

# Loyalty or Profitability

## **Banks are wising up to ways of segmenting their customers that may spell the end for long-term relationships**

There's a change underway in personal retail banking in New Zealand, at least for high net-worth customers. With many fixed-term mortgages coming up for renewal, banks are promoting heavily at the moment, especially on interest rates, and openly inviting customer switching.

There seems to be a realisation in the market that only a few of us actually defect totally from a bank. Surveys show that around one-quarter of bank customers say they'd like to switch banks, but in fact fewer than one in 10 actually do so. More realistically, we quietly begin business with a new beau leaving the previous beau with reduced activity.

The New Zealand banking public now averages more financial suppliers than previously - and banks are actively courting such customer volatility. Look at Rabobank's current TV campaign, which explicitly positions its new online account as a bit-on-the-side for high net-worth customers.

It's a major shift in customer behaviour, and it's forcing banks to take a long, hard look at their customer databases. Gone are the laudable but uneconomic service mantras of the past where all customers receive equal treatment, irrespective of their value to the organisation. New Zealand banks are using modern database management tools in conjunction with individual customer information to migrate customers to cheaper delivery systems and to adjust their customer service levels (customer support, privileges, fee waivers, discounts, etc) according to customer profitability.

The essence of this database management is still customer segmentation. It's also a response to the increasing trend towards cherry-picking high net-worth customers, even poaching them from rival banks.

To protect their most profitable customers - or indeed to identify a competitor's prized customers - banks are increasingly reliant on a segmentation model that accurately matches customer characteristics with current and potential profitability.

To investigate a possible model for customer segmentation, one of the authors was given access to proprietary customer contribution data for one New Zealand bank over a three-month period, supplemented with survey-based customer data.

The bank's data revealed that over the three month period, one third of customers were loss-makers, one third were breakeven customers and one third were profitable - significant impetus indeed to apply a customer segmentation model to determine the characteristics of profitable and unprofitable customers.

First up for consideration was the question of loyalty: are loyal customers always profitable?

Up until the 1990s, the watchword among marketing academics and practitioners alike always used to be -as Reinartz and Kumar put it, writing in the *Harvard Business Review*: - "Win loyalty, and profits will follow as night follows day." Indeed, both relationship marketing and customer relationship management are posited on the assumption that regular customers are cheaper to serve, less price sensitive and more zealous about recommending the company to others.

But times have changed, and commentators today are not so sure. Recent international research in this area shows - perhaps surprisingly - that there is little correlation between loyalty and profitability for banking customers.

Instead, there's plenty of evidence to show that short-term customers can be highly profitable. Research looking at four different market sectors - mail order, retail food, direct brokerage, corporate services - in three different countries confirms that a great deal of high-margin business comes from short-term customers. Might the same be true for banks?

Banks are rather different to the discretionary markets looked at in the international research. By comparison they are characterised by low customer churn rates, inertia, small brand portfolios and penalties for early exit from loan contract. Yet short-term customers are often also the high net-worth customers that can - and do - take the banks on at their own game, cherry-picking the best rates and deals across a number of banks. There's certainly plenty of encouragement to do so - currently some of the major retail banks are giving out some very mixed advertising messages, exhorting us to shop around yet at the same time emphasising customer service.

Garland's research into one New Zealand bank reveals that these short-term high net worth customers make up around one third of the total. We've named them butterflies - they flit from bank to bank, putting some of their business here, some of their business there. They're attractive to banks because they are potentially hugely profitable.

On average, butterflies are younger and wealthier, perhaps with a second home (and therefore higher mortgages and borrowings) and city based. They're likely to have two incomes in the household, and true to their name they do business with an average of 2.3 banks, compared to just over 1.1 for other customers.

The rise of the butterfly reveals a crucial element in customer segmentation: share of wallet. To establish just how important a customer is to a bank or business, marketers need to know how much of the customer's business is coming their way - currently and potentially. This enables marketers to assess whether it's worth pursuing more business from currently unprofitable customers in the expectation that getting a bigger share of the customer's wallet will allow the bank to turn a profit.

Analysing bank customers on the basis of how long they've been with the bank, how much business they put with the bank, and their (short-term) financial value to the bank, we come up with four categories of customers: the butterflies described above, friends, strangers and barnacles.

Using this categorisation, we can identify long-term and profitable 'friends', who make up about one third of all customers. One fifth fall into the 'stranger' category, they're the loss-making customers who haven't been with the bank very long. And finally there are the 'barnacles', unprofitable customers that the bank can't seem to get rid of.

Plainly then, different customers provide dissimilar value to the organisation, and have varying profit potential. Implicit here is the diverse service they might receive as befitting their value- to the bank.

Yet around half of all customers still do most of their banking with one bank, and they're the ones who are still playing the relationship management game. They expect their loyalty to be rewarded with better rates or preferential treatment, but the truth is that in the harsh new world of customer segmentation they can expect little return for their continued custom - unless of course they're currently or potentially profitable.

Moreover, any rewards for loyal and profitable customers will be geared towards retaining a share of their business. Strangers and barnacles will fare worse. For these less preferred customers, banks are likely to raise fees to encourage them to move to another bank.

Inadvertently, perhaps, banks have set in motion a new game, we could call it butterfly netting. The idea is to capture and retain as much butterfly business as possible, and to this end the bank's marketers must first identify the lucrative butterflies and then lure them into the net with a variety of incentives.

Trouble is, a rival can easily trump a special offer - as we're seeing right now with the onset of another mortgage interest rate war. And buying custom can be a short-lived strategy.

How then to capture those elusive butterflies and keep them for longer? Perhaps banks need to switch their focus from selling products to helping their customers to use those products, a transformation from sales rep to mediator/helper. This might involve re-energising the role of the personal banker.

Part of the solution may also lie in the banks' own customer databases. Data mining can reveal patterns of use, which over the longer term can provide a valuable insight into individual financial needs - and the potential for the bank to turn a profit. Personal bankers can use this information to tailor products to individual customers' needs - a new house, a baby on the way, redundancy. The key priority must be to maintain the more valuable long-term customers who will more than repay the bank's marketing investment.

Here we have the classic marketing dilemma - on the one hand, banks seek to derive value from the customer relationship, yet on the other hand a long-term perspective requires them to deliver value to the customer.

So have some of the major banks taken their eye off the ball at the moment? We would suggest so with the mixed advertising messages we are seeing in the market. Netting butterflies by high-profile advertising campaigns would seem to be a high risk strategy and is likely to further fuel customer volatility. More direct relationship management strategies involving personal bankers might ultimately prove more satisfying - and more profitable.

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