Cluster III in 2005

Customer Management in a Multi-Channel Environment

1 Motivation

For decades, financial institutions have pursued strategies which are product and transaction oriented. Hence, they focused on the profitability of an individual transaction with a customer, rather than the profitability of a long lasting customer relationship. But financial institutions are becoming aware of the value of a customer relationship orientation. This paradigm shift was primarily triggered by the research conducted by Reichheld and Sasser. They have shown that a customer relationship orientation can tremendously improve the overall profitability.

Financial institutions are now trying to derive clear benefits from operationalizing this customer orientation. Customer management has emerged as the marketing practice which aims to implement and to profit from a customer orientation philosophy. Customer management deals therefore with the acquisition and retention of customers with the aim to increase the customer lifetime value and customer equity, an aggregate measure of the life time value of current and potential customers.

As sales channels represent the link to the customer, their management is one crucial factor of the customer management approach. But many financial institutions are currently faced with a confusing array of choices and operational challenges in managing their multiple sales channels. Hence, the mission of Cluster III is to optimize Customer Equity by standardizing and automating the Customer Management in a multi-channel environment.

Decomposing and standardizing the management of the customer buying cycle will provide the basis to develop decision support tools for the management of the customer relationship. Thus, the decision support tools will provide the opportunity to increase decision quality, further automate and optimize customer management decisions and to advance the industrialization of relationship management in the financial services industry.

Our cluster is structured in four work packages which all aim to optimize the Customer Equity of a financial institution. The work packages are as follows:

- **Customer Acquisition**: This work package studies the impact of acquisition channels on the customer equity of financial institutions. Different acquisition channels can generate customers with different customer lifetime values. Understanding the relationship between channel and customer lifetime value is for example a basis to attract the most profitable customers for the financial institution. To achieve this, it is necessary to predict the customer reaction to acquisition efforts and to forecast the prospective customer lifetime value.

- **Add-On Selling**: This work package studies the possibilities to improve the cross-selling and up-selling rate in the financial service industry. In contrast to existing cross-selling approaches, these projects try not only to improve the response rate of cross-selling activities but to maximize the activities' profit. The results of this analysis will be used in a marketing decision support system that guides the optimal allocation of the budget across different cross-selling activities.

- **Customer Channel Migration**: This work package pursues two objectives. Firstly, it analyzes what factors influence the customer channel choice behaviour and predicts the channel choice of banking customers. Knowing what influences customers' channel choice allows then to actively migrate customers to those sales channels that improve the customer lifetime value. The second objective of this work package is therefore to determine these sales channels which positively impact the lifetime value of a customer. Channel usage can impact the customer lifetime value by either serving customers with channels of a lower cost structure or by increasing the revenues generated with a customer by improving the service relationship. The results of this analysis will be used in a marketing decision support system that guides the optimal customer channel migration strategy.

- **Customer Churn Management**: This work package studies the impact of retaining customers on customer equity. Studies show that the retention rate has a great impact on customer lifetime value as well as customer equity. Nevertheless, it seems not reasonable to retain all customers. Therefore, this work package aims to identify those customers who are profitable and likely to migrate to competitors and then to prevent them from churning by developing tailored churn-avoiding strategies. The results of this analysis will be used in a marketing decision support system that guides the optimal customer retention management.

The insights from the four work packages will be used to develop marketing decision support systems that guide the customer management strategy in a multi-channel environment for financial institutions. Based on these results, financial institutions can employ this decision support tool to increase their Customer Equity and to predict the impact of different strategies on enterprise value.

In 2005 the Cluster III will focus on the following work packages: add-on selling, customer channel migration and customer churn management.

2 Customer Management Projects

2.1 Expert Panel on Multi-Channel Management

The current situation in Multi-Channel Management can be described as follows: most organizations are involved in establishing or are already trying to manage a multi-channel system. But as our research indicates, none of these organizations can be described as best practice, nor as an organization without any problems in Multi-Channel Management. So far, sales channel managers have no institution to address which might provide some guidance in order to resolve the encountered problems.

The solution to this problem is to establish such an institution which provides answers to pressing issues of the multi-channel manager. For the E-Finance Lab, there are several opportunities how to support and help organizations in solving their problems. One aim is to provide research in the area of multi-channel management which should aid organizations to redesign their channel systems. Another approach of the E-Finance Lab in supporting organizations to solve their problems is the subsidiarity principle. The E-Finance Lab helps multi-channel managers to help themselves. This can be achieved by offering an infrastructure, so managers can discuss certain issues and therefore help and learn from each other.

This project have already started in 2004. Two expert panels were conducted and we established a panel of designated experts who are working in the financial service industry. Two other expert panels are scheduled in 2005. The panels deal with hot topics in Multi-Channel Management and provide the participants a platform for interesting discussions and networking.

2.2 Frühjahrstagung 2005 “Customer Management in a Multi-Channel Environment”

In February 2005 Cluster III will organize the Frühjahrstagung. The topic of this conference will be “Customer Management in a Multi-Channel Environment”. We invited Peter Fader – a well-known academic from Wharton - who agreed to be the keynote speaker of this conference. This conferences has the aim to bring the multi-channel managers and marketing managers of leading financial institutions together. Furthermore, the purpose will be to promote the E-Finance Lab and its members.

2.3 Analysis of the Relationship between Add-On Selling and Customer Retention

When allocating the marketing budget it is a crucial question how much money should be spend in add-on selling activities and retention activities. Because it is often discussed whether the ownership of different products strengthened the customer relationship and results in a higher retention rate or if a long lasting customer relationship results in a higher add-on selling rate. However, it is still an open question whether add-on selling positively influences the retention rate or vice versa.

Therefore it is the aim of this project to shed light on this question. On the basis of a large data set containing customer transaction data it will be investigated which one of the postulated hypotheses will be proved to be true. To answer the question a system of simultaneous equations will be formulated and solved. The results allow to derive implications for the optimal allocation of the marketing budget. According to the mission statement of Cluster III the objective will be the maximization of the company’s customer equity.

2.3.1: The first part of this work packages will be the development of the model to investigate the proposed research question.

2.3.2: The second part of this work package will be a research publication describing the model as well as the methodology and the implications for customer management.

This project will be conducted in collaboration with Prof. Michaela Draganska (Stanford University).

2.4 Multi-Channel Availability

Banks have added a multiplicity of new electronic channels in hope to substitute labor intensive sales channels such as the branch network by automated channels such as the Internet. But until now, banks have only added new channels without reducing the cost for their traditional channels. This could be achieved for example by reducing the number of bank branches and therefore reducing the availability of this channel. Banks still hesitate to reduce the number of branches as they are yet not able to predict customer reactions. In light of strong competition within the retail banking market, banks are not willing to reduce the number of branches and increase the possibility to loose customers to the competition. The aim of this module is therefore to determine the number of bank branches. It will be investigated how many branches can be closed until customers are motivated to use alternative sales channels or until they are lost to the competition. In other words, the objective is to calculate a branch availability elasticity for each customer. The aim is therefore to (1) predict channel migration influenced by the branch availability of a bank and (2) to investigate the impact of branch availability on customer churn.

2.4.1: A customer survey will determine the changes in customer channel migration dependent on the availability of bank branches. Customers will be asked to indicate their likely reactions to predetermined levels of branch availability. This will allow to calculate a branch availability elasticity. Based on this elasticity it is possible to determine the threshold when customers are starting to use alternative channels. It is therefore possible to predict customer reactions to changes in the number of bank branches.

2.4.2: The approach to determine the effect of channel availability on customer migration can be extended to include a churn option. It is therefore possible to predict which customers are going to be lost at which point of time. Based on this knowledge, it is possible to determine the optimal number of bank branches which still retains the highly profitable customers, migrates the customers with low profitability to low cost channels, and drives unprofitable customers to the competition.

2.5 Customer Channel Choice and its Impact on Customer Lifetime Value

This work package will analyze the monetary implications of the channel choice behavior of banking customers. It will therefore extend the research that has started in 2004 on customer channel choice factors and their importance for the choice of a sales channel. Being able to improve the Customer Lifetime Value by managing the channel choice process requires not only a complete understanding of the channel choice factors and their importance, but as well to estimate the monetary implications of sales channels usage.

2.5.1: The research project has started in 2004 and it is the aim of this part of the project to describe the development of a scale to measure factors that influence customers' channel choice. These factors included for example marketing variables such as price or convenience. Up to know no scale exists that can be applied for evaluating the perceived value of a channel. Therefore, it is the aim of this project to develop such a scale and to publish the used approach.

2.5.2: The follow-up research in 2005 will focus on the "indirect" factors impacting the channel choice behavior of banking customers. The basic idea of the indirect channel choice factors is that experience with a certain sales channel will increase the likelihood of reusing the sales channel. In other words, the use of a certain sales channel will reinforce the future use of this sales channel. In this context, it is of special interest how the sales channel usage is related across the different process stages. The work package is designed to explicitly model these process interactions as there are different strategic implications depending on their strength. It is therefore beneficial for the effectiveness of a multi-channel strategy to have a good understanding of these interactions. If there is for example a strong channel inertia between the information and the purchase stage, it is sufficient to migrate customers in the information stage because they will continue to use this channel for the subsequent process steps. If there is no inertia between process steps, it would require to motivate customers at each process stage to use a certain channel.

2.5.3: The second objective of this work package is to determine the monetary implications of sales channel usage. After all channel choice factors have been identified and modeled, it is necessary to estimate as well the effects of a sales channel on the Customer Lifetime Value. This work package will build as well on research which has been conducted in 2004. Whereas the research of 2004 has focused primarily on the behavioral effects of a sales channel, this work package will concentrate on the actual monetary differences of sales channels. The aim of this work package is therefore to provide an overview of the cost and revenue structure for the different sales channels available to the financial services industry. This can be achieved by either conducting expert interviews or by reviewing the literature. Due to the limited number of research that has been conducted in this area we will rely to a large degree on self conducted expert interviews.

2.5.4: The final objective of this work package is to extend the existing decision support system on customer channel migration. The enhanced decision support system will incorporate the two aspects which have been described above.

2.6 Dynamic Customer Channel Switching Behavior

Internet usage in retail banking continues to grow. This evolution is customer-driven, as customers' increased familiarity with the medium results in a growing level of e-business activity. Actively managing multiple sales channels requires knowing the customers' channel preferences. Otherwise, unwanted effects like customer dissatisfaction and churn may occur when customers are too aggressively addressed to switch from their preferred channel to another one (see also work package "customer channel migration"). A key component of customers' channel preference is their intrinsic loyalty to a sales channel. Not only is channel loyalty a main driver of the channel's long-term viability, it will also provide management with an indication on how easy it will be to make customers switch from its other direct channel(s) towards the by the company preferred (new) channel. Similarly, the channel loyalty of customers that have already made the transition will offer key information on the investments needed to prevent them from switching again.

However, channel loyalty is only one component of a channel's performance. Channel choice is often characterized by a substantial amount of dynamism (e.g., because competitors also introduce new channel options, because some incumbent channel attributes change, etc.). Moreover, some customers may not have a strong intrinsic preference for one specific channel, and occasionally (or even regularly) switch among different channel formats. Nevertheless, the ability of a given channel to keep a large fraction of its existing customers is not sufficient for long-run growth or viability, as this customer base will eventually get eroded. Therefore, a second key characteristic for a channel's performance is its ability to attract these switching customers.

To address the question whether the channel usage behavior of banking customers changes over time, a study will be conducted. Based on transaction data it will be investigated if customer channel usage behavior evolves over time. The results of this study provide deeper insights into the customer behavior of multiple sales channels. It will be possible to derive implications regarding the management of multiple sales channels and the profitability impact of those sales channels.

2.6.1: The first part of this work package will be the development of the model.

2.6.2: The following part of this work package will deal with the results of the empirical study and the implications that can be derived. Those will be published in a research publication.

2.7 Bank Valuation by Using Customer Lifetime Values

For banks which have a direct relationship with customers, the value of its customer base contains an essential part of their enterprise value. Instead of a group of products, brands, services, functions or territories, these enterprises can be viewed as a *portfolio of customers*. Thereby, customers are the only source of operating cash flow and all other assets of the enterprise support the generation of these customer cash flows. Managers and investors of such enterprises like to analyze the impact of changes in marketing value drivers on enterprise value and shareholder value. Such an analysis is usually not possible in traditional DCF models and requires knowledge about who your customers are and how large their cash flows and the associated expenditures are. Until now, there are no sophisticated approaches identifying critical value driver that influence the value of an enterprise's customer base and shareholder value.

A solution for the above raised problem might be focussing on the customer while valuing enterprises and therefore using a customer-centric enterprise valuation approach. A customer-centric enterprise valuation builds upon the idea of regarding an enterprise as a portfolio of customers and models free cash flows to the enterprise at the level of individual customers or groups of individual customers. Within a customer-centric enterprise valuation, the value of the operational side of the business is modelled by using the customer equity concept and value of all non-operating assets indicates the non-operational side of the business.

2.7.1: It is one aim of this work package to develop such a customer-centric enterprise valuation approach for the banking industry. This approach will illustrate the composition of aggregated cash flow which, for example, could be negative due to high acquisition expenditures. Hence, such a disaggregated approach assists doing feasible cash flow forecasts. Furthermore, it breaks down the enterprise value into several value components to visualize what could be influenced by operating decisions (e.g., existing and future customers by segment). It provides a business case for communication with investors (e.g., bottom-line argumentation for customer management activities) and enables to communicate enterprise's focus on customers' (customers' perspective) need and customers' profitability (shareholders' perspective).

2.7.2: The developed approach will be applied to a German bank to validate the approach and to enhance insights into the relationship between different drivers of customer lifetime value and their effect on enterprise value.

2.7.3: Development of software tool for enterprise valuation.

2.8 Market Analysis: German Retail Banking Market

"Typologie der Wünsche Intermedia" (TdWI) is published by Burda Advertising Center and under license by 19 partners in the advertising media. This survey provides data on a regular basis on German consumer behavior and covers the financial service industry. It is based on the German-speaking population from the age of 14 belonging to private households in Germany. The participants are sampled by their addresses selected at random. The sampling scope is about 20.000 households. The survey is based on personal interviews and a written questionnaire. Interviews are carried out using a structured questionnaire; the written part of the survey is based on instructions provided by the interviewer. The survey is conducted once a year and we have got the data for a time period of 3 years.

Based on these data it is possible to conduct several analyses. For example, market shares for different product categories can be determined as well as the cross-selling rates of different financial institutions can be evaluated and compared. It is the aim of this project to provide several analyses of the German retail banking market to provide the partners of the E-Finance Lab with additional information.