer equity management in the Journal of Targeting, Measurement and Analysis in Marketing, and the Journal of Service Marketing respectively show the emphasis now being placed upon these related topics. Some of the articles within these special issues address, albeit indirectly, bank marketing. It is Storbacka,[2] Barnes and Cumby,[4] Connell[5] and Gurau and Ranchhod,[6] however, who have provided working examples of methods for calculating customer profitability (and its related longer-term variable: customer lifetime value) in the standard accountancy-based schemes of revenue minus costs. It should be noted that such analysis is somewhat difficult to obtain in retail banking because bank record formats are dictated by legislative requirement (as well as certain accounting requirements). Additionally, banks tend to emphasise the role of products rather than the role of customer relationships as instrumental in bank profits. Thus only changes in account balances are recorded; the costs of selling efforts and advice given are not recorded systematically in their databases. And while it would be desirable to estimate profitability over the total length of a customer relationship (by calculating net present value of yearly revenues and costs), difficulties in accessing data longitudinally restrict

profitability analysis to smaller time periods.

In retail banking, revenue is generated by banks by both the margins they earn on their lending and investment activities and by earnings from transaction fees, credit card fees, establishment fees for mortgages, etc. Retail banking is characterised by large numbers of customers (compared to wholesale banking with its few customers), many of whom make relatively small transactions. With cost centre control at the branch level, many costs (such as rent, utilities and staff) are accrued by each branch. The study bank's own analysis showed that 70 per cent of its branches' functions are transaction based. Derivation of the 'customer contribution' variable for this particular study was achieved as follows.[7] All items in the Income and Expenditure Statement of the study bank's Annual Report were scrutinised by a bank-appointed project team and costs apportioned where possible. Obviously, certain assumptions were made at this stage. Using for illustration the example of apportioning telephone costs, the project team found 70 per cent of telephone costs accrue to branches, 10 per cent each to head office lending and finance sections, and the remaining 10 per cent to head office as a 'marmalade' overhead. Therefore, 70 per cent of telephone costs need to be apportioned to customer transactions and for the three-month time period, transaction volume was divided into these telephone costs yielding a per transaction cost of $0.0197. Then each customer's 'branch' telephone cost could be computed as well as their share of the remaining 30 per cent of telephone costs. The same approach was used for the direct transaction costs relating to customer activity for cleaning, computing, heating and lighting, rates and insurance, repairs and maintenance, salaries, security, staff costs and allowances, stationery, sundry costs, superannuation and training. The study bank's project team spent six months testing its customer contribution algorithm before releasing it for the author's use.

Share of wallet as an indicator of profitability

Much of the research[8-12] that encompasses share of wallet and customer duration in personal retail banking has come from studies attempting to trace the chain of effects from service quality programmes upon customer satisfaction, customer loyalty and customer profitability, that is, the so-called service-profit chain.[13] Results have been mixed but seem to suggest that quality improvements help both customer acquisition and customer retention. Anderson and Mittal[14] have warned that disenchantment arises because the links in the satisfaction-profit chain are probably asymmetrical and non-linear rather than the 'conceptually tidy' linear chain. Nonetheless, new customers are attracted by positive endorsements from existing customers about quality products offered in a quality 'envelope' of service. Existing customers are encouraged to remain (resulting in higher retention and lower customer churn rates for the bank) and devote a greater share of wallet to their main bank. As Reichheld[15,16] and Reinartz and Kumar[17] have shown, small increases in retention rates result in measurable effects on profitability.

In a Scandinavian banking context, Storbacka[2] demonstrated direct relationships between customer longevity with their main bank and share of wallet given to that bank. In New Zealand, Colgate,[18] in his study of customer satisfaction with New Zealand banks, wrote that the depth of relationship with customers (the 'quality' of the relationship rather than the number of relationships) was particularly important. Gummesson[1] echoed these sentiments in the context of long-term customer relationships in general, supported by earlier work by Fornell,[19] Anderson, Fornell and Lehman[20] and Anderson, Fornell and Rust.[21]

Minimisation of customer churn is a priority for most banks. Personal retail banking (as opposed to business banking or wholesale money market banking) is a typical subscription market characterised by customers not regularly switching among a repertoire of brands (unlike fast-moving goods), and giving most of their banking business to one or two suppliers for long periods of time. It is often stated that banks need to operate on a long-term 'cradle-to-grave' customer management strategy where youthful customers are recognised as being unprofitable in their earlier years but becoming profitable as they move on through the family lifecycle. Concomitantly, customers can become 'entangled' with their main bank to such an extent that the perceived cost of defection outweighs the benefits of shifting banking business to a new provider. Usually, this phenomenon is called 'inertia'. Cradle-to-grave strategies are discussed in the academic literature in terms of customer relationship management and customer lifetime value. That literature is now voluminous but reference to Zeithaml[22] gives a suitable overview while in personal retail banking, the material from CRM-Forum (for example, Forsyth)[23] is most useful.

Switching and the customer pyramid

Colgate[18] found that New Zealanders have an annual switching rate of 4 per cent but at any one time 15 per cent of personal retail banking customers claim they intend to switch banks. He concluded that there is a relatively high level of inertia among New Zealand's banking customers. Remaining with a bank even though less than satisfied with its service performance is not just a characteristic of New Zealand personal retail banking. Jones, Mothersbaugh and Beatty, studying retail banking behaviour in the USA, reported that 'the effect of core-service satisfaction on repurchase intention was reduced when customers perceived high switching barriers. These switching barriers became particularly important when satisfaction with the core service was lower and thus mitigated, at least to some extent, customer reactions to sub-optimal performance.[24]

Customers' value to the study bank is at the heart of the customer contribution measure used in this study. As Storbacka[2] noted, among a bank's customer base, at any time there are those who are profitable, those clustering around a break-even point and those who are unprofitable. Point-in-time studies like the one reported here tend to exacerbate the rigidity of these categories but using customer asset management strategies over time, banks try and move their unprofitable customers into

profitability. Zeithaml[22] and Zeithaml et al.[11] have written extensively on banks segmenting their customers on the basis of their profitability to the bank. They recount instances of the most profitable customers being differentiated from the least profitable and loss-making customers in call centres and other customer-provider interfaces. Thus service delivery is differentiated at point-of-sale or point-of-contact and different pricing and/or reward schemes then follow. Zeithaml et al. advocate 'customer alchemy' ('the art of turning less profitable customers into more profitable customers)[11] and derived this term from the naming of their study bank's customer tiers as platinum, gold, iron and lead. Variations on this nomenclature abound but the challenge to banks using customer segmentation by profitability remains: how to migrate less profitable or loss-making customers up the customer pyramid. As the discussion thus far shows, attempting to optimise returns from a bank's customer base relies heavily on the relationship marketing paradigm and its essential premise that it is cheaper to retain customers than to recruit new ones.

It is acknowledged that the customer contribution measure used in this paper gives a cross-sectional, static picture of customer relationships for a short period of time (three months). Obviously banking relationships last longer, often decades, with customer acquisition costs amortised over such time periods as stated by commentators such as Reichheld and Sasser,[25] Heskett et al.,[13] Storbacka,[2] Rust et al.[9] and Loveman.[10] The analysis presented here is better described as customer contribution rather than customer profitability because contribution is the difference between income and expenditure per customer over the time period of the analysis. Comparatively, the term 'profit' is better used to describe the net of the study bank's income over expenditure for the financial year.

AIMS AND OBJECTIVES

The overall aim of this paper is to investigate the efficacy of using share of wallet at a 'main bank' (that at which most personal retail banking business is conducted) as a first-level indicator of customer profitability for a retail bank. The 'hoped for' outcome is that this relatively 'easily obtained' measure might be substituted in sonic instances of bank management practice for more expensive customer contribution cum customer profitability measures.

METHODOLOGY

Context

The study bank for this paper's empirical research is New Zealand's only locally owned regional bank. With 12 branches it is one of the smaller banks, serving a regional clientele, although it now actively encourages customer acquisition from beyond its region by electronic and telephone banking. Nearly two-thirds of its region's adult population have an account at this bank and nearly half (47 per cent) claim it to be their main bank. New Zealand's banking industry in the late twentieth century shared turmoil similar to that reported in Scandinavia[26] where the governments of the day have had to 'bail out' the 'people's bank' because of misguided focus on

short-term profitability. Branch management had financed risky projects in boom times and the high returns earned from these projects (initially) helped earn promotion for these managers. Yet the legacy of their risk-loaded portfolios stayed at branch level long after they had departed. The recession of the late 1980s and early 1990s led to customer insolvencies, bank foreclosures and a spectacular failure of the government's bank. Now the New Zealand banking industry is quite different. The five major banks are all foreign owned. In eight years branch numbers fell from 1,500 to 960(27) as mergers and takeovers of locally owned banks by the foreign owned 'Big Five' (ANZ, ASB, BNZ, National and Westpac-Trust) took effect, along with modern retail banking systems based on electronic banking and mortgage broking, etc.

Method and sample

The research for this paper formed part of a larger project which was conducted in several stages. Following a qualitative phase and then pilot study, the main (quantitative phase) involved surveying 1,700 randomly selected personal retail banking customers from the study bank by mail. After three waves, the response rate (after allowing for deaths, gone aways, sickness, mental incapacity, etc) was 70 per cent resulting in a processing sample of n = 1,128. The maximum margin of error, at 95 per cent confidence, on this random sample is just under 3 per cent.

The survey instrument contained a mixture of seven-point Likert-type scale questions on service quality, customer satisfaction and customer loyalty, behavioural questions on customers' personal retail banking and questions on demographics. The usual limitations are expressed about the advisability of deriving means from Likert-type scales, about inferring attitudinal dispositions as precursors to behaviour and about nonsampling errors generated in the data collection phase. Respondents self-reported their share of wallet with a main bank which may have resulted in some respondent accuracy bias but the direction of such bias is unknown. In the pilot phase of the study the categories of share of wallet were more disaggregated than in the major study but the findings of the former influenced the author to settle eventually on five uneven categories (<68 per cent, 68-80 per cent, 81-90 per cent, 91-99 per cent, 100 per cent). An additional limitation is the time period of the customer contribution data, made available from the study bank under conditions of confidentiality, for only three months. Thus only a 'snap-shot' in time is possible in this study thereby introducing potential for misclassifying customers' 'profitability' in terms of sudden fluctuations in their lives at that very time. Ideally, a longer time period to smooth out the financial impacts of these fluctuations would have been desirable but alas was not possible. Finally, the study focuses on but one regional bank in one small country in the Southern Hemisphere. Nevertheless, New Zealand's banking system has similar characteristics to Australia, Scandinavian countries and the UK and there are some similarities to banking systems in certain states of the USA.

RESULTS AND DISCUSSION

Bivariate analysis

After its own validation testing the study bank provided the customer contribution data for three months for each customer in the sample. These data were highly skewed (mean $320, median $45, standard deviation $797, range $13,249) and were receded into the three-category customer contribution variable as depicted in Table 1. For share of wallet (proportion of banking business at main bank) another skewed distribution resulted with half of the study bank's customers claiming sole loyalty and three-quarters claiming at least 91 per cent of their business in one bank. One of the major findings from Table 1 is that 32 per cent (one-third) of the study bank's customers were 'unprofitable' (make no or negative contribution to the bank's revenue), while two-thirds were 'profitable', in a three-month period. Yet within the 'profitable customer' segment a cogent finding emerges: the 34 per cent of customers who each contributed in excess of $170 per quarter in net revenue (see Column 'All customers' in Table 1) for the study bank accounted for almost all (98 per cent) of the dollar profit. Table 1 is analysed in detail here to assist the reader with its complex layout. The upper portion of the table displays the percentage results for each 'share of wallet' category (<68 per cent . . . 100 per cent). Interpretation of the upper portion of the table shows that 48 per cent (almost half) of the under 68 per cent share of wallet group were 'unprofitable' contrasted with only 30 per cent of the solely loyal (100 per cent) group. Strong associations between share of wallet and customer contribution are prevalent throughout these data as verified by the chi-squared test statistic. Turning to the lower portion of Table 1, two descriptive statistics (sum and mean) are displayed there for the cross-tabulated data investigated in the upper portion of the table. The first cell in the lower portion of the table shows the total sample's sum of customer contribution ($360,980) and the mean (being $360,980 divided by 1,128 customers = $320, rounded to the nearest whole dollar). The subsequent cells in the lower portion of Table 1 display the relevant customer contribution sums and means (in dollars) for each share of wallet group. Undoubtedly, those who spread their personal banking business across several banks are less profitable to the study bank than solely loyal customers (100 per cent share of wallet to main bank). For example, the lowest share of wallet category (<68 per cent) has a mean profit of $71 (for three months) whereas solely loyal customers gamer a mean profit of $382 for the study bank. The variation in mean contribution by share of wallet is statistically significant (F = 2.58, p = 0.03). Hence, at the bivariate level, share of wallet appears to be an important indicator of customer profitability.

One needs to be cautious in regarding 'unprofitable' customers as a long-term liability, especially on the basis of these (three-month) results. Storbacka[2] argued that some unprofitable customers were termed such because of the high fixed costs in their relationships with their main bank. Ceasing business with these customers would mean redistributing those

fixed costs across the remaining customers, driving some of them into the unprofitable category. While it is well known that young, unprofitable customers become tomorrow's older, profitable customers, it is worthwhile for banks to try and identify their 'gatekeeper' customers, that is, those who give counsel and advice to others in their households or organisations. 'Cleaning up the balance sheet' by inducing gatekeepers to switch to a competitor bank may not be good business.

Multlvariate analysis

Two multivariate methods (multiple regression and multiple discriminant analysis) were chosen to analyse the relationship between customer contribution and a set of independent variables among which is the variable of interest, share of wallet. To meet the assumptions of multiple regression (linearity, homoscedasticity and normality) the dependent variable customer contribution was recoded into a binary profit/loss variable because of the nonparametric distribution of the original, disaggregated customer contribution data. While logistic regression could have been used, Sudman and Blair state that 'if the purpose of doing an analysis is simply to compare the relative contributions of various independent variables, logistic regression is not needed. A conventional multiple regression will provide satisfactory results in these circumstances.28 Hence the multivariate analysis reported in Table 2 is a stepwise ordinary least squares multiple regression.

Table 1 Customer contribution by share of wallet

Twenty-six independent variables from the survey (including age group and share of wallet along with variables representing perceived service quality, customer satisfaction, customer loyalty and other demographics) were regressed on the level of customer contribution to the study bank which identified a weak relationship (adjusted R

sup 2

 = 0.14) between it and four independent variables as shown in Table 2. Age group and share of wallet were the major contributors in this (weak) solution.

The relatively small number of significant explanatory variables probably reflects the use of the dichotomous structure of the dependent variable, customer contribution. Thus share of wallet is shown to make a sizeable impact upon customer contribution even in the presence of many other independent variables. Indeed, the stepwise regression results in Table 2 confirm those of Table 1 (at the bivariate analysis level): the greater the share of customers' wallets (their personal retail banking business) the study bank has, the more profitable these customers are to the study bank. Multiple discriminant analysis was used here to explore whether share of wallet is among the group of independent variables that discriminate between loss-making and profitable customers. Unequal sample sizes in the two groups is not a limitation of discriminant analysis, but the size of the smallest group must exceed the number of independent (predictor) variables. Table 3 shows that the discrimination between loss-making and

profitable customers is partially explained by share of wallet in conjunction with several other variables, namely age, household income; two attitudinal dimensions of customer loyalty, namely interpersonal bonds (bonds with bank staff) and attitude to being solely loyal to one's main bank, satisfaction levels with borrowing from the main bank and the presence of joint accounts.

Table 2 Stepwise regression results: Customer contribution

Table 3 Summary multiple discriminant analysis results

The ability of the discriminant function correctly to classify customers to their rightful profit or loss status is rather disappointing at 68 per cent suggesting that the independent variables in the discriminant analysis give, at best, only a partial explanation of what distinguishes a profitable customer from a loss-making one. Nevertheless, share of wallet is among those variables that help discriminate among these two types of customer.

MANAGERIAL IMPLICATIONS AND FUTURE RESEARCH

Given that calculation of individual customers' contributions to bank profitability can be a complex task for a bank, this paper set out to investigate the efficacy of using a relatively easily obtained proxy variable, namely share of wallet, for measuring customer contribution. While important, the relationship between share of wallet and customer contribution docs not appear to be sufficiently strong to act alone as a substitute. It would seem that specific details of customers' financial relationships with their banks are the largest contributors to customer profitability. Hence, the terms of loans and investments that individual customers have with their banks, the terms of the accounts in which they keep their savings, the size of their average daily balances, the portfolio of financial services that they have with their main bank etc, all directly affect customer contribution. These are all entwined in the customer contribution measure used in this study and are impossible for the author to disaggregate, although the study bank itself is in a position to do so.

Yet there is still merit in management's procurement and use of share of wallet data. While customer age and income will always feature as discriminating variables in any personal retail banking study, a bank has no control over these. Not so with share of wallet. Bank management has the ability to target those customers it wants to nurture, those it wants to keep in 'steady-state' and those it wants to 'send to the opposition'. As demonstrated by much other research on personal retail banking,11,22 relationship length is a crucial driver of profitability along with gaining as big a share of wallet (the customer's personal retail banking business) as possible. While rather obvious, this is unlikely without a relationship that suits customers on their terms. Rewarding 'profitable' customers in inexpensive but compelling ways seems appropriate and indeed New Zealand banks offer their most valuable retail clients fee waivers, lottery prize draws, enhancements and bonus points in their customer loyalty programmes, etc.7 The converse is also true. Persuading unprofitable customers by

pricing and fee mechanisms to flee to the opposition or upgrade their relationship to one of profitability for the bank is implicit in banks' customer management strategies.

A bank's share of wallet for each of its customers is a measure most banks would like to obtain. Customers have to be willing to divulge such information but the results of this research project show that its procurement is not always difficult. The author advocates that share of wallet should become a standard entry in a bank's customer database. Perhaps collection of these data can be obtained as part of the annual review of financial health that is conducted by personal bankers (the managerial title used in New Zealand banks) with their clients. At the same time personal bankers always check on their clients' current circumstances, which allows them to update the bank's records. Change in number and composition of dependents, ownership of assets, financial calamities, bequests, windfalls, etc, all suggest that share of wallet management needs to be moderated by customer life cycle changes. While these changes may be reflected in quarterly customer contribution results, their causation will not and forecasting future customer value from their current value will remain somewhat elusive. Storbacka[2] has shown that predicting customers' future value from their current value is fraught with problems not the least of which is life cycle change.

It is acknowledged that one of the shortcomings of this study is the 'snapshot' nature of the quarterly customer contribution data allied with the point-in-timc, cross-sectional share of wallet data. Due to the confidentiality agreement between researcher and study bank, it was not possible to explore customers' prior profitability (that is, a longitudinal approach backwards in time) to assist with forecasting future profitability.

Future research into the aspects of personal retail banking covered in this paper is obviously required to help generalise results and examine variations in different settings. Development of algorithms for the measurement of customer contribution/customer profitability will no doubt continue. Perhaps banks might seek their own proxy variables for customer contribution; some of the 'financials' such as specific account balances or amount of funds under management have already become useful indicators.

REFERENCES

1 Gummesson, E. (1999) 'Total relationship marketing: experimenting with a synthesis of research frontiers", Australasian Marketing Journal, Vol. 7, No. 1, pp. 72-85.

2 Storbacka, K. (1994) "The nature of customer relationship profitability', Swedish School of Economics and Business Administration, Research Report 55, Helsingfors.

3 Ryals, L. (2002) Editorial to Special Issue on Customer Profitability, Journal of Targeting, Measurement and Analysis in Marketing, Vol. 10, No. 3, pp. 197-200.

4 Barnes, J. G. and Cumby, J. A. (IWS) "Thr cost of service quality:

Extending the boundaries of accounting systems to enhance customer value', in Glynn, W. J. and Barncs, J. G. (eds) 'Understanding Services Management', John Wiley & Sons, Chichester, pp. 178-202.

5 Council, R. O. (1997) 'How the profitability of customers and services can be measured', Journal of Financial Services Marketing, Vol. 2, No. 2, pp. 137-151.

6 Gurau, C. and Ranchhod, A. (2002) 'Measuring customer satisfaction: A platform for calculating, predicting and increasing customer profitability', Journal of Targeting, Measurement and Analysis for Marketing, Vol. 10. No. 3, pp. 203-219.

7 Garland, R. (2002) 'Non-financial drivers of customer profitability in personal retail banking', Journal of Targeting, Measurement and Analysis for Marketing, Vol. 10, No. 3, pp. 233-249.

8 Rust, R. T. and Zahorik, A. J. (1993) 'Customer satisfaction, customer retention, and market share', Journal of Retailing, Vol. 69, No. 2, pp. 193-215.

9 Rust, R. T., Zahorik, A. J. and Keiningham, T. L. (1995) 'Return on quality (ROQ): making service quality financially accountable', Journal of Marketing, Vol. 59, April, pp. 58-70.

10 Loveman, G. (1998) 'Employee satisfaction, customer loyalty, and financial performance', Journal of Service Research, Vol. 1, No. 1, pp. 18-31.

11 Zeithaml, V. A., Rust, R. T. and Lemon, K. N. (2001) 'The customer pyramid', California Management Rview, Vol. 43, No. 4, pp. 118-142.

12 Duncan, E. and Elliott, G. (2002) 'Customer service quality and financial performance among Australian retail financial institutions', Journal of Financial Services Marketing, Vol. 7, No. 1, pp. 25-41.

13 Heskett, J. L., Jones, T. O., Loveman, G. W., Sasser, W. E. and Schlesinger, L. A. (1994) 'Putting the service-profit chain to work', Harvard Business Review, Vol. 72, No. 2, pp. 164-174.

14 Anderson, E. W. and Mittal, V. (2000) ''Strengthening the satisfaction-profit chain', Journal of Service Research, Vol. 3, No. 2, pp. 107-120.

15 Reichheld, F. F. (1992) 'The truth of customer retention', Journal of Retail Banking, Vol. 13, No. 4, pp. 21-24.

16 Reichheld, F. F. (1996) 'Learning from customer pp. 56-61.

17 Reinartz, W. and Kumar, V. (2002) 'The mismanagement of customer loyalty', Harvard Business Review, Vol. 80, No. 7, July, pp. 86-94.

18 Colgate, M. (1999) 'Customer satisfaction and loyalty: How New Zealand banks need to improve', University of Auckland Business Review, Vol. 1, No. 1. pp. 36-48.

19 Fornell, C. (1992) 'A method for improving customer satisfaction and measuring its impact on profitability', International Public Relations Review, Vol. 15, No. 3, pp. 6-10.

20 Andeson, E. W., Fornell C. and Lehman, D. R. (1994) 'Customer satisfaction, market share and profitability: findings from Sweden',

Journal of Marketing, Vol. 58, July, pp. 53-66.

21 Anderson, E. W., Fornell. C. and Rust. R. (1997) 'Customer satisfaction, productivity and profitability: Differences between goods and services', Marketing Science, Vol. 16, No. 2. pp. 129-145.

22 Zethaml, V. A. (2000) 'Service quality, profitability and the economic worth of customers: What we know and what we need to learn', Journal of the Academy of Marketing Science, Vol. 28, No. 1, pp. 67-85.

23 Forsyth, R. (2001) 'Re-evaluating CRM cliches: Customer lifetime value', CRM-Forum, www.crmforum.com/library.

24 Jones, M. A.. Mothersbaugh, D. L. and Beatty, S. E. (2000) 'Switching barriers and repurchase intentions in services', Journal of Retailing, Vol. 76, No. 2, pp. 259-274.

25 Reichhcld, F. F. and Sasser, W. E. (1990) 'Zero defections: Quality comes to services', Harvard Business Rview, Vol. 68, No. 5, pp. 105-111.

26 Paltschik, M. and Storbacka, K. (1992) 'Monitoring the customer base to achieve profitability', Marketing and Research Today, ESOMAR, Vol. 20, No. 3, pp. 155-166.

27 KPMG (1999) 'Financial institutions' performance survey: New Zealand', Wellington.

28 Sudman, S. and Blair, H. (1998) 'Marketing research: A problem-solving approach', McGraw-Hill, Sydney.

Ron Garland

is a senior lecturer in the Department of Marketing, Massey University, Palmerston North, New Zealand where he teaches market research, sport marketing and services marketing. His research interests embrace all areas of services marketing.

Ron Garland

Department of Marketing, Massey University, Private Bag 11222, Palmerston North, New Zealand

Tel: +64 6 350 5581;

Fax: +64 6 350 2260;

e-mail: b.r.garland@massey.ac.nz

What influences customer profitability? Service-profit chain: Non-financial drivers of customer profitability in personal retail banking

Garland, Ron

Abstract:
The first of its kind in the public domain in New Zealand, this study
presents an empirical analysis, for one bank, of non-financial factors that
help generate profitable customers. Just over 1,100 personal retail
customers of a New Zealand regional bank were surveyed and these customers'
contribution to the bank's revenue and costs for three months were
calculated using activity-based accounting procedures. For that period, 1/3
of the bank's customers were unprofitable, 1/3 hovered around breakeven and
1/3 contributed 98% of customer profit. In general, the greater the share
of a customer's banking business, the more profitable that customer is to
the banks. The overriding theme is that customers are assets and can be
managed accordingly.

Text:
Abstract The first of its kind in the public domain in New Zealand, this
study presents an empirical analysis, for one bank, of non-financial
factors that help generate profitable customers. Just over 1,100 personal
retail customers of a New Zealand regional bank were surveyed and these
customers' contribution to the bank's revenue and costs for three months
were calculated using activity-based accounting procedures. For that
period, one third of the bank's customers were unprofitable, one third
hovered around breakeven and one third contributed 98 per cent of customer
profit. In general, the greater the share of a customer's banking business,
the more profitable that customer is to the bank. The overriding theme is
that customers are assets and can be managed accordingly. The distribution
of customer contribution is discussed along with its implications for the
study bank and retail bank marketing in general.

BACKGROUND

The banking industry in New Zealand has had its share of trials and
tribulations. In the early 1990s the New Zealand government 'bailed out'
the people's bank - the Bank of New Zealand -- to the value of $NZ1bn.

Paltschik and Storbacka[1] reported similar turmoil in Scandinavian countries and showed how banking systems tended to value short-term profitability. Consequently branch management tended to finance risky projects in the boom times and the high interest earned from these projects helped promote these managers. Yet the legacy of a portfolio of risk-loaded financing was left at bank branch level which in the recessions of the late 1980s and early 1990s led to customer insolvencies.

The New Zealand personal retail banking industry of the 21st century is now quite different. Only one bank is in local ownership while the four major banks are all foreign owned. The 'service scape' is quite different too. In 1994 there were nearly 1,500 full service retail bank branches; by 2001 there were less than 1,000[2] as the realities of bank mergers, mobile mortgage banking, electronic banking and telephone banking take effect. When the primary research for this paper was conducted, Internet banking (with its interactive online systems allowing customised solutions for banking customers) was in its infancy in New Zealand but it too is now a reality.

The study bank for this paper's empirical research is New Zealand's only locally owned bank. It is one of the smaller banks and has a regional clientele served by 12 branches, although it actively encourages customer acquisition from beyond its region by electronic and telephone banking. In 1999 nearly half of the region's adult population claimed the study bank to be their 'main bank' (that in which the majority of their personal retail banking business is done) while nearly two thirds of the adult population had some type of banking relationship with this bank.

INTRODUCTION

Relationships between customers and their service providers have been at the forefront of marketing inquiry for decades. The value of enduring long-term relationships has been a recurring theme to such an extent in services marketing research that in 1999 Gummesson[3] began calling for a 'return-on-relationship' (ROR) measure. Actually this type of measure was mooted rather earlier, albeit in a retail banking context, by Storbacka.[4] He coined this measure 'customer relationship profitability' (CRP), being an individual customer's contribution, derived from relationship revenue minus relationship cost.

Relating the contribution that individual customers make to a bank's profitability has long been handicapped by an inability to allocate transaction costs to individual customers. Modern activity-based accounting procedures have made it possible to trace the contribution of individual customers to profitability in personal retail banking which, in turn, allows customers to be viewed as assets and to be managed accordingly. In this paper, activity-based cost accounting measures were used by the bank under study to derive a measure of customer contribution. This measure, used as a proxy for customer profitability, was then used to investigate relationships and associations with various independent variables in an attempt to isolate the non-financial 'drivers' of customer

profitability Readers familiar with the service quality literature will see parallels with the abbreviated service-profit chain5 as depicted in Figure 1.

Examination of customer profitability and the service-profit chain as it applies to personal retail banking builds upon previous research in services marketing and services management. Many researchers have examined the associations between some of the constructs of the chain: perceived service quality, customer satisfaction and customer loyalty. Few have been able to link these constructs to customer contribution although some researchers6 have investigated the profitability of service quality using aggregate, cross-sectional data while the Harvard 'school' of researchers7 have described the profit impact of reducing customer defection.

Studies by Rust and his co-authors, Zahorik9 and Keiningham,9 and by Loveman10 are among the few that have endeavoured to trace the chain of effects from service quality programmes to customer satisfaction to customer retention (measures of behavioural loyalty) to measures of profitability. In a banking context this translates to gaining a greater 'share of wallet or purse' among existing customers as well as gaining greater share of customers. Yet in services, with their intangible qualities (like the quality of the personal interactions with service providers), results are not always immediate or measurable. Nevertheless, the benefits of quality improvements help customer acquisition in the form of improved ability to attract new customers by positive word-of-mouth and confidence in knowing the bank is offering quality products in a quality 'envelope' of service. Quality improvements also support the defensive marketing strategies of gaining more patronage from existing customers (that is, a greater share of their 'wallets or purses') coupled with higher retention (lower customer 'churn'). Small increases in retention rates have been shown to have measurable effects on profitability.11 Existing customers tend to buy more than newly acquired customers do.

Figure 1

Personal retail banking context

In a banking context, the longer that customers are with their main bank, the greater the 'share of wallet' given to that bank, and, as this paper shows, the greater the share of wallet, the more profitable customers are to their bank.

Storbacka12 demonstrated this relationship in his study of two Scandinavian banks while Colgate13 in his study of customer satisfaction with New Zealand banks writes of the depth of their relationships with their customers (the quality of their market share) rather than the quantity of that share as being important. Gummesson14 echoes these sentiments in the context of long-term customer relationships, along with earlier work by Fornell and his co-authors.15-17

Customers' value to the study bank is at the heart of the customer contribution measure used in this study. As Storbacka18 noted, among a bank's customer base at any time there are those who are profitable, those

clustering around a breakeven point and those who are unprofitable. Point-in-time studies like the one reported here tend to exacerbate the rigidity of these categories but using customer asset management strategies over time, banks try and move their unprofitable customers into profitability.19

Building relationships based on customer life cycle is important. Storbacka20 reports that youthful customers can be unprofitable initially (if they have small account balances but many transactions) but will become profitable later in life. Hence enduring, long-term relationships with customers are especially important to banks. Attempting to optimise returns from a bank's customer base relies heavily on the relationship marketing paradigm and its essential premise that it is cheaper to retain customers than to recruit new ones.

Profitability from customer relationships

In retail banking, revenue is generated in two main ways. First, revenue is derived from the margin the bank earns on its lending and investment activities. Secondly, revenue from fees for transactions, credit cards, etc needs to be included too. Customer profitability analysis can be conducted on activity-based accounting principles.21-23 As many costs as possible are set against the relationship with each customer and then the costs are deducted from the revenue the bank earns from that customer. The resultant positive or negative amount is profit or, more correctly, contribution.

Hence a bank can influence profitability in three major ways:
- by taking an operations management approach which usually means striving for better performance in cost control, and/or increased efficiency, ie an internal approach
- by taking an external approach or a service management and marketing approach which is based on customer satisfaction driving profitability
- by both internal and external approaches simultaneously.

The notion that customer satisfaction 'drives' profitability has been discussed above in relation to reviewing Reichheld and Sasser's,24 Heskett et al.'s25 and Rust et al.'s26 work. Stated even more simply, but with a more behavioural emphasis (rather than a more attitudinal emphasis), is that customer retention drives profitability - satisfied customers tend to be loyal and hence they tend to repeat buy. A satisfied customer, however, may not always be profitable.27-29 Such customers might have many automatic payments and direct debits but small account balances, meaning that the interest margin earned by the bank on these customers' funds (both investments and borrowings) is not enough to cover transaction costs. While customer satisfaction appears to be necessary for profitability in some sectors it is not sufficient in retail banking, which serves private customers, households and small business operators. Retail banking is characterised by many customers, many of whom make relatively small transactions (measured in dollar terms). Cross-subsidisation of customers is common. Customers who borrow from or invest with a bank subsidise those who merely use banks to pay their bills by automatic payment. And certain

customers are 'locked in' to their obligations with their bank by contract (for example, loans and mortgages) which acts as a switching barrier. Loans are considered as relatively binding and customers show substantial levels of 'claimed' loyalty during the duration of the loans or mortgage. As soon as the loan or mortgage is cleared there is, however, evidence of movement in banks' customer files, especially around age 40-49.(30,31) This is the very stage in the conventional (that is, excluding the effects of divorce, late marriage, etc) life cycle that the bank is likely to make profits on its customers with further profitability potential in customers' later lives from investment potential.

Calculating customer profitability in personal retail banking

Storbacka,32 Barnes and Cumby and Connell34 have provided working examples of methods for calculating customer profitability in the standard accountancy-based schemes of revenue minus costs. It should be noted that such analysis is extremely difficult in retail banking because bank record formats are dictated by legislative requirement (as well as certain accounting requirements). For example, only changes in account balances are recorded; the costs of selling efforts and advice given are not recorded systematically. And while it would be desirable to estimate profitability over the total length of a customer relationship (by calculating net present value of yearly revenues and costs), difficulties in accessing data longitudinally restrict profitability analysis to smaller time periods.

Measuring customer contribution

At its simplest, a business's total profit is the sum of every one of its customers' contributions.35 In personal retail banking this definition suffices but not, of course, in wholesale banking where large sums are placed on wholesale markets for varying terms. In personal retail banking, which dominates the study bank's business, however, the contribution each customer makes requires each income and cost activity to be traced. With cost centre control at branch banking level, many costs are accrued by each branch (costs like rent, utilities and staff) and the study bank's own analysis shows that 70 per cent of its branches' functions are transaction based. Obviously, there are costs in recruiting customers in the first place and costs for exiting customers too. Unfortunately, none of these are reported separately in the study bank's general ledger and have to be overlooked. It is acknowledged that this paper's customer contribution analysis gives a cross-sectional, static picture of customer relationships for a short period of time (three months). Obviously banking relationships last longer, often decades, with customer acquisition costs amortised over such time periods as stated by a number of commentators.36-40

The analysis presented here is better described as customer contribution rather than customer profitability because contribution is the difference between income and expenditure per customer over the time period of the analysis. Comparatively, the term profit is better used to describe the net of the study bank's income over expenditure for the financial year.

The contribution (income generated minus costs incurred) any one customer

makes to the bank under study was depicted by Storbacka41 as customer relationship profitability (CRP) and for any time period can be expressed as:

Contribution = Relationship Revenue - Relationship Cost.

Given that the study bank levies few fees on its customers (apart from the recognised 'front-end' fees for establishing mortgages, buying foreign exchange, arranging insurance, etc) the revenue generated per customer is relatively straightforward. It comes almost exclusively from volume-based income, being the weighted rate of return (a confidential figure but in the range 5-8 per cent per annum) on individuals' average daily balances. Expressed another way, at the aggregate level, the net after tax margin between the bank's investment income and its cost of funds was 2.91 per cent in 1998-1999. As stated above, the study bank does not charge its personal retail banking customers any transaction fees. Several small fees, however, like setting up automatic payments, changing automatic payments and the telephone banking fee ($10 per annum) which affected only 9 per cent of personal customers at the time of the study had to be overlooked for the contribution analysis. As Connell states, 'it may have to be accepted that some data will never be available because it is just not economical to capture or generate costs for every activity. If this is the case, an acceptable error in the calculated results will need to be determined and, provided this deviation is less than the likely error in the forecast results, there will be no problems.42 Storbacka.43 expresses similar sentiments when accounting for the omission of cross-selling attempts (such as insurance, travel, superannuation, which are part of the study bank's portfolio), especially those that did not result in any type of sale. Nor is it possible to factor in the costs of establishing the relationship apart from the transaction costs of account opening; true longitudinal analysis to establish contribution over a customer's life cycle would require careful recording of all costs incurred in establishing, nurturing and ending the relationship.

Calculating the expenditure side of the equation - relationship costs (to the bank) - is more difficult. Interest paid out to customers on their accounts' average daily balances is relatively easy but the difficulties come with transaction costs. Connell44 has likened the derivation of these costs for each customer to the peeling of an onion, with each layer of costing being exposed progressively. The first layer involves activities relating to cash flow like interest and charges, balance levels for the cost of funds, etc. These have been discussed already. The next layer is direct costs, apportioned to customers, which vary in direct relationship to customer activity, such as issuing chequebooks, issuing statements etc. 'The third layer adds the costs of the operational parts of the organisation that have a direct impact upon the customer. For ease of application this third part can be further divided into personnel costs, such as the wages of the branch staff, and the fixed costs of branches'.45 The fourth layer includes all remaining personnel and infrastructure costs

from the central departments.

In this paper, the allocation of costs to customers was approached in a similar vein to Connell's suggestions. All items in the study bank's Annual Report's Income and Expenditure Statement were scrutinised and costs apportioned where possible. Obviously, certain assumptions were made at this stage. To take one example for illustration, telephone costs (rental and tolls) were available from the general ledger and internal bank analysis showed that 70 per cent of telephone costs accrue to branches, 10 per cent each to head office lending and finance sections, and the remaining 10 per cent to head office's branch servicing facility, information services, marketing, etc. Hence 70 per cent of telephone costs are directly related to customer transactions and need to be apportioned accordingly. For the time period (in this case three months) transaction volume was divided into telephone costs yielding a per transaction telephone cost of $0.0197. Allocating transaction volume per customer per time period for telephone costs then becomes easy, as does the apportioning per customer of the remaining 30 per cent of telephone costs.

The same approach was used for direct transaction costs relating to customer activity for the following expenditure items: cleaning, computing, heating and lighting, rates and insurance, repairs and maintenance, salaries, security, staff costs and allowances, stationery, sundry costs, superannuation and training. The actual per transaction rate struck for each of these is confidential. The study bank spent six months testing its customer contribution algorithm before releasing it for use in this paper. Interestingly, the driving forces for building the customer contribution model came from the marketing director and the information technology director, just as predicted by Connell.46 Further, the case for managing customers as assets has been cemented with top management, and a managerial appointment made to coordinate customer asset management.

The overall aim of this paper is to identify the 'non-financial drivers' of customer profitability for a New Zealand regional bank. The emphasis is upon 'non-financial drivers' because it is obvious that the contract terms and conditions of financial instruments such as loans and investments will always account for substantial proportions of the variance in the analysis for any applied research. An ancillary objective of the research is to describe the behavioural and demographic characteristics of profitable and unprofitable customers.

SURVEY METHODOLOGY

The research was conducted in several phases. First, it involved two group discussions with customers of the study bank where the elements of service quality, customer satisfaction and customer loyalty received special attention. The issues raised in these group discussions shaped the research objectives and measurement procedures used in the later phases of the research process. A pilot study followed that led to refinement of the customer loyalty measurement process as well as providing a forum for trialling multivariate methods of analysis. Then 1,700 randomly selected

personal retail banking customers were surveyed by mail and after three waves the response rate (after allowing for deaths, gone away addresses, sickness, mental incapacity, etc) was 70 per cent resulting in a processing sample of n = 1,128. The maximum margin of error, at 95 per cent confidence, on this random sample is just under 3 per cent.

The survey instrument contained a mixture of seven-point Likert-type scale questions on service quality, customer satisfaction and customer loyalty, behavioural questions on customers' personal retail banking and questions on demographics. The usual limitations are expressed about the advisability of deriving means from Likert-type scales, about inferring attitudinal dispositions as precursors to behaviour and about non-sampling errors generated in the data collection phase.

RESULTS AND DISCUSSION

The study bank provided the customer contribution data for each customer in the sample after its own validation testing. Data are for a business quarter (three months). Deliberately, there is no extrapolation from the sample of 1,128 cases in this study to the bank's entire personal retail customer population (although this has been done by the study bank) to preserve confidentiality for the study bank. Hence the following analysis is confined to the sample results. Note that all statistics (chi-squared, t tests and ANOVA outputs) in Tables 2-7 are based on the actual frequencies in any given cell although percentages are shown in the tables so as to emphasise the relative differences between results.

An immediate reaction to the results in Table 1 is the wide range of contribution but the substantial number of customers (40 per cent) clustered in a narrow band between -$15 and +$107. Consequently there is a high standard deviation of $797 and a mean value ($320) skewed to positive contribution by the few customers making massive contributions. The median of $45 is a more appropriate gauge of central tendency here. The non-normal distribution of the disaggregated customer contribution variable violates one of the crucial assumptions for multiple regression analysis. Hence, for the purpose of subsequent analysis, customer contribution has been recoded into a three-category variable with similar sized (but meaningful) categories as depicted in Table 2. The major findings from Table 2 are that 32 per cent (one third) of the study bank's customers were 'unprofitable' (make no or negative contribution to the bank's revenue), while two thirds were 'profitable', in a three-month period. Yet within the 'profitable' segment there is a cogent finding: the 32 per cent of customers who each contributed in excess of $170 per quarter in net revenue for the study bank (the more 'profitable' customers) accounted for almost all (98 per cent) of the dollar profit.

Notable too is that profitable customers have banked with their main bank longer than unprofitable customers have. The results presented here in Table 2 show the efficacy for profitability of longer rather than shorter banking relationships. This trend has been noted by bank marketing researchers such as Storbacka[47] and Colgate,[48] and by relationship

marketing commentators such as Gummesson,[49] Fornell[50] and Anderson.[51] Hence, over time, banks have the opportunity to generate revenue from their customers by selling them banking products and services that align with customer life cycles. Youthful customers, especially those in tertiary education or in their early working lives, may be unprofitable in the short term given their use of banking resources relative to the revenue they generate for their bank. Typically, numerous account transactions and borrowing will preoccupy these customers in the early years of their banking behaviour. As the banking relationship matures, along with the maturation of these customers, opportunities for the 'main bank' to 'cross-sell' its customers into superannuation, insurance, travel (foreign exchange) and various investment products present themselves. Customers who buy multiple products and services from their main bank, recommend this bank to others, and perhaps act as 'gatekeepers' for their families, etc may then become very profitable.

Table 1:

Table 2:

Identifying who the various types of 'contributors' are dominates the ensuing results. It should be noted though that the proportions of unprofitable customers reported in the marketing and management literature vary across industrial sectors, with commentators such as Reichheld and Sasser[52] and Cooper and Kaplan[53] suggesting revision of the 80:20 rule upwards to account for even smaller numbers of profitable customers carrying many 'unprofitable' customers. In studies of customer contribution in retail banking these examples of few customers contributing almost all the 'profit' seem to hold true.

Profitable and unprofitable customers

The following analyses of customers, in terms of their contributions to the study bank's revenue, are supported by the results presented in Tables 3-7 and Figure 2. The analyses in the tables cover two streams of data. First, there are the proportions of unprofitable and profitable customers and how they are characterised by age, household income, banking behaviour etc. These results are portrayed in the upper levels of each table and their associations (or lack of) are assessed by the accompanying chi-squared statistics. Secondly, each table carries data, in the lower levels of the table, on customer value, that allow the assessment of how much (in dollars) each group of customers contributes. Comparative testing here is by means tests and their t test or F-ratio statistics.

Table 3:

Table 4:

Table 5:

Table 6:

To address the complex data portrayed in Tables 3-7, Table 3 is analysed in detail here to assist the reader. Two variables (namely 'main bank' and customer's age) are cross-tabulated separately (for convenience of table layout) with customer contribution. The upper portion of Table 3 displays

the percentage results for each category of the customer's main bank (either the study bank itself or a competitor bank because customers can bank with more than one bank) and for each age group (under 30 years, 30-39 years, etc). Interpretation of the upper portion of the table suggests that the study bank's customers who claimed it as their 'main bank' were actually more profitable (in the three months of the customer contribution data) and the chi-squared test statistic bears this out. In the age versus customer contribution part of Table 3, 52 per cent of the under 30 years group were 'unprofitable' contrasted with only 20 per cent of the over 65 years group. Strong associations between age and customer contribution are prevalent throughout these data as verified by the chi-squared test statistic. Turning to the lower portion of Table 3, two descriptive statistics (sum and mean) are displayed there for the cross-tabulated data investigated in the upper portion of the table. The first cell in the lower portion of the table shows the total sample's sum of customer contribution ($360,980) and the mean (being $360,980 divided by 1,128 customers = $320, rounded to the nearest whole dollar). The subsequent cells in the lower portion of Table 3 display the relevant customer contribution sums and means (in dollars) for each type of customer. For example, customers who regard the study bank as their 'main bank' on average contributed $376 each to the (three monthly) customer contribution whereas study bank customers who regarded another (competitor) bank as their main bank contributed, on average, only $113 to the (three monthly) customer contribution for the study bank. These differences in mean contribution are statistically significant (t = 20.8, p = 0.00). The lower right-hand portion of Table 3 displays the relevant sum and mean contributions for each age group. For example, customers aged under 30 years made significantly lower contributions (mean $147) than their 40-49-year-old counterparts (mean $477). The variation in mean contribution by age is highly significant (F = 9.53, p = 0.00). In turn, Tables 4-7 follow the same format as Table 3.

Unprofitable customers

Customers with negative or zero contribution are more likely than average to be youthful. Over half are aged under 30 (see Table 3) and while the under 30s form 20 per cent of the study bank's customer base, they contribute only 9 per cent of the profit, with a mean per capita profit of $147 compared to the study bank average of $320. Not unexpectedly, those with the lowest household incomes are less profitable (see Table 4) as are those who spread their banking business across several banks (see Table 5). While those with access to annual household incomes of under $20,000 make up 20 per cent of the customers, 43 per cent of them are unprofitable, returning only 6 per cent of the profit, with a meagre average of $99. Even worse are the few (6 per cent) customers who give the study bank less than 68 per cent of their banking business (Table 5).

Half of these customers were unprofitable, with the group as a whole returning only 1 per cent of the profit. This trend is supported by the results in Table 3 where those customers nominating their main bank to be

the study bank are more profitable (average of $376) than those nominating a competitor bank (average of $113).

No significant differences emerged in the results between customer contribution and gender, education or recent defection from a bank. For time with main bank (see Table 6), more recent customers (0-7 years) are less likely to be profitable in proportional terms, but this has no statistically significant effect in dollar terms.

The presence of joint accounts (Table 7) seems to be an important indicator of customer profitability with the 39 per cent of customers with no joint accounts contributing only 15 per cent of the profit.

Turning to satisfaction constructs, Figure 2 shows that satisfaction with main bank does not vary by customer profitability except for satisfaction with the main bank's borrowing (lending) section (F = 4.96, p < 0.01) where unprofitable customers are, on average, less enamoured. Herein may lie a predictable association between attitude and behaviour in that some unprofitable customers may have had requests for loans denied.

Low profit customers

Customers whose contributions were between $0.01 and $170 for the three months under analysis were more likely than average to be the over 50s and especially the over 65s (see Table 3). Their annual household incomes are either quite low or very high (but under-represented in the middle ranges of $30,000-$80,000 per annum) and their banking business tends to be spread across more than one bank (see Tables 4 and 5). For the high-income customers one could speculate that their main bank is not receiving much of their financial business (investments, etc) as opposed to their 'banking business'. Higher than average numbers of these 'low profit' customers have been with their main bank for more than 30 years, which aligns well with their older age profile.

Table 7:

Medium-high profit customers

Obviously, some profitable customers are a necessary prerequisite for successful retail banking. In the analysis in Table 3, the study bank had an over-representation of highly profitable customers. In turn, these customers are over-represented by middle-aged people (30-64 years) who collectively comprise 54 per cent of customers but return 75 per cent of the 'profit'. Annual household incomes are most likely to exceed $40,000 (Table 4), their banking business tends to be concentrated mostly in one bank (Table 5), and there is a direct relationship between time (in years) with main bank and the number of profitable customers (Table 6). This particular relationship does not, however, follow through to customer contribution by dollars. People with short (less than eight year) histories yield fewer profits for the study bank, but beyond this period, time with main bank does not necessarily guarantee profitability.

Attitudinally, the medium-high profit customers are little different to the lower profit customers (Figure 2) though notably their global satisfaction with their main bank is extremely high at 6.14 on a seven-point scale.

Multivariate analysis

To test the degree of impact that any one of the independent variables has upon customer contribution, multiple stepwise regression was used and the impact captured by the beta coefficient. Hair et al.54 warn that beta coefficients should only be used as indicators of relative impact when collinearity is minimal. In no instance did any correlations between independent variables used in the regression analysis here exceed 0.30 suggesting that any confounding effects between variables due to multicollinearity are minimal. The multiple regression results are shown in Table 8. Probability for inclusion of variables into the regression was lifted from the rather severe default setting of 0.05 to the less severe 0.10. The dependent variable customer contribution was recoded into a binary profit/loss variable because of the non-parametric distribution of the original, disaggregated customer contribution data. While it may have seemed apposite to use logistic regression, which relies on binary (zero-one) dependent variables, 'if the purpose of doing an analysis is simply to determine whether the dependent variable relates to the independent variables, or if the purpose is to compare the relative

Figure 2

Table 8:

contributions of various independent variables, logistic regression is not needed. A conventional multiple regression will provide satisfactory results in these circumstances'.55

Hence the multivariate analysis reported here is restricted to ordinary least squares multiple regression.

A stepwise regression of 26 independent variables (representing perceived service quality, customer satisfaction, customer loyalty and demographics) on the level of customer contribution to the study bank identified a weak relationship (adjusted $R^2 = 0.14$) between it and four independent variables as shown in Table 8. These explanatory variables (in their order of importance) were: age group, 'share of wallet' (percentage of banking business with main bank - a measure of behavioural loyalty), level of household income and the presence of joint accounts. The relatively small number of significant explanatory variables probably reflects the use of the dichotomous structure of the dependent variable, customer contribution.

The stepwise regression results do show a semblance of relationships between customer contribution and two key demographics, age and income, in that increases in the former result from increases in the latter. This confirms Tables 3 and 4 at the bivariate analysis level - the study bank's 'better' customers are older and more 'well heeled'. Similarly, share of wallet (Table 5) is reconfirmed in that the greater the share of a customer's personal retail banking business the study bank has, the more profitable that customer is to the study bank; that is, high share of wallet leads to high contribution. And the presence of joint accounts is a

signal of more profitability for the study bank. (This variable had the value of 0 as having joint accounts and 1 no joint accounts, yielding the negative beta coefficient.) This confirms Table 7's results.

MANAGERIAL IMPLICATIONS AND FUTURE RESEARCH

As demonstrated in this study, there are managerial benefits in quantitative empirical research into customer profitability derived from personal retail banking. A bank's population of customers contains individuals who are, at any one time, unprofitable given their use of resources relative to the revenue they supply. In this study's case, one third of the study bank's customers were unprofitable at the time of the analysis. While the individuals who were unprofitable at that time may not always remain so, it is expected that a substantial proportion of a bank's personal retail customers will remain unprofitable. Indeed, these findings substantiate those found previously.56,57 Having unprofitable customers in a customer portfolio has implications for banks as they move towards managing customers as assets. There is now widespread understanding among bankers that relatively small segments of profitable customers subsidise large groups of less profitable or even loss-making customers. Bankers are developing strategies to nurture their most profitable relationships and realign their unprofitable customers. In New Zealand this is being done with bank fees, aimed at persuading the most expensive-to-service customers to change their costly habits or pay for them directly. Currently, banks are loathe to lose customers; it would appear they would rather try (at least initially) to convert them to a 'profitable' state.

This paper set out to investigate the non-financial drivers of customer profitability in personal retail banking. While the multivariate results on the non-financial factors that drive customer profitability are not as unequivocal as hoped for, they still offer some comfort for bank management. Nothing can be done directly about two of the most potent variables - customer age and annual household income - but the confirmation that older and wealthier customers are more profitable gives credence to the 'lifetime value of customers' and 'cradle-to-grave' philosophies prevalent among some managers. Relationship length is a crucial driver of profitability along with gaining as big a share of the customer's personal retail banking business as possible. This is rather obvious but is unlikely without a relationship that suits customers on their terms. Rewarding 'profitable' customers in inexpensive but compelling ways seems appropriate and indeed New Zealand banks offer their most valuable retail clients fee waivers, lottery prize draws, enhancements and bonus points in their customer loyalty programmes, etc.

It is recognised that the relationship between customer contribution (profitability) and the independent variables that help 'explain' this crucial dependent variable is quite weak. It should also be remembered that the profitability measure (customer contribution) is the study bank's assessment (and not the customer's assessment) of the customer-main bank relationship. Herein may lie some of the reasons for weak relationships

between customer contribution and preceding constructs in the service-profit chain. Nevertheless, knowing that non-financial drivers seem to have only moderate impact on customer profitability leads to speculation that various financial variables to do with the breadth of relationship are the biggest contributors to customer profitability. Hence, the terms of loans and investments that individual customers have with their banks, the terms of the accounts in which they keep their savings, the size of their average daily balances, the portfolio of financial services that they have with their main bank, etc will all directly affect customer contribution. These are all entwined in the customer contribution measure used in this study but are impossible for the author to disaggregate.

Determining customer profitability in personal retail banking is neither easy nor straightforward. Once this capability exists, however, customers can be managed by the bank as business assets. The results of this study show that different customers have different value profiles and can be managed accordingly to enable banks to improve their financial performance. Segmenting customers on the basis of their value to their banks affects both long- and short-term decision making. The former state is much more oriented to market positioning endeavours; the latter (short-term) state addresses day-to-day operational actions where, for example, customer profitability data can help drive level of service delivery. Selective offers of fee waivers and interest rate reductions to retain profitable customers are becoming commonplace. Front-line banking staff need information systems that allow service to be aligned to individual customers based on customer profitability (at a minimum) but ideally also on customer value. Certain clients can act as gatekeepers to other profitable customers and thus are more important to the bank than the simple netting of financial costs and earnings. If a marketing cum management system can be implemented that includes qualitative data on customer value (referral sales, potential for future revenue growth, etc) alongside standard customer profitability data then management decisions ought to be stronger. In turn, use of such an information system would allow bank management to, for instance, tailor service levels to specific customers or customer groups, and to anticipate when a change in customer lifecycle might threaten or change the banking relationship.

Future research in the field of customer contribution in personal retail banking is obviously required to help generalise results and examine variations in different settings. This call for macro-level future research is really a form of replication research conducted to corroborate or refute the findings reported above. It could be argued that the content and time periods used to measure customer contribution in this paper still require modification as does the customer profitability algorithm. Perhaps the last word on future research can be left to Zeithaml in her review of academic research on customer profitability where she states that

'few rigorous studies have been published documenting the moderating effects of tiers of customers on profits...developing the skill to tier

customers may be the most essential step companies must take to link service quality and profitability.'58

References
1 Paltschik, M. and Storbacka, K. (1992) 'Monitoring the customer base to achieve profitability', Marketing and Research Today, ESOMAR, Vol. 20, No. 3, pp. 155-166.
2 KPMG (1999) 'Financial institutions' performance survey: New Zealand', Wellington.
3 Gummesson, E. (1999) 'Total relationship marketing: Experimenting with a synpaper of research frontiers', Australasian Marketing Journal, Vol. 7, No. 1, pp. 72-85.
4 Storbacka, K. (1994) 'The nature of customer relationship profitability', Swedish School of Economics and Business Administration, Research Report 55, Helsingfors.
5 Heskett, J. L., Jones, T. O., Loveman, G. W, Sasser, W E. and Schlesinger, L. A. (1994) 'Putting the service-profit chain to work', Harvard Business Review, Vol. 72, No. 2, pp. 164-174.
6 Fornell, C. (1992) 'A method for improving customer satisfaction and measuring its impact on profitability', International Public Relations Review, Vol. 15, No. 3, pp. 6-10.
7 Reichheld, E F (1992) 'The truth of customer retention', Journal of Retail Banking, Vol. 13, No. 4, pp. 21-24.
8 Rust, R. T and Zahorik, A. J. (1993) 'Customer satisfaction, customer retention, and market share', Journal of Retailing, Vol. 69, No. 2, pp. 193-215.
9 Rust, R. T., Zahorik, A. J. and Keiningham, T. L. (1995) 'Return on quality (ROQ): Making service quality financially accountable', Journal of Marketing, Vol. 59, April, pp. 58-70.
10 Loveman, G. (1998) 'Employee satisfaction, customer loyalty, and financial performance', Journal of Service Research, Vol. 1, No. 1, pp. 18-31.
11 Reichheld, E E (1996) 'Learning from customer defections', Harvard Business Review, Vol. 74, No. 2, pp. 56-61.
12 Storbacka (1994) op. cit.
13 Colgate, M. (1999) 'Customer satisfaction and loyalty: How New Zealand banks need to improve II University of Auckland Business Review, Vol. 1, No. 1, pp. 36-48.
14 Gummesson (1999) op. cit.
15 Fornell, C. (1992) 'A national customer satisfaction barometer: The Swedish experience', Journal of Marketing, Vol. 56, January, pp. 6-21.
16 Anderson, E. W, Fornell, C. and Lehman, D. R. (1994) 'Customer satisfaction, market share and profitability: Findings from Sweden', Journal of Marketing, Vol. 58, July, pp. 53-66.
17 Anderson, E. W, Fornell, C. and Rust, R. (1997) 'Customer satisfaction, productivity and profitability: Differences between goods and services', Marketing Science, Vol. 16, No. 2, pp. 129-145.

18 Storbacka (1994) op. cit.
19 Paltschik and Storbacka (1992) op. cit.
20 Storbacka (1994) op. cit.
21 Paltschik and Storbacka (1992) op. cit.
22 Storbacka (1994) op. cit.
23 Barnes, J. G. and Cumby, J. A. (1995) 'The cost of service quality: Extending the boundaries of accounting systems to enhance customer value', in Glynn, W J. and Barnes, J. G. (eds) 'Understanding services management', John Wiley & Sons, Chichester, pp. 178-202.
24 Reichheld, E F and Sasser, W E. (1990) 'Zero defections: Quality comes to services', Harvard Business Review, Vol. 68, No. 5, pp. 105-111.
25 Heskett et al. (1994) op. cit.
26 Rust, Zahorik and Keiningham (1995) op. cit.
27 Fornell (1992) op. cit.
28 Anderson, Fornell and Lehman (1994) op cit.
29 Anderson, Fornell and Rust (1997) op. cit.
30 Meidan, A. (1996) 'Marketing financial services', MacMillan Press, Basingstoke, Hampshire.
31 Connell, R. 0. (1997) 'How the profitability of customers and services can be measured', Journal o, Financial Services Marketing, Vol. 2, No. 2, pp. 137-151.
32 Storbacka (1994) op. cit.
33 Barnes and Cumby (1995) opt cit.
34 Connell (1997) op. cit.
35 Storbacka (1994) op. cit.
36 Reichheld and Sasser (1990) op. cit.
37 Heskett et al., (1994) op. cit.
38 Storbacka (1994) op. cit.
39 Rust, Zahorick and Keiningham (1995) op. cit.
40 Loveman (1998) op. cit.
41 Storbacka (1994) op. cit.
42 Connell (1997) op. cit.
43 Storbacka (1994) op. cit.
44 Connell (1997) op cit.
45 Ibid.
46 Ibid.
47 Storbacka (1994) op. cit.
48 Colgate (1999) op. cit.
49 Gummesson (1999) op cit.
50 Fornell (1992) op. cit.
51 Anderson, Fomell and Rust (1997) op. cit.
52 Reichheld and Sasser (1999) op. cit.
53 Cooper, R. and Kaplan, R. S. (1991) 'Profit priorities from activity-based costing', Harvard Business Review, May-June, pp. 130-135.
54 Hair, J. E, Anderson, R. E., Tatham, R. L. and Black, W C. (1992) 'Multivariate data analysis with readings', 3rd ed, Macmillan, Sydney.

55 Sudman, S. and Blair, E. (1998) 'Marketing research: A problem-solving approach', McGraw-Hill, Sydney.
56 Zeithaml, V. A. (2000) 'Service quality, profitability and the economic worth of customers: What we know and what we need to learn', Journal of the Academy of Marketing Science, Vol. 28, No. 1, p. 80.
57 Storbacka (1994) op. cit.
58 Zeithaml (2000) op. cit.

Ron Garland
is a senior lecturer in the Department of Marketing, Massey University, Palmerston North, New Zealand where he teaches market research and services marketing papers. His doctorate is on the service-profit chain in personal retail banking. His research interests embrace all aspects of services marketing.
Ron Garland
Department of Marketing, Massey University, Private Bag 11222, Palmerston North, New Zealand
Tel: +654 (6)350 5581;
Fax: +64 (6)350 2260;
e-mail: B.R.Garland@ massey.ac.nz

THIS IS THE FULL-TEXT.