In a continuing tight market, banks can no longer pump out an assortment of their very best products and rest assured that profits will come rolling in.

Looking Beyond Products to Customer Lifetime Value

BY SHERIEF MELEIS

Ever since large-scale banks began surfacing more than four decades ago, the management division of labor has centered on products and channels. Each product team primarily focuses on meeting its individual profit goal for the year, with far less emphasis on building the overall profitability of each customer relationship.

This system actually can work quite well in a strong market, where surging customer demand helps to satisfy the essential quest for sales volume. In turn, banks see less of a need for a coordinated marketing and sales outreach and in-depth composite knowledge of customers and households.

But times have changed. There is a revenue drought in retail banking, provoked by a triple whammy of slack demand, a flat rate environment and a legislatively-induced fee revenue crunch. Banks can no longer pump out an assortment of their very best products and rest assured that profits will come rolling in. Instead, growth will critically depend on claiming a larger share of a shrunken revenue stream.

Relationship *acquisition* will remain important, but ultimately relationship *expansion* will win the day, with much greater emphasis on established customers. That means winning more of the business fragmented among multiple providers. The next few years are shaping up as a wallet-by-wallet battle for market share. Winners will be the ones that more fully serve each customer.

To succeed in this quest, banks will need to look beyond individual products to the total customer relationship. Along with more carefully considering the full range of customer needs, banks will need a more robust frame of reference to manage and measure their progress. Customer lifetime value (CLV) is this frame of reference.

Along with considering the big picture of customer needs, CLV examines how various individual products mesh with each other to encourage cross-sell and build long-term relationship profitability. It also explicitly recognizes the "hidden value" in deep customer relationships, including the potential for lowered credit risk; longer account tenure and higher usage; and improved pricing, and factors this into decisions.

Typically today, a bank

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provides only 15% to 20% of the total financial service needs of a given retail household, meaning that 80% to 85% of the opportunity usually is splintered among competitors. Winning banks will change those odds in their favor, and customer lifetime value is one of the major tools they will use to do it.

SELECTIVE APPROACH

Why isn't blanket, high-intensity cross-sell the answer to the banking revenue challenge? For one thing, the level of receptivity for various product offers differs sharply among customer groups. Equally skewed is the value realized by the provider, depending on the specific transactions and behaviors of a given customer or household.

Selectivity, therefore, is of critical importance in profitable relationship expansion. Only by considering the total customer relationship can banks identify the right high-value offers for the right set of customers. Targeted cross-sell of home equity loans, for example, can trounce a typical mass-market campaign for the same product.

In the same vein, it is important to look at the full life of the customer relationship, and not just the current-year profit picture for individual products. By motivating customers to actively use their debit cards, for example, the bank may see a substantial improvement in customer loyalty, and even reduced credit losses on loan products (as the more involved customer feels a greater sense of repayment obligation).

There are several components of an action plan based on customer lifetime value. Most immediately, these include: 1) recognizing the "hidden value" in deep customer relationships; 2) identifying the customer behaviors and product combinations that really matter (from a total CLV perspective); and 3) setting immediate priorities, based on knowledge of the total customer relationship. Longer term, CLV can be incorporated into a variety of customer-facing activities and decisions in the organization.

Hidden value. In building the specific business case for relationship expansion, it is important to look beyond the obvious fact that providing two profitable products to the customer is better than just one. Powerful additional benefits include:

- ❖ Lowered credit risk, given that institutions with deeper ties to consumers are likely to be placed higher in the repayment hierarchy;
- ❖ Longer life and higher usage, given the extra stickiness that is observed when customers commit more of their finances and transaction stream to an institution; and
- ❖ Higher pricing power, reflecting an attitudinal shift that occurs as in-depth customers place more emphasis on intangibles such as rewards, recognition and service.

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Our research indicates that, all told, the average lifetime value of a consumer banking customer ranges between $2,000 and $4,000. For a small business banking relationship, the CLV total can approach $10,000 (especially when the bank is able to serve both the enterprise and the household financial needs of the proprietor).

But while the total value is significant, it is not self-optimizing. The individual drivers of CLV need to be studied and nurtured in a systematic manner.

SYSTEMATIC SEARCH

To set a solid foundation for cross-sell, activities must be identified and prioritized within the context of customer needs and receptivity, along with variations in economic potential. Banks will need answers to the following questions:

What is the best first product? The longstanding answer has been the checking account, but at a time of reduced account turnover and fee revenue potential, banks need to expand their thinking. For example, other valuable points of entry to a profitable customer relationship include the credit card and the money market deposit account.

What is the subsequent "path to profitability"? After a new customer comes to the bank, for example, cultivating an active payment relationship – particularly with online bill pay and active debit –

has proven a critical driver of CLV. Another valuable follow-on is the home equity line of credit.

It can be enormously helpful to serve the customer in multiple product categories. In the best circumstances, expanding the retail customer relationship across deposits, loans and investments can propel a more than five-fold boost in CLV.

What about targeting and sequencing of offers? As the bank improves its analytical understanding of customers, then it can begin to refine offers for major customer groups, and focus on selectively presenting various offers where they will do the most good. As an example of how conventional practice falls short, targeting the home equity product to all of the "best customers" (a fairly standard technique at big banks) is ineffective for customers who primarily are valuable in terms of high MMDA balances – they have liquid resources and likely don't need credit.

In many cases, banks have opportunities to improve their anticipatory sales strategies, based on an understanding of customer stage of life, major life events, and an analytical understanding of likely cross-sell progressions from one product family to another. Along with being financially constructive, this sort of proactive outreach brings authenticity to a relationship orientation.

What are the core enablers of cross-sell and CLV? Transaction intensity can make a big difference in CLV, for example, not only with the primary checking account, but also with the credit card account. The biggest driver of high CLV continues to be capturing the primary payment relationship, including direct deposit, online bill bay, and active debit card usage.

POTENTIAL APPLICATIONS

As leading banks work through these questions, they are using the findings for a number of important applications. Examples include marketing and promotions; relationship packaging and pricing; relationship credit; organizational incentive design; and sales processes and targeting.

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Marketing and promotion. Especially in an uneven economy, it is critical to concentrate scarce marketing resources where they will do the most good. CLV insights help the bank to rise above individual business lines to consider the total potential for value creation among prime customer groups. As an example of how this helps, consider the question of customer promotional incentives, such as a $150 "bonus" on account opening. Such an outlay can be a bargain if it helps to acquire a $4,000+ CLV customer, as is possible within certain customer segments. In this and myriad other instances, CLV is the compass that winning banks will use to set priorities for customer acquisition and relationship expansion.

Relationship packaging and pricing. Banks have only taken baby steps in developing relationship-based products and pricing strategies, with many institutions automatically slapping discounts on multi-product offers – not always necessary and not always in line with customer expectations for rewards, recognition and service.

For a more rational and productive approach, the bank first needs to understand the value produced by the sale of different product combinations – critical in determining how much can be shared back with customers in the form of discounts, rewards, etc. The bank also needs to understand what "currency" customers really value. This includes price levers (both rates and fees), as well as non-price features such as rewards, premium service and enhanced functionality (combined statements; auto-transfers between accounts; payments services and information; etc. Understanding both sides of this equation will enable banks to offer relationship pricing and other kinds of benefits that optimize value both for the customer and for the institution.

Relationship credit. In more than a few instances, the progressive bank should be able to underwrite credit that other providers cannot, simply by virtue of the superior information access provided by in-depth customers (this gets back to the importance of capturing the core payments account). Also, the bank that is able to look at the total customer relationship has an improved opportunity to spot unfolding household credit distress and work with customers before situations spin out of control.

Incentive design. It has been a continuing challenge to refine sales incentives in the branch. Volume-based performance metrics often back fire, encouraging representatives to go to extremes in originating accounts that have little or no potential. Through CLV, the bank can re-orient sales incentives around the opportunities that really matter, in terms of acquiring and expanding profitable customer relationships.

Sales process and targeting. CLV helps to narrow down the cross-sell menu to a short list of targeted offers that will generate the greatest value for the bank and customers alike. By understanding each "path to profitability," banks can identify the highest-value "next product" at each stage of the customer relationship lifecycle. And because of the thoughtful construction that goes into these offers, they provide a valuable context for staff training, coaching and sales management.

The early fruition of this effort lies in targeted initiatives that, through intelligent marketing, allow the bank to get a lot more mileage out of the current product set – without a lot of reinvention. For example, one major regional bank was able to lift its home equity cross-sell effectiveness by more than 15% by establishing a multi-faceted relationship filter that allowed it to focus on a prime subset of the most eligible and potentially receptive customers within the retail bank.

FOLLOWING THROUGH

Obviously, CLV enables a distinctly different approach than what was seen 15 to 20 years ago, when cross-sale first gained widespread industry attention. Early attempts were more of product-push exercise, with lots of time wasted on low-value or implausible offers, and less consideration given to underlying customer needs.

But various kinds of preparation will be needed inside the institution. The marketing team will need to develop robust models that will accurately measure the total lifetime value of every customer, and communicate this information in a way that is both clear and credible with other constituencies within the bank. Individual product teams will need to collaborate with distribution if the bank is to succeed with centrally-designed cross-sell offers that branch and call center reps can sell within a relationship context.

Executive management will need to bring these groups together in a focused way that unlocks opportunity with a minimum of strife and wasted effort. One issue, for example, is that individual product silos typically have their own performance goals that discourage feature or pricing tradeoffs that, while successful with customers, might cut the profitability of an individual product line.

Banks will need to establish mechanisms to allow for transfer pricing between product groups (for example, with relationship pricing). To make clear, this is not a call to immediately reorganize banks around customer segments. There is, however, a pressing need for an informational overlay that will allow banks to effectively pursue customer-focused initiatives within the current product/channel hierarchy.

Some banks are already solving the management and operational problems in making this happen. Others have a long way to go and they will be at an increasing competitive disadvantage. While some level of substantial effort is required to expand relationships and customer lifetime value, it is not clear that banks have any other choice, given the prospects for a continuing revenue drought. Institutions simply must find a way to generate more value with their established customers.

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