

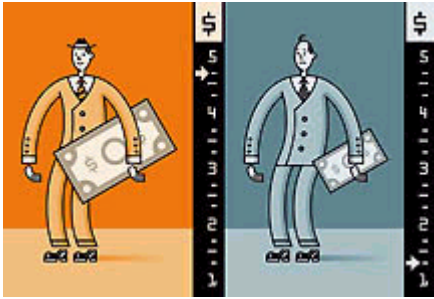
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Banking

What the customer wants

Advances in database technology are enabling banks to measure customer value at the root, one account at a time



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Illustration: Bob Daly

Computing detailed value or loss for each banking relationship is not a new idea, although, until recently, it was seldom put into practice. Even today, such calculations remain something of a rarity, but that's about to change - and in a big way. As banks seek to increase their "share of wallet," the importance of managing individual client relationships has come to the forefront in the financial services industry. At the same time, technology has paved the way for more accurate measurement of such relationships, and has designed new ways to process and store the information.

In retail service industries in general, the concept of managing customer relationships has been discussed for more than a decade. But retail financial institutions have been slow to go beyond their traditional focus on products (and their goal of increasing transaction volume) partly because it was so difficult to measure customer value, especially down at the account level, with accuracy.

In the past, financial institutions estimated a customer's value by calculating net interest revenues and then applying costing factors reflecting the products in use. This "top-down" approach is based on the characteristics of the bank's products, not on the actual customer's behaviour. As such, this approach treats all accounts as "average" and cannot take an individual's behaviour and income implications into consideration. Perhaps not surprisingly, such measures tend to be misleading.

In a recent examination of its practices, an international bank found that a top-down approach resulted in value being reassigned in both the most, and the least, valuable customers - to the tune of many millions of dollars. This called into question the appropriateness of its customer relationship strategies for a significant proportion of its customers. (The discovery subsequently caused the bank to re-evaluate its key account relationships.)

This bank is not unique. Recent studies by First Manhattan Consulting indicate that, in large North American banks, 20% of retail customers contribute between 120% and 150% of consumer banking profits. The remaining 80% of customers are either at break-even levels or are "loss makers."

Such discoveries have come as a revelation to many banks. While the top-down approach was intended to improve service delivery, it often did little to help a financial institution improve or add services. Worse, changes wrought as a result of skewed results may even have alienated good (or potentially good) customers.

How to measure value

Enter the "bottom-up" approach to value measurement. By analysing individual transactions in individual customer accounts, such as current accounts, personal loans, deposits and mutual funds, the bottom-up approach builds up detailed, consistent information to provide comparable information on each customer.

Traditional product-based indicators (such as sales, revenues, margins, run-offs and write-offs) are no longer enough. Key performance indicators on items such as customer acquisition cost, customer lifetime value, channel effectiveness and distribution cost provide additional perspectives for measuring value.

Using the bottom-up approach, a financial institution computes an accurate measure of value that is represented in a monthly profit and loss statement for each account (see the accompanying exhibit). In other words, account ownership becomes the building block for aggregations across a variety of dimensions (e.g., customer, channel cost and product).

A growing number of financial institutions are now making accurate valuations down at the account level to examine the bank's relationships with individuals. "I'm looking at the products and segments my customer prefers," says a leading banker in the Far East. "I need solid data if I am to strengthen the bond with my customer."

Profit & Loss Statement at the account level	
Net interest income	
Net interest paid / received	\$200
Other income	
Safe-deposit-box fee	\$ 15
Cheque certification fees	0
Account monthly fees	25
Other	5
	<u>\$45</u>
Expenses	
Cash withdrawal transactions	\$ 10
ATM deposits	<u>12</u>
Call centre inquiries	3
Indirect expenses	<u>25</u>
Credit risk	<u>15</u>
Other	0
	<u>\$ 65</u>
Total value / account	\$180
Risk-adjusted return on capital	7.5%

Technology is the enabler

Why has it taken so long for such a simple concept to see the light of day in the financial services industry? Part of the reason lies in the role of technology, especially data management technology. Larger banks must keep track of anywhere between 10 million and 30 million individual accounts. Accurate measurements require the processing and storing of huge amounts of data. More important, additional computing power is required to model the complex relationships contained within the data.

In the 1990s, developments in data warehousing – especially accessing huge pools of complex data – have made it possible to apply business and computational rules to measure value rapidly and accurately right down at the account level, and also to help make business decisions based on patterns observed at that level. The rules can be flexible enough to be improved continually, so that sophistication of the calculations can be increased as more data can be made available. Advances in relational database

technology and powerful computing engines are enabling financial institutions to capture ever more information points. Today, a bank or insurance company can find and transform more raw transaction data rapidly into usable data.

Improved mathematical models provide not only the "what," but the "why," in customer relationships. Sophisticated modeling techniques can take advantage of the much more granular and accurate account value data to determine customer propensity and likely retention, then to test and develop satisfaction strategies. Models can be driven by transaction patterns of individual customers. Not only do the models indicate when a good customer should be contacted, they also advise when it is preferable not to make contact - for example, when the customer has only recently been contacted.

Valuing the individual customer

Typically, the first customers to come under the value-measurement microscope were the all-important profitable 20%. They are likely using several value-added bank services, such as loans and wealth management. They may also be using some of the electronic channels (PC or telephone banking) for routine transactions. The cost of acquiring the customer is probably already amortized, leaving the bank to focus on retaining his or her business - typically, through attentiveness to needs and preferences. The bank can also "help customers migrate through our product line over their life," as the banker in the Far East put it. Similarly, the North American bank referred to is re-evaluating the impact of changing service standards on customer satisfaction and value.

Interestingly, the unprofitable 20% has served up some surprising discoveries. With this group, the intuitive answer may not always be the right one. For example, several banks have left the student loan business, citing its unprofitable reputation. But other banks have chosen to build this portfolio, on the basis of lifetime value. After graduation, many students offer their banks myriad opportunities for future growth. Potential, as well as existing, business is an important consideration in measuring value.

Frequently, such measurements will drive a financial institution to re-examine the basis on which it assigns the costs of transactions and other events to customers. This has led one bank's finance department to install an entirely new costing system in response to the need for accurate costs at the account level and to make sure that costs, drawn from many bank source systems, reconcile to the general ledger.

With the advancements in modeling techniques have come concerns about privacy of information. Knowing your customer has long been a basic tenet of business, but recently consumers have been asking questions about the amount of personal information required by institutions - and who has access to it. Some safeguards are available, such as privacy software programs that restrict data access. Others are being developed and implemented, including privacy policies and providing customers with access to bank information about them. Soon, we may see banks and other institutions seeking some sort of "privacy certification" from professional advisers or data consultants in response to consumer demand.

What can we expect next from a bottom-up approach to value measurement? Already, customers' "channel" preferences are being re-examined by many financial institutions. In the mid-1990s, many banks looked at non-branch channels - such as automated teller machines (ATMs), the Internet and call centres - as preferable because they reduced the cost of delivering a service. Today, however, most institutions have come to recognize that cost is only one of several factors in the equation; the customer's preference is much more important to the long-term relationship.

As a result, we can now initiate a mortgage application by phone or the Internet, provide supporting documentation at an ATM, sign the documents at the dealership and draw down the funds electronically - all in a matter of days, even hours. It's not unrealistic to expect that banks will soon provide consistent service across all delivery channels, depending on the customer's preference and what is convenient to him or her at the time.

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