An Investigation into Customer Profitability Analysis and Relationship Marketing Strategy: A New Zealand Case Study

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Abstract

There has been an increasing recognition of the importance of customer profitability analysis and its use in a relationship marketing strategy (Carrol, 1992-1993; Johnson, 1992; Storbacka, 1993). Yet, to date, this has largely been unsubstantiated by academic research. A case study was conducted at a bank to describe a relationship marketing strategy and a customer profitability analysis (CPA) system and to discover how the customer profitability information provided by the CPA system is used to support the relationship marketing strategy.

The Bank follows a relationship marketing strategy as described by Christopher et al (1991). It was found that the bank currently has a first generation CPA system (Bellis-Jones, 1989). Recognising the limitations of such an analysis, the bank is in the process of designing and implementing a new CPA system, which clearly exhibits the characteristics of second generation CPA (Foster & Gupta, 1994). It was found that customer revenue is easily definable, yet customer costs and customer risk pose a significant issue when included in a CPA system. A number of cost and risk areas are still unresolved, as are some issues regarding the use of the customer profitability information.

The Bank does not use customer profitability as the basis of its customer segmentation due to the inadequacy of the current CPA system to accurately determine customer profitability. Instead, income is used as a substitute for profitability and it is income that forms the basis of the bank's customer segmentation. It was also found that the Bank intends to merge CPA information with customer relationship information, once the new customer profitability system is implemented.

Despite limitations, this thesis extends the body of knowledge concerning management accounting information and relationship marketing, by providing a valuable insight into these areas in a New Zealand context.

Acknowledgements

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Chapter One: Introduction

"Firms should not strive to build a relationship with every customer, only those that are profitable or can become profitable" (Carroll, 1991-1992).

1. Introduction

Drucker (1954) believes that the only reason for a company to be in business is for the customer. Several authors note the importance of building relationships with customers (Christopher et al, 1992; Johnson, 1992; Storbacka, 1993; Peck, 1997). The necessity for organisations to focus on customers and customer retention has also been well documented (Intindola, 1991; Johnson, 1992; Reichheld, 1994). Timewell (1994) regards a customer focus as being "the critical success factor of the 1990s" (p. 29).

Johnson (1992) highlights the importance of customer relationships:

> To be competitive in the global economy, companies must be responsive to customer wants. The best way to become responsive is to build long-term, mutually dependant relationships with customers...A truly customer-focused global competitor understands that its profits come from customers not products (p.73).[1]

In order to react and respond to customer needs, and adopt a relationship marketing strategy, firms must have information on their customers. Several authors believe that firms should not strive to build a relationship with every customer, only those that are

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[1] Throughout this thesis, quotations from the literature will be in normal type face.

profitable or can become profitable (Carrol, 1992-1993; Johnson, 1992; Storbacka, 1993).

Furthermore, information on the profitability of customers and products is one of the most important pieces of customer information to obtain (Howell & Soucy, 1990; Bellis-Jones, 1989). Customer profitability can be assessed using a customer profitability analysis (CPA) system.

CPA involves the identification of customer revenues and costs and the recognition and incorporation of risk. Having achieved this, it is then possible for firms to measure a customer's profitability and use this information to support their relationship marketing strategy.

Stuchfield & Weber (1992) argue that any customer information that is gathered must be relevant and useful. Many suggestions have been put forward for using customer profitability information to support a relationship marketing strategy. These include:

- Selling different products to existing customers (Petro, 1990; Storbacka, 1993; Morris, 1994; Hartfeil, 1996),

- Segmentation of the customer database (Petro, 1990; McCormick et al, 1996; Berry & Britney, 1996),

- Price negotiations with customers (Storbacka, 1993; Booth, 1994; Hudson, 1994) and,

- Analysing customer behaviour (Howell & Soucy, 1990; Storbacka, 1993; Booth, 1994; Smith & Dikoli, 1995; Hartfeil, 1996; Jeffry & Franco, 1996; Anonymous, 1996),

Consequently, this thesis has three aims;

- to describe the relationship marketing strategy of a Bank,

- to describe how customer profitability analysis is conducted at a Bank and,

- to describe how CPA information is used to support the bank's relationship marketing strategy

The aims of this thesis were achieved by conducting a case study at a major New Zealand bank. The justification for using the case study method to conduct this research is detailed in chapter two. A bank was chosen because much of the literature on relationship marketing and customer profitability analysis concentrates on the banking industry. Chapter two describes the research site and outlines how the case study was undertaken.

In order to fully understand the context of this research a detailed discussion of the relevant literature is presented in chapters three and four. Chapter three presents a discussion on relationship marketing and chapter four explains customer profitability analysis and describes how customer profitability information can be used to support a relationship marketing strategy.

The bank's experience is described in chapters five, six and seven. Chapter five presents the relationship marketing strategy of the bank. Chapter six explains the CPA system at the bank, whilst chapter seven puts forward an account of how the bank will use customer profitability information.

The results of this research are reviewed in chapter ten, and some concluding remarks are put forward. No method of research is without limitations. Chapter nine highlights the limitations of this study and suggests areas for further research.

This thesis combines management accounting and marketing. There has been a call for research combining these two disciplines (Foster & Gupta, 1994). The combination of management accounting and marketing is further justified as the two disciplines share two fundamental principles:

- A move away from a product focus to a customer focus (Christopher et al, 1991; Johnson, 1992; Reichheld, 1993; Storbacka, 1993), and

- A long term approach (Dwyer et al, 1987; Bellis-Jones, 1989; Shani & Chalasani, 1992; Storbacka, 1993; Foster & Gupta, 1994; Gronroos, 1994; Berry & Britney, 1996).

The following chapter describes how management accounting and marketing were combined in a case study.

Chapter Two: Method

2. Method

> "Walk their walk, talk their talk, and write their story", (Jonsson & Macintosh, 1996, p. 6)

2.1 Introduction

The case study method of research was used for this thesis. This chapter begins by discussing the need for case study research into "real life" business situations and processes. Prior research in management accounting has been predominantly quantitative, focussing on empirical testing of "scientific" hypotheses (Johnson, 1992). It is argued that, the quantitative approach may not be the most appropriate method for conducting management accounting research.

The chapter begins with a discussion on the need for case study research into management accounting practices. This is followed by a description and definition of case study research.

A Bank was chosen as the research site for two reasons. Firstly, this thesis seeks to compare and contrast the experience of a New Zealand banking institution with the existing literature. Yin (1992) notes the importance of relating the research site to the literature: "each case study and unit of analysis...should be similar to those previously studied by others" (p. 25). Secondly, the researcher had prior contact with the bank based on previous research undertaken at the site and, once again Yin (1992) indicates

that the selection of a case study site can be based on prior contact. This chapter

concludes with a description of the Bank, and the steps that were taken to achieve the

objectives of this thesis.

2.2 The Need for Case Study Research

> "Business schools lost sight of the professional "forest" by focusing too intently on the academic "trees", (Johnson, 1992, p. 179)

Johnson (1992) believes current research practices in management accounting fail to

address the issues facing managers of firms. Graduate schools and academic journals

have encouraged quantitative research that tests scientific hypotheses, thereby

producing research that is of limited use to manage a firm in today's global economy

(Johnson, 1992).

The result has been a rarity of academic research in areas addressing the growth and

change in management information over recent years (Kaplan, 1991, referenced in

Johnson, 1992). Hopwood (1983) notes that "little is known of the organisational

nature of accounting practice" (p. 287). This view is echoed by Drury and Tayles

(1995) who state "until recently, little was known about the current state of

management accounting practice" (p. 267).

The lack of insight into accounting practices results from the inward focus of graduate

schools aiming to satisfy academics (Kaplan, 1984; Johnson, 1992). Consequently,

the majority of accounting research fails to:

> Relate their [the researchers] insights to broader understandings of the development of the corporate form, its social and economic setting, and the roles which organisational accounts might have played in the emergence of both the organisation as we know it now and the relationships which it has to other bodies and interests. (p. 289)

Peck (1997) believes the "long standing dominance of the positivist approach to social research" (p. 14), has led to "an overall bias in favour of quantitative research methods" (p. 14).   Ryan & Scapens (1992) note the tradition of positivist methodologies in accounting research. Deshpande (1983, cited in Peck, 1997) argues that an adherence to the positivist paradigm has impeded the development of marketing theory by creating an overemphasis on quantitative research methods.

Whilst this belief relates to the field of marketing research and its effect on the development of marketing theory, the argument is applicable to this research which crosses the boundaries of marketing and management accounting research. Foster & Gupta (1994) note there is "minimal integration between marketing and management accounting literatures" (p. 43).   They argue that "while many decisions facing managers require integration of issues covered in both literatures, there are few published examples of such integration" (p. 44).   The lack of integration is a result of the different research focii of marketing and management accounting. Foster & Gupta (1994) cite an example:

> "Marketing has traditionally focused on revenues and the attraction of customers. In recent years, however, the emphasis has been shifting from revenues to profits. Moreover, retention as well as attraction of *profitable* customers has become a top priority. The analysis of customer profitability is enhanced by an understanding of the behaviour and drivers of customer-related revenues and costs" (p. 44).

This contrasts the traditional marketing focus on increasing sales and turnover without much regard for profit, to the management accounting focus on increasing profit.

Peck (1997) argues that relationship marketing is an emerging yet recognised area and as such must be investigated in its natural setting. This argument can be equally applied to the area of management accounting. Like marketing, management

accounting is also a developing area (Bruns & Kaplan, 1987; Johnson, 1992; Otley et al, 1995; Otley, 1996). Authors from both fields have called for a focus on customers and, the need to understand how the firm can respond and react to customer needs (Christopher et al 1991; Johnson, 1992; Reichheld, 1994; Otley et al, 1995; Peck 1997). Furthermore, this research combines areas of marketing and management accounting. Therefore it is appropriate to use examples from both disciplines.

Peck (1997) argues that interpretivism is a more effective approach to marketing research than a positivist approach. Chua (1986) points out "interpretive knowledge reveals to people what they (the subjects of the research) and others are, when they act and speak as they do" (p. 615).

The interpretive approach contends that "the researcher may only understand the meanings of a social phenomena if he or she views it from the perspective of those involved" (Peck, 1997, p. 9). Furthermore, "interpretivism demands that the researcher should endeavour to discover knowledge from within" (p. 10). Clearly a case study approach is the most appropriate method of research in this instance.

Yin (1992) believes that a case study is the most appropriate research method to use when "a how or why question is being asked about a contemporary set of events" (p. 20). This research seeks to understand how a Bank's relationship marketing strategy is structured, how a Bank calculates customer profitability and how customer profitability and other customer information is used by the different areas at the Bank to support their relationship marketing strategy. Therefore a case study method was adopted.

2.3 Case Study Research

Yin (1992) defines case study research as:

> An empirical inquiry that:
>
> • investigates a contemporary phenomenon within its real-life context; when
>
> • the boundaries between phenomenon and context are not clearly evident; and in which
>
> • multiple sources of evidence are used. (p. 23)

Ryan et al (1992) explain that case studies are used to describe research into accounting in its practical setting. Bruns & Kaplan (1987) describe case studies as "snapshots of existing systems in companies...they are intensive examinations of a single organisational unit during a single time period" (1987, p. 8).

Furthermore, Bruns & Kaplan (1987) believe "case studies can develop extensive information about a single entity and suggest hypotheses, but they cannot conduct formal tests on hypotheses, except perhaps to serve as counter examples" (1987, p. 8). This philosophy is in keeping with the nature of this study, that is, to provide an extensive insight into how a Bank's relationship marketing strategy operates and how its customer profitability analysis system is used to support the relationship marketing strategy. The findings are compared and contrasted with the literature and the differences and similarities are highlighted, adding to the body of knowledge in management accounting and marketing. This further justifies the choice of the case study method.

The flexibility of case studies to explain, explore, describe and illustrate areas of accounting, means that different approaches are required (Ryan et al, 1992).

Ryan et al (1992) note that explanatory case studies seek to provide explanations of observed behaviour. Observations are linked back to theory to provide an explanation for the behaviour. Should the observed behaviour not conform to existing theories, the opportunity for theory modification exists. The modified theory can then be tested in further case research.

Exploratory case studies look to understand why particular accounting practices exist. The aim of exploratory case studies is to generate hypotheses that can be empirically tested after the case study is completed (Ryan et al, 1992).

Illustrative case studies highlight "new and possibly innovative practices" (Ryan et al, 1992, p. 114) in use by a certain organisation. They do not provide an evaluation of such innovations. Instead they merely serve to document what is in use and what has been achieved.

Ryan et al (1992) believe descriptive case studies provide an account of systems, techniques and procedures currently in use by organisations. Their objective is to provide a description of accounting practices in use, so that differences between theory and practice can be identified. They are not required to offer causal factors for the documented observations:

> Positivistic sociology seeks causal explanations of social phenomena. It does so through the use of a variable-analytic language that is largely divorced from the everyday life world. The search for causal "whys", causal paths, causal chains, and causal antecedents is detrimental to the study and understanding of directly lived experience (Denzin, 1983, p. 132).

This study does not seek to explain or explore the observed phenomena. Rather, this research is both an example of an illustrative and a descriptive case study as it seeks to

describe the relationship marketing strategy, the customer profitability analysis system, and illustrate their interconnection.

Whilst it has been acknowledged that integration of marketing and management accounting research is required (Foster & Gupta, 1994), to date there are no published examples of this type of research. As such, this research provides an innovative insight into the integration of management accounting and marketing practices, and it was achieved by investigating them in a contemporary business setting, namely a bank.

2.4 The Bank

A bank was chosen as the research site for two reasons. Firstly, there is a predominance of banking literature in the areas of relationship marketing and customer profitability. Yin (1992) notes the importance of relating the research site to the literature: "each case study and unit of analysis...should be similar to those previously studied by others" (p. 25). This justifies the choice of a Bank as the research site. Secondly, the author had a contact at the Bank from a case study undertaken the previous year[2].

The Bank is one of the four major trading banks in New Zealand with assets in excess of $23 billion. It is owned by an off-shore parent company which operates through more than 2,300 branches in 17 countries and employs more than 52,000 people. Group assets exceed $197 billion and the parent bank has a long term rating of AA by the rating agency, Standard & Poor's. The group is listed on the Stock Exchanges of

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[2] Arnold et al (1996)

New Zealand, Australia, London, New York and Tokyo and as at 30 September 1996, had a market capitalisation in excess of $21 billion.

An initial approach was made by telephone to the author's contact at the Bank. The request for access to conduct a study of the Bank's relationship marketing and its customer profitability systems was received positively. It was learned that the manager who had helped to facilitate the 1996 project[3], now held a senior position in the marketing department at the bank, and the author was advised to contact him directly. This was done and the marketing manager suggested that a formal written request be submitted, outlining the research topic and requesting the bank's assistance. It was explained that most of the information required to complete the study would be obtainable at the Bank's head office in Wellington. Two weeks following the submission of the request, a follow-up telephone call was made. It was learned that the request had been forwarded to the bank's head office in Wellington, and had been received favourably. The author was given the name and contact details of a different manager in the marketing department at the Bank's Head Office, who was eager to assist in the research.

This marketing manager was contacted by telephone, and during this conversation, the exact nature of the research was explained. This enabled the marketing manager to have a full understanding of what was under investigation as he was to select the interviewees and arrange the interview times[4].

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[3] Arnold et al, 1996.

[4] The problem of bias associated with the researcher not being able to select the interviewees is discussed in Chapter six.

Three areas of the Bank's relationship marketing strategy were investigated. These were:

1. The Rural Banking Sector; This sector provides all banking facilities, both personal and business for customers whose major source of income is derived from farming.

2. The Middle Business Sector; This sector caters for business customers whose total business is between $100,000 and $15 million. This sector includes the personal banking of company principals.

3. The Home Loan Sector; This sector caters solely to personal home loans and lending. There is no commercial banking services provided by the home loan sector.

The Bank is currently developing[5] a new customer profitability analysis system to replace the existing system. This project is being undertaken by the finance department of the Bank with input from other departments, including the marketing department. To investigate Customer Profitability, the leader of the customer profitability project was interviewed. Lastly, to further investigate the customer information database, a research analyst from the bank's research department was questioned. This was to add depth to the customer information and provide an insight into the use of customer information. The research analyst provided valuable insight into the collection, use and integration of external information into the relationship marketing strategy.

The questionnaire[6] consisted mainly of open-ended questions as advocated by Yin (1992). This was used with all interviewees[7], but in some cases not all questions

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[5] This research was conducted during the latter half of 1997.

[6] See appendix A.

[7] See appendix B for a schedule of interviewees.

could be answered. The reason for this was that interviewees from the Rural and Home Loan sectors had limited knowledge regarding the development of the new customer profitability system.

The Middle Business area was well informed on the development of the new customer profitability system. This is because the system will initially be implemented in the middle business area only[8] and, as such, they are heavily involved with the design of the new CPA system. Conversely, interviewees from the Finance and Research departments were not familiar with the bank's relationship marketing strategy and were unable to answer questions of this nature.

All interviews were conducted informally, so that advantage could be taken of new areas that were uncovered as the interviews progressed. When this occurred[9], the interview became less structured in an attempt to gain a complete understanding of all aspects of the relationship marketing strategy and customer profitability systems.

Prior to commencing the interviews, all interviewees enquired as to the nature of the research. The author provided a brief description of the study, not wanting to introduce bias to the responses, but at the same time ensuring the interviewees understood what information was being sought. All interviews were tape recorded and transcribed to enable complete representation of the information collected.

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[8] It is planned to extend the new CPA system to the rural and middle business areas after successful implementation in the middle business area

[9] For example, during the course of interviewing it was discovered that the Bank would be using the new customer profitability analysis system to analyse customer behaviour. This had not been uncovered in the literature prior to interviewing but the interviewer deemed it important enough to pursue further see Chapter five.

At the completion of all interviews the author requested permission to contact the interviewees following transcription of the tapes, to clarify any information that was unclear. This was required in some cases, mainly to clarify bank terminology and policy.

Information obtained from the Bank was divided into three distinct areas: relationship marketing, customer profitability analysis and how the bank uses customer profitability information to support its relationship marketing strategy. The following chapter begins the literature review by presenting a discussion of relationship marketing.

Chapter Three: Literature Review - Relationship Marketing

3. Literature Review - Relationship Marketing

3.1 Introduction.

This chapter begins with a discussion of the various elements of relationship marketing. Christopher et al (1991) believe a relationship marketing strategy should incorporate the following elements:

- High customer contact,

- A focus on customer retention,

- A long time-scale,

- A high level of customer commitment,

- An orientation on product benefits and,

- A high emphasis on customer service.

This framework is used in the discussion of relationship marketing, and also in chapter six to describe the relationship marketing strategy of the Bank. To set the scene for this discussion, the following section traces the development of relationship marketing and explains why a relationship marketing strategy is of importance to a firm operating in today's competitive market.

3.2 Relationship Marketing

"The best way to become responsive is to build long-term, mutually dependent relationships with customers" (Johnson, 1992, p. 73)

3.2.1 Background

Dramatic changes in the social landscape have led to the fragmentation of markets for firms competing in today's global economy (Clark et al, 1994). Technological advances and the deregulation of markets have contributed to increasing global competition (Miles & Snow, 1984; Piercy & Cravens, 1994; Biemans & Brand, 1995). Peck (1997) notes: "the world is becoming a buyer's market, where increasingly discerning customers are freer than ever to select from the global marketplace" (p. 3.).

The traditional model of a vertically integrated firm, controlled from the top down, is no longer the most effective organisational model for a firm competing in today's market (Clark et al, 1994; Peck, 1997). Competitive advantage is often lost as new opportunities are not recognised, due to the lack of integration and communication between different sections of the firm (Badaracco, 1991; Clark et al, 1994). Classical corporate structures are changing, as organisations focus on core processes and concentrate on value-added activities.

This corporate structural revolution is bringing about the emergence of organisations built around networks of customers, suppliers and competitors (Peck, 1997). The network structure is believed to be the best way to maintain greater organisational specialisation yet retain flexibility (Miles & Snow, 1986; Johnson & Lawrence, 1988)

The emergence of these environmental changes has highlighted the incompatibility of the traditional marketing paradigm, which is based on the marketing mix and the concept of exchange (Gronroos, 1994; Clark et al, 1994; Gummesson, 1987).

Marketing models based on the marketing mix framework, concentrate on selling a product, and hence, a single sales transaction. Such models are inappropriate for organisations which focus on building networks and cultivating on-going relationships with customers (Gronroos, 1994; Clark et al, 1994; Peck, 1997). This is because these models have a product focus not a customer focus. The customer also plays a passive role, the active role being that of the seller (Clark et al, 1994). Furthermore, it has become widely recognised that the classical marketing paradigm is no longer useful or appropriate in the 1990s (Brady & Davis, 1993; Storbacka, 1993; The Economist, 1994). It has been suggested that a marketing framework based around a mutual relationship between the seller and the customer is a more effective means of achieving competitive advantage (Gronroos, 1990; Clark et al, 1994; Peck, 1997).

Relationship marketing originated in the area of services marketing (Berry, 1983). It began as a focus "on the development and cultivation of longer-term profitable and mutually beneficial relationships between a supplier and a target customer group" (Peck, 1997, p. 3). Gronroos (1990) notes that

> "marketing should establish, maintain and enhance relationships with customers and other partners, at a profit, so that the objectives of the parties involved are met. This is achieved by mutual exchange and fulfillment of promise." (p.138).

Furthermore, a relationship marketing strategy is usually, but not necessarily, long term.

Shani and Chalasani (1992) believe relationship marketing is:

> "an integrated effort to identify, maintain, and build up a network with individual consumers and to continuously strengthen the network for the mutual benefit of both sides, through interactive, individualised and value-added contacts over a period of time" (p. 44).

This is supported by Gronroos (1994), who describes a relationship as an interaction between two parties. In the context of marketing, the two parties are the customer and the supplier. He views relationship marketing as combining "relationships, networks and interaction" (p. 5).

No single definition of relationship marketing exists in the literature. Gummesson (1987) believes "[t]he term relationship marketing offers a fragmented smorgasbord of definitions, statements, examples, checklists and conceptual models" (p. 5). To clarify the discussion on relationship marketing, a model developed by Christopher et al (1991) (see table 1) is used to compare and contrast the differences between traditional marketing and relationship marketing.

Table 1. Contrast Between Transaction and Relationship Marketing

Transaction marketing	Relationship Marketing
• Moderate customer contact	• High customer contact
• Focus on single sale	• Focus on customer retention
• Short time-scale	• long time-scale
• Limited customer commitment	• High customer commitment
• Orientation on product features	• Orientation on product benefits
• Little emphasis on customer service	• High customer service emphasis

Source: Christopher et al (1991).

To gain a better understanding of a relationship marketing strategy, each of the points in table 1 are now presented and discussed.

3.2.2 High Customer Contact

Christopher et al (1991) suggest that a relationship marketing strategy is characterised by a high level of customer contact. The level of customer contact is also noted by Palmer (1995), who believes relationship marketing is a business strategy which aims to turn casual, discrete transactions between buyer and seller, into an ongoing relationship by extending customer contact past the initial transaction phase. The concept of an ongoing relationship is closely linked to the shift from a single sale to one customer, to the strategy of customer retention.

3.2.3 Customer Retention

Relationship marketing is focused on the enhancement of the customer relationship and the ultimate retention of customers (Storbacka et al, 1994; Harrison, 1993). Whilst a customer retention strategy has been advocated by many authors (Christopher et al, 1991; Reicheld, 1994; Heskett et al, 1994) the precise meaning of this can be unclear, as no concise definition of customer retention can be found in the literature. Some authors have suggested a customer is retained if they:

- Consistently spend their entire budget with a firm (Fay, 1994);

- Are in the firm's database (Heskett et al, 1994);

- Use more than one of the services or products offered by a firm (Heskett et al, 1994);

- Are satisfied, however, satisfaction in itself does not guarantee customer retention (Reichheld, 1993).

Storbacka et al (1994) argue that customer retention and relationship longevity represent similar concepts.

It is widely believed that the development of the relationship takes place over time (Dwyer et al, 1987; Shani and Chalasani, 1992; Gronroos, 1990, 1994). Christopher et al (1991) also comment on relationship longevity, contrasting this with the shorter time scale approach of traditional marketing. Arnold et al (1996) found that the length of time a customer had conducted business with a bank was one indicator of a retained customer[10]. Christopher et al (1991) note that relationship marketing transforms a single transaction between the firm and a customer, into a series of episodes leading to customer retention.

The transformation of discrete transactions into relational exchanges is also noted by Dwyer et al (1987). A discrete transaction is one where both parties conduct a specific transaction. There is no contact prior to or following the transaction. This is in contrast to relational exchange, which grows over time through the exchange of expectations and information between the parties. Furthermore, the relationship between buyer and seller is likened to a marriage, where two parties agree only to exchange with each other until such time as an imbalance occurs and the relationship is dissolved (Dwyer et al, 1987; Morgan & Hunt, 1994; Palmer, 1995).

In the banking industry, some authors believe that a product and transaction oriented approach is obsolete, (Payne, 1994; Hales, 1995) and should be replaced with a relationship approach to both products and customers. Storbacka et al (1994), view each service encounter with the customer as constituting part of an "ongoing sequence of episodes" (p. 22).

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[10] The study was conducted in the same bank as this thesis.

Whilst it is widely accepted that customer retention does not solely rely on customer satisfaction (Reichheld, 1993), Storbacka et al (1994) argue that relationship longevity and customer retention results from customer satisfaction.

3.2.4 Customer Satisfaction

If a customer is satisfied with their relationship with a firm, they may remain loyal to that firm. This often occurs even when that loyalty fails to be in the customer's best self interest (Shani & Chalasani, 1992; Storbacka, 1993). Storbacka et al (1994) note that this is evident in the banking industry, where customers who are dissatisfied with a particular service episode may still show satisfaction with, and sustain the relationship.

Exit barriers are widely recognised as a reason for customers remaining with any firm (Dwyer et al, 1987; Storbacka, 1993; Morris, 1994). In the Banking industry, it is often very difficult for a customer to end a banking relationship because there are often legal obligations that must be fulfilled (Dwyer et al. 1987). The existence of exit barriers can work against a firm who is striving to build customer relationships and retain customers. This is particularly evident when a relationship exists with unprofitable customers.

3.3 Chapter Summary

Relationship marketing evolved from changes in the global marketplace which rendered the traditional marketing mix model inappropriate for some firms. Whilst there is no concise definition of relationship marketing, its underlying philosophy is a move away from a sales transaction focus to a customer relationship focus.

Christopher et al (1991) believe several characteristics identify a relationship marketing strategy. These include:

- High customer contact,

- A focus on Customer Retention,

- A long time scale,

- High customer commitment

- An orientation on product benefits and,

- An emphasis on high customer service

The underlying belief for the shift from the single transaction to customer retention, is that retained customers will purchase more than once and subsequent purchases will increase in profitablilty (Reichheld, 1991-92: Reichheld, 1994). Howell & Soucy (1990) note that this is a common assumption: "many companies think their highest-volume customers are their most profitable" (p. 44). Clark et al (1994) however, argue that high volume customers may be unprofitable as their transactions may be conducted through unprofitable or higher cost channels, leading to an unprofitable customer relationship[11].

The following chapter describes customer profitability analysis and presents suggestions from the literature on how customer profitability analysis can be used to support a relationship marketing strategy.

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[11] The implications of transactional behaviour on customer profitability are discussed later in this chapter.

Chapter Four: Literature Review - Customer Profitability Analysis

4. Customer Profitability Analysis

"Not all customers are created equal" (Jeffry & Franco, 1996, p. 15)

4.1 Introduction

The first step to effectively manage customer relationships is an assessment of not only product profitability, but more importantly, customer profitability. This chapter begins with a review of the literature, highlighting the need for customer profitability analysis. A brief discussion follows, which describes an early approach to CPA termed "first generation profitability analysis", (Bellis-Jones, 1989). The shortcomings of a "first generation" approach are highlighted, and an alternative method - "second generation profitability analysis" is suggested.

Second Generation profitability analysis uses a "lifetime" approach to customer generated costs and revenues (Foster & Gupta, 1994). However, a "lifetime" approach to customer costs and revenues is not without its problems. The problems and issues that arise when allocating and identifying customer costs and revenues, and the treatment of risk, are highlighted and discussed.

Customer profitability analysis provides information about customers. This information can be used in a number of ways and this chapter concludes with

suggestions from the literature about how customer profitability information can be used to support a relationship marketing strategy.

4.2 Background

Several authors believe current management accounting systems fail to provide cost information relating to individual customers (Foster & Gupta, 1994; Foster et al, 1996; Jeffry & Franco, 1996). Most management accounting systems focus on the product, department, or geographic location as the cost object. Foster & Gupta (1994) note that "only rarely can a management accounting system produce customer profitability figures" (p. 5). Furthermore, individual customers are seldom identified as a cost object (Foster & Gupta, 1994).

Stuchfield & Weber (1992) argue that management accounting information "is a by-product of the firm's records of customer transactions and internal production activities" (p. 68). Bellis-Jones, (1989) believes many management accounting systems fail to recognise that the sale transaction is the link between customer and product and "is therefore the *ultimate profit centre*" (p. 27).

A failure to understand the true costs of doing business, has resulted in many firms depleting otherwise profitable areas of their business by providing services at less than their true cost (Bellis-Jones, 1989). Stuchfield & Weber (1992) believe:

"With profitability measures, by customer, by line of business, or by product line, managers can increase accountability for portions of the firm's total earnings, can better allocate the firm's resources, can support bids for new business, and can make well-justified decisions to expand or to exit certain businesses" (p. 54).

Van der Velde (1990) identifies three areas requiring profitability analysis: the firm, its products and its customers. He argues that whilst most firms are readily able to

accurately identify product costs, few can determine the costs involved in doing business with a particular customer or customer segment. Jeffry & Franco (1996), believe few firms can accurately identify their profitable customers. To overcome these problems, Bellis-Jones (1989) suggests that firms conduct a profitability analysis of their customers.

The next section describes first generation customer profitability analysis. First generation customer profitability analysis however, is a simplistic approach to a complex problem, and the shortfalls of first generation customer profitability analysis are highlighted.

4.3 First Generation Customer Profitability Analysis

Customer Profitability Analysis (CPA) involves the identification of the costs and revenues associated with doing business with a customer (Bellis-Jones, 1989; Van der Velde, 1990; Foster & Gupta, 1994; Booth, 1994). This is described by Foster & Gupta (1994), as "first generation customer profitability analysis". Firms that use this form of CPA, typically find that a small percentage of customers contribute a large percentage of the firm's profits, and that up to 70% of customers are unprofitable (Foster & Gupta, 1994).

Table 2 is a typical first generation customer profitability report. The report ranks customers of a pharmaceutical products distributor by profitability. It shows the ratio of cumulative profits to total company profits, for example at the 30th percentile, the total customer contribution to firm profits is 261%. The remaining 70% of customers are unprofitable and are being subsidised by the 30% of profitable customers.

Table 2. First Generation Customer Profitability Report

Customers ranked in terms of profitability	% of profits to total company profits	% of cumulative profits to total company profits
0 - 1%	22%	22%
1 - 5%	57%	79%
5 - 10%	71%	151%
10 - 20%	83%	234%
20 - 30%	27%	261%
30 - 40%	-4%	257%
40 - 50%	-14%	243%
50 - 60%	-18%	225%
60 - 70%	-22%	203%
70 - 80%	-30%	148%
80 - 90%	-30%	148%
90 - 95%	-18%	130%
95 - 99%	-20%	110%
99 - 100%	-10%	100%

Source: Foster & Gupta (1994) p. 1

First generation customer profitability analysis does not break down costs into customer specific costs, general costs and corporate costs. Customer specific costs are costs that are directly traceable to a customer. For example, ATM transaction costs can be directly traced to a customer by analysing that customer's transactions. General costs arise from providing a service for customers. However, they are difficult to trace to a specific customer, for example, the costs of maintaining a branch network of a bank. Corporate costs include areas such as a bank's treasury and marketing departments etc. These costs, by their nature, are very difficult to allocate to customers.

Furthermore, the variability of customer specific costs is not realised in a first generation analysis (Foster & Gupta (1994). In the banking industry it is possible for

a customer to transact in many different ways using a current account[12]. First generation analysis ignores these differences and the consequence is often a misleading indication of customer profitability.

A major failing of first generation CPA is that it does not recognise the profitability potential of non-profitable customers (Foster & Gupta, 1994). From the report shown in table 2, it is clear which customers are profitable and which are unprofitable, yet the analysis only concentrates on the immediate profitability of the customer. It does not analyse the causal factors underlying the customer relationship. This occurs for three reasons:

1. The quality of data used in the analysis is often insufficient to accurately identify revenue factors such as duplicate customers[13] and barter transactions[14] (Foster & Gupta, 1994). First generation CPA does not consolidate customers with several accounts, nor does it account for non-financial transactions;

2. Costs can be distorted by assuming all customer costs are variable; and

3. The analysis assumes that all costs can be assigned to individual customers.

To overcome the shortfalls of first generation customer profitability analysis, second generation customer profitability analysis was developed (Foster & Gupta, 1994). The next section describes second generation customer profitability analysis and

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[12] Cheque writing, direct credits and debits, ATM withdrawals, and EFTPOS transactions are just some examples of current account transactions. The costs for these transactions vary greatly.

[13] Duplicate customers occur when a single customer has more than one account with a firm.

[14] Barter transactions are transactions that do not involve monetary exchange. Instead reciprocal services are provided, for example a paper merchant may require printing services. These could "paid" for by supplying the printing company with paper.

explains how it is a superior analysis tool to first generation customer profitability analysis.

4.4 Second Generation Customer Profitability Analysis

For CPA to be a useful strategic planning tool for management, it is necessary to overcome the weaknesses of a first generation analysis and incorporate the "lifetime" value of customers, (Bellis-Jones, 1989; Storbacka, 1993; Foster & Gupta, 1994; Berry & Britney, 1996). Lifetime CPA is referred to as "second generation customer profitability analysis". This analysis incorporates all the costs and revenues that will occur during the entire life of the relationship (Foster & Gupta, 1994).

Second generation CPA covers the three areas that first generation CPA fails to address. Firstly, its relationship[15] approach allows appropriate identification of lifetime revenues and costs. This means that customers who are reported as unprofitable in a first generation analysis, may be identified as profitable over the lifetime of the relationship (Foster & Gupta, 1994). A lifetime analysis of costs and revenues is advocated by several authors (Storbacka, 1993; Foster & Gupta, 1994; Foster et al, 1996; Hartfeil, 1996). The reason for this is that higher costs often occur at the beginning of a relationship and higher revenues accumulate as the relationship develops.

The term "lifetime analysis" however, is somewhat ambiguous. It is impossible to accurately determine the "lifetime" of a customer relationship. Instead, Storbacka

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[15] Second generation CPA is deemed to be a relationship approach to analysing customer profitability because it recognises that customer transactions are ongoing and not discrete (Storbacka, 1993; Foster & Gupta, 1994)).

(1993) believes that a firm should choose the time horizon most appropriate to them. Furthermore, the time horizon should be a "rolling" horizon. Storbacka (1993), in a study of the Swedish Banking industry, believes a one year time horizon is appropriate for the Banking industry.

Secondly, cost variability differences are identified in a second generation analysis. Some costs may be short-term variable costs (eg. account set-up costs), whilst others are long term variable costs (eg. on-going administration costs). Changes in customer numbers, and/or customer service levels, can also effect customer profitability over time (Foster & Gupta, 1994). These are more easily identified and hence, more correctly matched with revenues, in a second generation CPA report.

Secondly, second generation CPA categorises cost hierarchies (Foster & Gupta, 1994). Cost hierarchies differentiate costs into cost pools to which relevant drivers are attached. As previously mentioned, costs can be allocated into the following cost pools (Foster & Gupta, 1994, p. 3):

- Customer-specific costs,
- General customer costs,
- General corporate costs,

Foster & Gupta (1994) note that this analysis obviates the need to allocate general corporate costs to a specific customer.

Whilst it has been shown how a second generation analysis addresses the shortfalls of a first generation analysis, second generation analysis is not without its problems. The following section addresses the issues involved with second generation CPA.

4.5 Components of Customer Profitability Analysis

The key step in calculating customer profitability lies in understanding what drives profitability (Berry & Britney, 1996; Hartfeil, 1996). This involves an examination of customers, focusing on the behavioural differences that cause differences in profitability (Hartfeil, 1996).

Berry & Britney (1996) note that in the banking industry, profit drivers include:

- Deposit balance,
- Consistent fee income,
- Efficient lending practices,
- Targeted customer development focusing on:
    1. relationship building,
    2. targeting prospects that are within the profitable relationship profile, and,
    3. aggressive retention of profitable relationships.
- Sales and service delivery that meets predetermined profitability parameters.

When analysing profitability drivers such as these, Hartfeil (1996) warns against using average figures. He believes that averages mask the behavioural differences that cause profit to vary between customers. This is due to three factors: revenue, cost and risk. The next section details revenue and highlights key areas and issues to be considered in a second generation analysis.

4.5.1 Revenue

Revenue is generated in the banking sector by product margins and fees (Storbacka, 1993; Hartfeil, 1996). Whilst average fees are sufficient for use in a first generation analysis, Berry & Britney (1996) believe it is necessary to allocate actual fees to individual customers in a second generation analysis.

Whilst Hartfeil (1996) argues that averages should not be used to analyse profitability drivers in general, the use of average account balances in calculating margin revenue is seen as being the optimal method to project margin income (Howell & Soucy, 1990; Anonymous, 1991; Hartfeil, 1996). This is because of fluctuations in margin volume and percentage. However, Howell & Soucy (1990) warn that averages should only be used as a short-term solution, as over a long time period, averages can mask actual revenue.

Whilst most firms can easily identify and trace revenue to specific customers, this is often not the case with customer costs.

4.5.2 Costs

The determination of customer costs poses the greatest problem in analysing the profitability of customers (Storbacka, 1993; Anonymous, 1996; Foster et al, 1996). Customer costs cannot be treated in the same way as product costs (Hartfeil, 1996). In the banking sector, there are four main types of direct customer costs.

- Activity costs,

- Standard Costs,

- Origination Costs, and,

- Delinquency Costs.

4.5.2.1 Activity Costs

When a customer purchases a product or service from a firm, they generate activity costs. Activity costs are accentuated by the variety of transaction options available to customers. For example, bank customers typically have the choice of cheque writing,

electronic funds transfer, automatic tellers, and telephone transactions (Hartfeil, 1996). These transactions can all occur within the same account, yet the costs involved with each activity vary.

Hartfeil (1996) argues that transaction costs are particulary important in a second generation analysis as they "are one of the key differentiators of profit among customers", (p. 25). Furthermore Berry & Britney (1996) suggest the inclusion of transaction intensity in a customer profitability analysis. This will provide an indication of the transactional behaviour of the customer. Transactional behaviour is also an important consideration in the determination of standard costs.

4.5.2.2 Standard Costs.

When analysing customer profitability, Hartfeil (1996) argues the use of standard costs for products is essential, as "the use of actual costs alone could distort the interpretation of the cost and behaviour dynamics of the customer", (p. 26.). This would occur in the situation of an unprofitable customer using profitable transactions.

The next cost consideration is the treatment of origination[16] and delinquency costs[17].

4.5.2.3 Origination Costs and Delinquency Costs.

Origination costs cause variations in product and customer cost allocations (Hartfeil, 1996). Hartfeil (1996) believes it is most useful for a CPA system to allocate variable and fixed origination costs over the life of a product. This provides a more consistent

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[16] Origination costs are the costs associated with setting up a new customer, or a new product.

[17] Delinquency costs are the costs involved in collecting an overdue loan.

picture of customer value, by providing a more accurate assessment of actual customer behaviour and consumption preferences[18]. Furthermore, customers who continue to use the product past its expected lifetime would no longer incur origination costs, highlighting the value of long term customers.

Hartfeil (1996) suggests the precise tracking of delinquency costs to ensure that each customer reflects the full cost of delinquency and collection. Whilst it is often difficult to allocate delinquency costs prior to the customer severing the relationship, Hartfeil (1996) believes the identification of attrition[19] can be assisted by customer profiling and segmentation[20].

The final cost category to consider in a second generation analysis is indirect and general corporate costs.

4.5.2.4 Indirect and General Corporate Costs.

Howell and Soucy (1990) note that indirect and general corporate costs "are rarely assigned to products or customers" (p. 44). As many firms increase their service delivery efforts, indirect and general corporate costs, such as selling costs and administration costs, are growing (Howell & Soucy, 1990). Therefore, it is vital that these costs are allocated costs to customers to gain a more accurate picture of customer profitability (Dale, 1991; Storbacka, 1993; Foster et al, 1996).

The most effective method of allocating indirect and general corporate costs is by recognising that costs have hierarchies and should be allocated to customers based on

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[18] For a detailed discussion on customer behaviour see chapter 4.

[19] Attrition is the loss of customer accounts.

their hierarchical behaviour (Foster & Gupta, 1994; Foster et al ,1996; Anonymous, 1996).

Once customer costs have been identified and allocated to costs pools for inclusion in the second generation analysis, customer risk must be considered. Rose (1991) argues that "only a handful of banks have customer profitability models that take into account the true riskiness of a customer" (p. 22).

4.5.3 Risk

Hartfeil (1996) argues that higher-risk products[21] should be the primary focus of CPA, because higher-risk products exhibit the greatest customer variations. In the banking sector, higher risk products are usually loans to customers. Rose (1991) suggests "translating loan ratings into their public security-market equivalents" (p. 22). This method treats the loan as a bond and assigns a rating to the bond based on the rating of bonds issued by companies with similar financial characteristics. Hartfeil (1996) suggests obtaining credit ratings from independent agencies, such as debtor collection agencies, and using these ratings to adjust for risk.

Once revenue, costs and risk have been analysed and defined, firms can then move onto calculating customer profitability (Hartfeil, 1996).

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[20] A detailed discussion of customer profiling and segmentation occurs later in this chapter.

[21] For example unsecured loans are a higher-risk product than secured loans such as home mortgages.

4.6 Calculating Customer Profitability.

Unlike analysing and defining costs and revenue, calculating customer profitability is comparatively straight forward. Storbacka (1993) proposes the following formula:

$$CRP = RR - RC$$

Where:

CRP = Customer Relationship Profitability,

RR = Relationship Revenue, adjusted for risk,

RC = Relationship Costs adjusted for risk.

Several authors advocate this approach to providing high quality customer profitability information (Rose, 1991; Hartfeil, 1996; Foster et al, 1996).

4.7 Customer Profitability Information

Morehouse et al (1985) believe that marketers and accountants assume that all customers are equally desireable. This has been proven not to be so (Jeffry & Franco, 1996). The information from a CPA system can be useful to firms with a relationship marketing strategy (Stuchfield & Weber, 1992; Storbacka et al, 1993; Storbacka & Luukinen, 1994). One of the key aims of a relationship marketing strategy is to retain customers by the ongoing development of a relationship (Christopher et al, 1991; Harrison; 1993; Storbacka et al, 1994; Reicheld, 1994; Heskett et al, 1994). It must be noted however, that firms should not seek to build relationship with, or retain, all customers, only those which are profitable or can become profitable (Carrol, 1992-

1993; Johnson, 1992; Storbacka, 1993). CPA can be used in several ways to foster

profitable relationships including:

- The analysis of customer behaviour (Howell & Soucy, 1990; Storbacka, 1993; Booth, 1994; Smith & Dikoli, 1995; Hartfeil, 1996; Jeffry & Franco, 1996; Anonymous, 1996),

- Cross-selling products to other customers (Petro, 1990; Storbacka, 1993; Morris, 1994; Hartfeil, 1996),

- Defining customer segments (Petro, 1990; McCormick et al, 1996; Anonymous, 1996; Berry & Britney, 1996) and,

- Negotiating product prices (Storbacka, 1993; Booth, 1994; Hudson, 1994)

This section discusses each of these suggestions and explains how they can be useful

in supporting a relationship marketing strategy and optimise customer retention.

Deepening the customer relationship can enhance customer retention and therefore

customer relationships[22]. This can be achieved by cross-selling to customers. (Petro,

1990; Storbacka, 1993; Morris, 1994; Hartfeil, 1996)

4.7.1 Cross-Selling

Cross-selling involves selling more products to existing customers. This is one of the

key indicators of a retained customer[23]. Constanzo (1995) however, believes that

cross-selling is an ineffective marketing strategy when used in isolation. He argues

the inclusion of CPA information enhances the cross-selling strategies of firms by

highlighting profitable and potentially customers. It is these customers who should be

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[22] See chapter three

[23] See pg 26.

the focus of any cross-selling efforts. The result is profitable customers becoming more profitable, and potentially profitable customers becoming profitable by purchasing more products.

However, customers must purchase products in a profitable manner. Even with the inclusion of CPA information, the concept of cross-selling is flawed as it does not take into account the behaviour that makes a customer profitable (Clark et al, 1994; Constanzo, 1995).

4.7.2 Customer Behaviour

Many authors advocate the use of customer profitability information to analyse customer behaviour (Howell & Soucy, 1990; Storbacka, 1993; Booth, 1994; Smith & Dikoli, 1995; Hartfeil, 1996; Jeffry & Franco, 1996; Anonymous, 1996). The reason for such strong support is because, once profitable customers have been identified, the behaviour that drives their profitability can be discovered and used to modify the behaviour of unprofitable customers.

The analysis and modification of customer behaviour can be used in a relationship marketing strategy to support customer retention. CPA information allows firms to target unprofitable customers and modify their behaviour to mimic the behaviour of profitable customers. This not only fosters the relationship goal of ongoing customer contact, but can also help firms to redefine their customer retention strategy.(Smith, 1993; Smith & Dikolli, 1995).

The identification of customer behaviour and profitability can also be the basis of customer segmentation (Petro, 1990; McCormick et al, 1996; Anonymous, 1996; Berry & Britney, 1996).

4.7.3 Customer Segmentation

Segmentation recognises that certain individuals respond to certain options in a similar way (Larson, 1996). Once identified, these groups can then be used as the basis for extending customer relationships and/or modifying customer behaviour. Smith (1995) argues that a customer segmentation strategy that includes customer profitability is an essential part of a relationship marketing strategy. He believes that once customers have been segmented into a matrix based on customer type, customer profitability should be included. Customer relationships can then be assessed, based on customer type and profitability, and non-value added activites can be reduced and/or eliminated. Furthermore, the matrix can be used to strengthen or terminate customer relationships, based on customer profitability (Smith, 1993; Smith & Dikolli, 1995).

Should the relationship be retained, it may be necessary to enter into price negotiations with the customer.

4.7.4 Price Negotiation

Price negotiation may be necessary for two reasons. Firstly, if the customer is unprofitable it may be necessary to re-price a product(s) to improve profitability. Secondly, the customer may be profitable and the relationship could sustain a reduction in price to foster customer satisfaction and strengthen the relationship. Clearly, CPA information is an invaluable tool to assist in this process. (Storbacka, 1993; Booth, 1994; Hudson, 1994). Information on a particular customer's profitability enables a firm to enter price negotiations knowing the full implications of any pricing decisions.

4.8 Chapter Summary

CPA involves the identification of customer revenue, costs and risk. In the banking industry customer revenue includes all fees and margins charged to customers. All customer costs should be included in the analysis and categorised into cost hierarchies, in particular; customer specific, general customer and corporate costs.

The analysis should reflect the "lifetime" of the customer relationship. In the banking industry a twelve month "rolling horizon" is appropriate (Storbacka, 1993). Once revenue, costs and a relationship time horizon have been identified, ALL customer revenue and costs can be risk adjusted to provide a measurement of customer profitability.

Hartfeil (1996) argues the end result of a CPA system is information. Customer profitability information can be used to; analyse customer behaviour, segment customers, identify cross-selling opportunities and as a price negotiation tool. These are all useful tools to support a relationship marketing strategy as they all help to optomise one of the key aims in relationship marketing – customer retention. The following chapter describes the relationship markting strategy at the bank.

Chapter Five: Research Results – Relationship Marketing

5. Research Results - Relationship Marketing

5.1 Introduction

This chapter describes the relationship marketing strategy at the Bank. Differences and/or similarities to the literature are highlighted and discussed throughout the chapter.

5.2 The Bank's Relationship Marketing Strategy

The bank follows a relationship marketing strategy. Whilst the bank does not specifically define the term, all respondents believe a relationship marketing strategy is used at the bank. When asked if the bank followed a relationship marketing strategy one respondent replied *"Yes, definitely"*. Another stated:

> *It (relationship marketing) is the primary method of service delivery to the customer...we don't really have any other form of direct delivery to business customers.*

There is a belief that relationship marketing occurred *"in some products"* and, using term deposits as an example: *"there would be a specific tactical plan put together to manage the retention of funds[24] (customers) brought in over a campaign period"*.

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[24] The bank often uses the term "funds" to refer to customers. This is because customers are often represented by their account balances.

The underlying reason for implementation of a relationship marketing strategy, was differentiation:

> *"Banking is primarily about relationships. Anybody can dish up accounts or loans and it is very difficult to differentiate yourself on products or price, for example. The only way to conduct banking effectively, certainly in the rural market, is to bank with the people, and that is the key differentiator"*

Another stated *"It comes down to the service. Because it is a service industry, you do not have a lot of differentiation amongst your product offerings"*. One reason given for the adoption of a relationship marketing strategy was the deregulation of the banking industry[25]:

> *"Basically New Zealand was over-banked, and the question was, how were you going to drive the business forward in an area where you were all targeting the same customers. The key was to find out what really makes a difference to the customer"*

Christopher et al (1991) suggest that a relationship marketing strategy is characterised by a high level of customer contact. The bank uses several techniques to maintain a high level of customer contact.

5.2.1 High Customer Contact

The belief that a transaction approach is no longer appropriate was echoed at the bank: *"Anyone can dish up transaction accounts"*. At the bank, customer contact is actively maintained, and enhancing the quality and longevity of customer relationships is a priority. Customer contact occurs in different ways, depending on the customer[26].

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[25] For a discussion on deregulation of the New Zealand banking industry see *The Reserve Bank Bulletin*, Sep., 1995.

[26] For a definition of the three different types of customers, see chapter 2.

In the middle business sector the main method of customer contact is the service interview. This is a customer needs analysis conducted annually on all middle business customers. A distinction was drawn between the service interview and an account review that was seen as *"a pretty nasty thing to do".* This is because an account review is often perceived by customers as an examination of *"how much money they do or don't have".* The service interview, on the other hand, is:

> *Going out and being proactive. Looking at the customer's financial needs, how they are going to change and what we are going to do to help them...it is very much a needs analysis.*

Middle business customers were generally not contacted prior to transactions. It was explained, *"If a customer contacts the bank and says "I need this", we will go out and talk to them".* If it is agreed that there is a need, the customer is monitored on a separate database called the sales funnel reporting system.

This system *"tracks transactions when they are initiated".* The example given was of a business manager who knows a customer has funds available for deposit. The business manager will approach the customer in an attempt to gain that business. At each contact with the customer, information is collected and updated in the system. The transaction is *"tracked"* on the sales funnel reporting system from initiation[27] through to either deal closure, or, if the deal is not closed, it was referred to as, *"I've lost them off the board somewhere along the way",* in other words the potential customer did not join the bank.

The rural banking sector has a sophisticated approach to customer interaction:

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[27] Initiation is the initial customer prospecting phase.

> *We interact with customers in all sorts of ways - remotely by fax and telephone, face to face, both in the branch, but 70% to 80% of it now is on the farm. All our relationship managers are fully mobile with 4WD vehicles, cell phones and laptops. Whilst most of it happens on the farm, obviously we still have our branch network for customers who prefer that.*

Contact with the customer prior to conducting transactions does occur in the rural sector: *"Yes, we talk to them before they buy a product - absolutely"*. Interaction with a customer, following a transaction also occurs, however it is not formalised bank policy:

> *There is no "Mr Farmer, we notice that you bought this product on this day. I am now ringing you up two days later to find out if you're happy with it or not". That process happens more informally, because the customer is managed on a relationship level and the relationship managers have targets for visits. They have to go out and see the customer periodically so following up product purchases are covered at that time.*

The frequency of contact with customers by the rural relationship managers varied according to the customer segment[28]. The premiere rural segment consists of *"very high gross income farmers"*. They receive *"at least 4 visits a year"*. High value traditionals, are defined as *"the middle gross income band of farmers"*. Farmers in this category receive:

> *"at least one visit a year, sometimes two. It is in the relationship manager's Key Result Areas[29] to visit the farmer once, but some will get two visits. The top operators are making a lot of money. Don't believe the "Paul Holmes[30]" version of the rural sector which is doom, gloom and despair, it is nonsense. There are some very very astute top customers doing very well and it is essential that we maintain regular contact with those farmers.*

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[28] A detailed description of customer segmentation at the Bank occurs later in this chapter.

[29] Key Result Areas are the basis of performance evaluation at the bank.

[30] Paul Holmes is a media personality in New Zealand, with a reputation for sensationalising social issues.

Low value traditionals are defined as *"the lowest gross income band of rural customers"*, and are *"reactively managed"*. It was described as *"You want something, you come to us and on our terms"*. This occurs because the main basis of customer segmentation at the bank is income[31], with the underlying assumption being, that higher gross income customers are more profitable that lower income customers. Howell & Soucy (1990) note that this is a common assumption: "many companies think their highest-volume customers are their most profitable" (p. 44). Clark et al (1994) argue that high volume customers may be unprofitable as the transactions may be conducted through unprofitable or higher cost channels leading to an unprofitable customer relationship. It was explained however, that:

> *The number of visits each customer receives is not cast in stone. Farmers' incomes fluctuate, and so some will migrate between segments. We are constantly monitoring that and tailor our visits accordingly.*

In the home loan area, customer contact took two distinct directions:

> *There is a reactive interaction. This is where a customer approaches us through whatever channel, for a particular reason. Secondly, there is our proactive approach where we try to drive leads through our mass marketing, or our tailored direct marketing, or whichever channel we choose. Whichever way we do it, we also have staff at the front line proactively marketing the customers that they manage.*

The home loan area also interacted with customers, prior to, and following a transaction: *"it is all about looking for opportunities and uncovering needs"*. Relationship managers use several techniques to uncover those needs:

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[31] The use of income as a surrogate for profitability is prevalent throughout all areas of the bank. The consequences of this are discussed further in chapter 9.

> *CARE interviews[32] are all about getting to know your customer better, talking to them and uncovering their needs.*

Post transaction interaction was also an integral part of customer interaction in the home loan area:

> *Say we arrange a home loan for a customer through a mobile manager, then everything gets into the process. A relationship banker would then follow up with that customer and complete the relationship with things like, "how are your banking arrangements organised?, is it convenient for you?, do you need an ATM card?". Following up on a transaction is all about bringing the customer's total banking on board with us.*

The ongoing contact with customers means the relationship takes place over time. Recall that Storbacka et al (1994) argue that customer retention and relationship longevity represent similar concepts. At the bank, customer retention was viewed in a similar vein.

5.2.2 Customer Retention

Often the terms retention and retained customer were used interchangeably, when referring to a customer relationship:

- *everything we do is about retaining the business (customers);*

- *There are specific tactical plans for the retention of funds[33] (customers).*

Relationship longevity was the factor that determined retained customers as the bank. Arnold et al (1996) found that the length of time a customer had conducted business

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[32] An interview is conducted where customer wants and needs are analysed. Interviews are described as a financial "Warrant of Fitness".

[33] The Bank uses the terms funds, accounts, and customers interchangeably. These terms all refer to customers.

with a bank was often indicator of a retained customer[34]. Retention of customers was evident in all areas of the Bank.

The middle business area incorporates customer retention within its relationship marketing strategy:

> *"The relationship managers have portfolios of customers to manage and certainly they must concentrate on retaining those customers".* Furthermore *"we want to lock in customer loyalty".*

The dangers of losing a customer group[35] were highlighted:

> *We get a daily balance report on the whole customer group. For example XYZ company, their service company and their partners personal accounts including their spouse. If a partner's wife was to write a cheque, and we bounced it, it could be very dangerous for us.*

Berry & Britney (1996) note that a business customer's relationship should include all business and personal accounts. It is believed that business owners "want a relationship" (p. 38) and neglecting personal accounts can be detrimental to the relationship. This view is clearly evident at the bank. Whilst total customer retention is the aim, it is acknowledged that, under some circumstances, it is necessary to discontinue the relationship with some customers:

> *If the customer has borrowed from us and their trade is going in the wrong direction then we would try to flick them on to someone else. The decision is based on their risk profile because that is what we understand. However, we hope that in the future we can base our exit strategy on customer profitability.*

The Rural Banking area also strives for customer retention:

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[34] This study was conducted in the same bank as this thesis.

[35] A customer group includes all accounts that relate to a particular customer. This includes the main customer account, subsidiaries, personal accounts of the principals in the organisation and also includes spouses accounts.

Even in our low-end, non-profitable segment, we do have competitors in the market who are actively discontinuing the relationship with those customers. We, at the moment, certainly have a position of not wanting to actively discontinue the relationship, but we do reactively manage, and we penetrate at any opportunity, to try and increase the revenue and improve the profitability

As with the middle business area, the rural area also recognised that sometimes it is necessary to discontinue the relationship:

Well, the only reason that we would actively discontinue a customer relationship is based on credit quality. If they are about to go "belly-up", or look like they are about to, then obviously any bank is exactly the same. You don't want to lose your money, so you would exit customers on that basis.

Despite the acknowledgement by the middle business and rural banking areas, that is was sometimes necessary to end a customer relationship, customer retention is also a priority in the home loan area:

Everything we do is all about retention. I am always looking at what the impact on customer loyalty and retention will be for every aspect of policy that I present, for example, fee policy for home loans.

It was also stated that the customer retention strategy included an overall approach towards the customer:

It's not something that we can pull a document out and say "this is what we do", but it is uppermost in our minds the whole time.

Storbacka et al (1994) argue that relationship longevity and customer retention results from customer satisfaction.

5.2.3 Customer Satisfaction

The bank strives to achieve customer satisfaction. However, it was recognised that *"we don't achieve it as well as what we would like"*. The main evidence cited for this was the bank's performance on industry service monitors. These are surveys

undertaken by independent research companies, on the performance of all banks in the

industry, to which any bank can subscribe. It was noted that:

> *"It* (customer satisfaction*) hasn't been an incredibly pretty sight"*, but it was
> recognised that *"It is not generally a pretty sight for most banks"*.

The bank acknowledged that it was *"in the middle of the pack"*, with regard to

customer satisfaction as measured by the independent monitors. It was noted however,

that whilst they may be in the *"middle of the pack"* with regards to customer's

perceptions of satisfaction:

> *The size of the perception is quite narrow...all the banks flock in a band in
> the average to bad range. If we could leap out of that pack, up towards the
> better end of the scale, we would have a major opportunity...actually
> realising that opportunity is going to be a damn difficult process.*

Figure 1 shows the bank's position in the customer satisfaction measure. The scale of

1 to 100 represents bank customer's individual perceptions of satisfaction, zero being

totally dissatisfied and 100 being totally satisfied. All banks included in the survey

scored between 40 and 44, with the bank in this study scoring 42.

Figure 1. The Customer Satisfaction Measure[36].

The Bank's position

| 0 | 10 | 20 | 30 | 40 | 50 | 60 | 70 | 80 | 90 | 100 |

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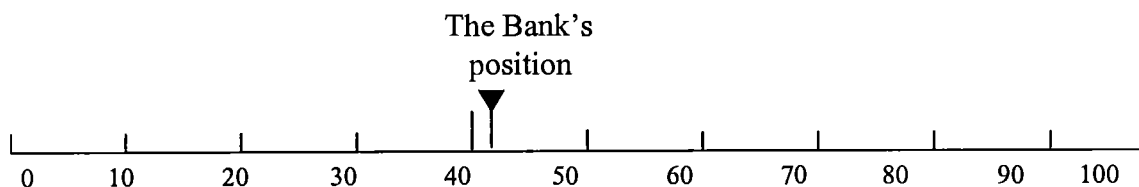
[36] As determined by an independent research company.

To improve customer satisfaction, the bank would need to overcome what it saw as the main reasons for this middle position, namely, *"our legacy of where we have come from, and the direction we are taking"*. This refers to the bank's previous ownership by the New Zealand Government and subsequent sale to an off-shore parent. The *"sell-out to overseas interests"* was believed to generate dissatisfaction in some customers, despite efforts by the bank to improve product and service delivery.

Despite customer's apparent lack of satisfaction, as reported by the industry service monitors, all interviewees acknowledged that there were customers that remained with the bank despite being unsatisfied. The predominant view on why unsatisfied customer remained were the existence of exit barriers:

> *"It is a big hassle to change";*

> *"It can be expensive for the customer";*

> *"With lending products especially, there are mortgages in place and it is not always easy to change";*

> *"With fixed rate products, there are often penalties to leave";*

> *"Heavily geared customers may find it difficult to get borrowing elsewhere"*

Customers in the middle business sector often required complicated transaction arrangements. An example was given of a city council, which could typically receive several thousand automatic credit transactions from rate payers, or a large employer, such as a university, which typically has several thousand payments to staff and students each pay period. If the customer's transactions are complicated, the correct

and efficient transfer of those transactions from one bank to another is important. For these customers, with very complicated transactions:

> *"you can almost bet that whichever bank you change to will "cock it up" [sic], and you can definitely bet that the bank that you are moving from will "cock it up" [sic] because they don't care any more".*

Hence, the customer will often stay with the bank, despite their dissatisfaction. The main reason for this is the threat of a new bank exhibiting the same unsatisfactory behaviour as their current bank, or in other words *"better the devil you know"*.

Another factor influencing customer's inertia to leave the bank was the cost of moving securities:

> *If a customer has a loan(s), it often means they will have securities to change around, either houses or commercial properties that have mortgages over them. As soon as there is borrowing, lawyers become involved and that gets expensive.*

The rural sector noted the same cost barrier:

> *Farmers are big on loans, they are not so big on deposits. Often, where you have complex relationships, there are a lot of securities in place, and it is not that easy to shift".*

Views on why unsatisfied customers remained with the bank differed in the home loan area. It was believed that customers with home loans drew a distinction between products and service delivery. Whilst a customer may be unsatisfied with a particular product or policy, it was believed that a customer would continue the relationship if they experienced satisfaction with the service they received:

> *Often when a customer leaves the bank, it is the result of a lot of little things that have irked them along the way. It is often "the straw that breaks the camel's back". That is why you have to be particularly aware of getting your service delivery right every time...You can't predict what is going to annoy some customers. Some of the complaints we get are about a particular policy,*

or particular aspects of a product, but more often they are about the interactions they have with staff.

Jackson (1993) notes that more customers leave because of dissatisfaction with service, than leave because of poor quality products or pricing issues. This highlights the importance of a high level of quality service delivery, and the importance of customer interaction.

This chapter has described the main components of the bank's relationship marketing strategy. A chapter summary follows in which the results are discussed and compared to the literature.

5.3 Chapter Summary

The relationship marketing strategy at the bank demonstrates many of the characteristics of relationship marketing noted by Christopher et al (1991). Two aspects of the Christopher et al (1991) framework dominate the Bank's relationship marketing strategy.

Customer retention and relationship longevity were viewed as a priority in all areas that were examined. There is also a definite move away from the single sales transaction to a relationship approach based on relational exchange. Customer interaction, prior to and following transactions, was noted by all interviewees, as was increased customer contact.

Other themes from the Christopher et al (1991) framework were documented. The bank has a commitment to its customers and a strong orientation on product benefits. The primary function of the relationship manager is to meet the customer's financial needs. This reinforces the move from a sales culture to a customer culture, where it

is recognised that selling every product that is available to a customer may not be in the best interests of that customer or the bank.

All areas of the bank noted the danger of not meeting a customer's needs. Correct identification of a product(s) to fulfil customer needs was paramount to the success of the bank's relationship marketing strategy. Failure to do so often resulted in the customer defecting. This goes against one of the primary aims of the bank's relationship marketing strategy - customer retention.

High levels of customer service were also evident. The Bank recognised that failing to meet the service levels required by customers often resulted in the customer terminating the relationship.

Whilst the bank strived for total customer retention it has been argued that firms should not strive to build a relationship with every customer, only those that are profitable or can become profitable (Carrol, 1992-1993; Johnson, 1992; Storbacka, 1993). The accepted method of determining customer profitability is by using a customer profitability analysis system. The next chapter describes the CPA system at the bank.

Chapter Six: Research Results - Customer Profitability Analysis

6. Research Results - Customer Profitability Analysis

6.1 The Bank's Current Customer Profitability Analysis System

The current model for determining customer profitability at the bank was described as being *"very limited"*. It was explained that *"The model as it stands now, dates back a good six or seven years, and the information within it has not been updated for quite sometime"*. The outdated information means the bank can no longer identify which of its customers are profitable and which are unprofitable,

> *We had a pretty good idea which were our profitable customers in the past, but our costing information certainly got out of date and we have now lost the ability to identify the profitable customers. However, we are trying to regain that ability.*

Furthermore the model:

> *Only looks at total customer costs...it was nothing flash...it showed the volume of all customer transactions, international business...everything that could be physically tracked for that customer was included...you name it, it was there...then the volume was multiplied by the fees that customer paid.*

The figures that are used in the current CPA system are not directly accessible by all staff. To calculate a customer's profitability it is necessary for a relationship manager to *"request a report to be printed out by the marketing department at head office showing the total volume of a customer's relationship"*. The customer's volume information from this report is then entered into a spreadsheet containing cost information, which calculates the customer's profitability:

> *We had quite a large spreadsheet model that had a lot of existing cost information in it.   You then have to manually transpose the volume figures into the spreadsheet... "yes they* (the customer*) did 4032 transactions through their current account and they did this that and the other, they had this much worth of facilities, they pay these kind of fees ".*

This would provide a picture of a customer's profitability.   The results from the spreadsheet model would then be used:

> *at the annual relationship review of all a customer's facilities.   We would use the profitability information, along with their creditworthiness, to assess the relationship.*

These features are typical of a first generation customer profitability analysis model. What is interesting about the calculation of customer profitability is that whilst the current model does not include a measure of customer risk, *creditworthiness* is considered along with the customer profitability information when the customer relationship is assessed.   Further implications of the treatment of risk in a customer profitability analysis system are discussed later in this section and in chapter 9.

Unfortunately, because the system has *"fallen into a state of disrepair"*, it was not possible to obtain a profitability report to compare with the profitability report in table 1.   However, it was determined that the current CPA system does not break down costs into customer specific, general and corporate costs, as suggested by Foster & Gupta (1994).

The ability to correctly determine customer profitability will be regained by the bank, with the introduction of the new CPA system, in approximately six months.

6.2 The Bank's Proposed Customer Profitability Analysis System

The new CPA model at the bank will have many features of a second generation CPA analysis:

> *The new model will have up to date costing information that will be separated into direct and indirect costs, so that marginal costing etcetera, can be calculated.*

As suggested by Foster & Gupta (1994), splitting costs into direct and indirect is a feature of second generation customer profitability analysis.

Another feature of a second generation analysis is the lifetime projection of customer costs and revenues. At the bank, it was explained that the new CPA system will *"project customer costs and revenues forward for the upcoming 12 month period, and roll the horizon over periodically"*. The bank's choice of a 12 month "rolling" time horizon supports the literature (Storbacka, 1993).

Once a time span for lifetime analysis has been identified, a number of other issues face firms when designing a second generation customer profitability analysis system. This was certainly the case at the bank. The design of the new customer profitability analysis system has raised many issues, the first of which is to understand what drives customer profitability (Berry & Britney, 1996; Hartfeil, 1996).

6.2.1 Drivers of Customer Profitability

At the bank there was no firm consensus of opinion on what drives customer profitability. In the middle business area it is believed that customer profitability is driven by customer behaviour, in particular the types of products and services a customer uses and their relative costs:

> *"It is very much a function of volume to value - the quantity of services and products a customer uses against what value they (the customers) are to us at the end of the day"*

Income was seen as the main customer profitability driver in the rural sector, *"income drives profitability, without a doubt"*. What is interesting about this viewpoint is that

"income" refers to the farmer's gross income, not fee income as suggested by Berry & Britney (1996). The bank believes that income is easy to define[37]. This could account for the belief that income is the main driver of customer profitability. Furthermore, the only customer profitability information available to the bank has been the output from a first generation CPA system. As previously explained a first generation CPA system provides an incomplete picture of a customer's true profitabiltiy. Such an analysis may show a correlation between income and profitability. This is certainly an area that requires further research and is discussed further in chapter 9.

In the home loans area there is consensus with Berry & Britney (1996). It is believed that *"definitely the fee revenue"* drives customer profitability. Berry & Britney (1996) qualify fee income by stating it should be consistent. Fee consistency is also deemed to be important in the home loan area:

> *We are constantly monitoring customer behaviour, and trying to gain a better understanding of collection rates for our different products...It's really understanding our pricing and fee strategy in order to maintain fee income.*

The home loan area also noted that customer profitability is driven by the margin between what the bank pays customers for deposits and what it charges customers for loans, *"margin management is one of the key drivers of (customer) profitability"*.

In the finance area there is no definitive opinion as to what drives customer profitability. The finance department is developing the new CPA model in consultation with the middle business, rural and home loan areas. Therefore it was

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[37] Bank income is discussed in detail in the next section.

deemed appropriate to discover what the finance department believes drives profitability. One interviewee believed:

> *My opinion is that it doesn't matter what sort of customer you are, how long you've been with the bank or what size your balances are. Profitability can be determined by some of those factors but no particular one fits total bank profitability...Many of our customers can be profitable with low balances...a customer with two products can be more profitable than a customer with ten products...I've also seen research from Washington regarding how long a customer has been with the bank and relating that to profitability...I believe they are all fallacies...I don't know that anyone really understands what drives profitability.*

What is particularly interesting about this view, is that it goes against some of the uses the bank is proposing for the new CPA system[38]. The implications of this view are also discussed in Chapter 9. Another important point to note is that this interviewee seems to confuse customer profitability with bank profitability. An individual customer's profitability contributes to total firm profitability (Johnson, 1992). Therefore customers can be seen as the individual "bricks in the wall" of total profitability for the bank. Failing to recognise this can have serious implications when desiging a CPA system and these are put forward in chapter 9.

Indentifying what drives customer profitability has been a source of confusion for the bank, with only one out of the four areas investigated providing consensus with the literature. The implications of this are discussed in more detail in the chapter summary. The discussion now centres on the components of the bank's proposed customer profitability analysis system.

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[38] The proposed uses of the customer profitability information are discussed later in this chapter.

6.2.2 Components of Customer Profitability Analysis

Recall from chapter 3 that customer profitability analysis involves the identification of customer revenue, customer costs and customer risk. The bank's treatment of these areas follows, starting with the issues involved in the identification and allocation of customer revenue.

6.2.2.1 Revenue

At the bank, revenue was perceived to be *"easily definable"*. The middle business, rural banking and home loan areas all recognised customer revenue from three areas:

- fees - the charge for using a particular product or service, eg. Cheque clearance fees, transaction volume fees, cash handling fees etc,

- margins - the difference between what the Bank pays customers for funds on deposit and what it charges customers for loans, and,

- financial products - commission collected from products such as life insurance, etc.

6.2.2.1.1 Fee Revenue

Fee revenue is easily traced directly to the customer. This is because fees are charged periodically to individual customers. One problem facing the bank is the treatment of fee revenue when projecting lifetime revenue:

> *You get into issues of seasonality. Every single fee type that the bank has, had to be analysed to understand how they are charged. Some are one-off fees, whilst others are charged monthly, quarterly, or yearly. The characteristics of each individual fee type are being built into the new CPA system.*

Another source of revenue for the bank is margins.

<u>6.2.2.1.2 Margin Income</u>

Like fees, margins are also not difficult to trace to customers:

> *It is very simple. It is the difference between the cost of funds and the retail purchase. If the cost of funds is 7% and the customer is being charges 9%, then the margin is 2%. On a one million dollar loan, that is $20,000 of revenue.*

The problem associated with projecting margin revenue for a second generation CPA,

is the difficulty in estimating what volume of margins are going to be generated by

customers and the margin itself:

> *The margin side has two components, the margin percentage and the margin volume. We have to try and estimate what is going to happen to interest rates in the up-coming 12 months to determine our margin percentage. We also need to estimate what volume of each product a customer is going to consume.*

Relationship managers will be called on to help with this process. The information

gathered at the CARE interview, along with information gathered from every

interaction with a customer, will be used to project a customer's future consumption:

> *Their (the customer's) facilities may have changed recently. Or, in our discussions, we determine that they are actually going to borrow money, or they have some extra money coming in from overseas. Those factors are going to affect their account balances, and hence our revenue projections.*

Gathering information from customers regarding their future intentions to purchase or

cancel margin based products does not obviate the problem. As customers deposit

funds into their accounts or repay loans, their balances fluctuate, effecting the margin

projections. To deal with the problem of margin volume the bank will use monthly

averages:

> *The margin balances we show are the average monthly margin balances and from this we calculate an average monthly margin transfer rate for each customer, to reflect fluctuations in the margin balances. The margins will be based on the actual rate that is applicable to the customer multiplied by the average transfer rate.*

Whilst Hartfeil (1996) argues that averages should not be used to analyse profitability drivers in general, the use of average account balances in calculating margin revenue is seen as being the optimal method to project margin income (Howell & Soucy, 1990; Anonymous, 1991; Hartfeil, 1996). This is because of the fluctuations in margin volume and percentage noted at the bank. However, Howell & Soucy (1990) warn that averages should only be used as a short-term solution, as over a long time period, averages can mask actual revenue. The bank was uncertain as to how long they would use average margins. Margins are also negotiable:

> *We can change the margin depending on the customer. If they are beating us around the head on price for one particular product, we may let them have it to keep the relationship group[39] with us.*

In the new CPA system, actual margins will be used. This will highlight customers who are unprofitable due to low margins, allowing management to take appropriate action. Furthermore, customers who are highly profitable, due to excessive margins, can be identified and their margins reviewed to alleviate any subsidisation of un-profitable customers as discussed earlier.

The third source of revenue for the bank is from financial products.

6.2.2.1.3 Revenue from Financial Products.

As with revenue from fees and margins, the bank can readily allocate revenue from financial products to customers:

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[39] A relationship group includes all business, and personal accounts of all company principals and their families.

We are in a partnership with one of the big players in the insurance industry. We simply collect commission on all premiums that are paid. We know exactly how much we are going to get and which customers it relates to.

It has been shown that customer revenue at the bank is perceived as being *"easily definable"*. This is not the case with the definition and allocation of customer costs.

6.2.2.2 Costs

The determination of customer costs poses the greatest problem in analysing the profitability of customers (Storbacka, 1993; Anonymous, 1996; Foster et al, 1996). In accordance with Foster & Gupta (1994) the bank will be recognising four different types of customer costs in its new CPA model:

- Activity costs,

- Standard costs,

- Origination and delinquency costs and,

- Indirect and general corporate costs.

6.2.2.2.1 Activity Costs.

At the bank it was acknowledged that there were different costs associated with different customer activities:

Yes, obviously branch transactions are the most expensive type, followed by cheques, and down on through the electronic transactions, which tend to be less expensive than the branch transactions.

Transaction intensity was also recognised at the bank, as an important aspect of customer costs:

Some customers have very heavy transaction requirements. Customers who pay large payrolls, or receive a large number of automatic payments, need to

be monitored closely so that we can provide them with the best service and at the same time minimise their costs as well as our own.

The bank is concentrating on analysing transaction intensity and type by looking at customer behaviour[40]. If necessary, customer behaviour can be modified to minimise activity costs for both the customer and the bank. Like direct customer costs, standard costs are directly traceable to a customer using the bank's transaction database.

6.2.2.2.2 Standard Costs.

Standard costs are the second cost consideration. At the bank, standard costs are used for pricing both products and services,

"Most of our fees are standardised across the board. "

"Our cheque clearance fee is standard, regardless of who the customer is, or how much that product or service actually costs us to sell to that customer".

"Our monthly activity fee on cheque accounts is based purely on number of transactions, not transaction types".

"Loan set-up fees are a percentage of the amount borrowed regardless of who the loan is for[41] ".

However, The bank sometimes alters these charges for different customers:

Some customers are given fee free banking. This is usually based on the value of the customer relationship to us.

The bank does this by charging the customer the appropriate fees, but then credits the fees back to the customer. This will allow the bank to conduct a multi-scenario analysis on customers, by calculating customer profitability with and without the fees, making the effects of providing free fees on a customer's profitability evident. Unlike

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[40] Customer behaviour is discussed in detail in chapter 7.

[41] Recall it was recognised that it costs more to set-up a loan for a new customer than it does to set-up a loan for an existing customer.

direct and standard customer costs, origination and delinquency costs pose a significant problem.

6.2.2.2.3 Origination Costs and Delinquency Costs.

The bank will include all origination costs in its new CPA system:

> *We have three main costs for a product; an opening cost (of an account), the cost of maintaining (the product and/or account), and the cost of closure. We pick up how many accounts for a particular product have been opened in the period and allocate the origination costs accordingly.*

Unfortunately it was not possible to ascertain how origination costs were amortised over the life of the product and or the life of the relationship[42]. This was also the case for delinquency costs.

Hartfeil (1996) suggests the precise tracking of delinquency costs to ensure that each customer reflects the full cost of delinquency and collection.

As mentioned in the previous section, the bank recognises *"costs of account closure"*. Costs of account closure refers to the actual costs of closing an account should a customer leave the bank. This includes, for example, any costs that are associated with early closure of a loan. Hartfeil (1996) believes customer profiling and segmentation[43] can identify attrition[44]. Customer profiling occurred at the bank, and was undertaken by the marketing department.

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[42] Due to the commercial sensitivity of the new system, it was not possible to gain information on some areas of the CPA system. See chapter 6 for a more detailed discussion on the implications of this limitation.

[43] See chapter 8 for a detailed discussion of customer profiling and segmentation.

[44] Attrition is the loss of customer accounts.

Marketing has done some customer profiling to identify which customers are at risk of taking off.

Delinquency costs are treated differently. Whilst it was recognised that delinquency costs are a cost that can be directly traced to a customer, it was unclear as to whether they would be included in the CPA system. When the interviews were conducted, the bank had still not decided on how these costs would be treated within the CPA model. The proposed treatment of indirect and general corporate costs, however, had been finalised.

6.2.2.2.4 Indirect and General Corporate Costs.

Recall that Foster & Gupta (1994) recommend the following cost hierarchies for indirect and general corporate costs:

- Customer-specific costs,

- General customer costs, and,

- General corporate costs.

The bank identifies cost these hierarchies:

We have average general costs for activities that directly relate to servicing the customer. With the new model, we will go to the person directly in contact with the customer, and they will be able to input the exact amount of time spent on that customer. From this we can then strip out all the directly traceable costs such as business manager costs, analyst's salary costs and non-salary costs, and put them back in the model based on actual not average costs.

General corporate costs "*aren't taken down to a customer level*". These costs are taken "*straight from our General Ledger down to a product level*".

Whilst the *"vast majority"* of indirect costs will be included in the new CPA model, there are some costs that will be excluded. Like general corporate costs, the indirect costs are obtained from the bank's general ledger. It was noted however, that *"extraordinary costs and abnormal items will not be allocated to customers"*. Unfortunately, it was not possible to determine the reason for the exclusion of extraordinary costs and abnormal items from the CPA. The exclusion of some costs from the CPA model could have serious implications on the final determination of customer profitability. These are noted and discussed in chapter 9.

Having established the basis of revenue and cost recognition at the bank, there is one further consideration before customer profitability can be calculated, namely the risk of the customer. Rose (1991) believes that "only a handful of banks have customer profitability models that take into account the true riskiness of a customer" (p. 22). The reason for banks excluding risk in a CPA model could be due to the difficulties associated with measuring customer risk. The bank is experiencing difficulties in its treatment of risk in the new CPA model.

6.2.2.3 Risk

Hartfeil (1996) argues that higher-risk products[45] should be the primary focus of CPA, because higher-risk products exhibit the greatest customer variations. This was evident at the bank:

> *The risk is quite an interesting point actually. We are still trying to get to grips with exactly how risky a customer is going to be so we can present it*

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[45] For example unsecured loans are a higher-risk product than secured loans such as home mortgages.

> *through the model. The way it is looking at the moment, is that if you are a high risk customer you are going to appear more profitable.*

This occurs because higher risk customers are charged a higher margin on products and services and therefore their revenue is higher than a lower risk customer. The bank has not yet decided what approach it is going to take when it includes risk into the customer profitability analysis: *"we have our resident expert working on that at the moment"*. It was recognised that:

> *It is an area of concern, and it is going to come down to how the information is reported[46].*

Recall, from the discussion on the current customer profitability model, that the bank currently considers *"creditworthiness"* alongside the customer profitability information. There was no mention of treating risk in the same manner with the implementation of the new customer profitability analysis system. Also remember this comment referring to the bank's customer retention strategy *"...the decision is based on their risk profile because that is what we understand"*. The bank clearly understands risk and creditworthiness, yet confusion and apprehension surround the inclusion of this information in its proposed CPA system. Despite the recommendations in the literature (Rose, 1991; Hartfeil, 1996), this author argues that incorporating risk within a CPA system may not be the best option for all firms. Instead, risk should be reported separately and used in conjunction with the CPA information to provide a true measure of customer profitability. The implications of this are discussed further in chapter 9.

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[46] For a more detailed discussion on the consequences of reporting risk, see chapter 5.

Once revenue, costs and risk have been analysed and defined, firms can then calculate customer profitability (Hartfeil, 1996).

6.2.3 Calculating Customer Profitability.

The bank will use the formula proposed by Storbacka (1993);

> *"customer profitability will simply be the difference between revenues and costs".*

However, as was discussed in the previous section, the bank is undecided how it will approach risk. This will obviously impact on the risk adjusted revenue and cost figures incorporated in the new system.

This chapter has described the current and proposed CPA systems at the bank. Several issues were highlighted regarding the design of the new CPA system and they are summarised in the next section.

6.3 Chapter Summary

The current CPA system at the bank is typical of a first generation CPA system. However, it is ineffective, due to outdated cost information. Recognising the limitations of supporting a relationship marketing strategy without an accurate determination of customer profitability, the bank is in the process of developing a new CPA system. The new CPA system will incorporate many of the features and advantages of a second generation CPA system and will be introduced in approximately six months.

The bank's treatment of revenue in the new model is in keeping with the literature. Revenue was perceived to be *"easily definable and understood"*. Furthermore

revenue was derived from three distinctly separate sources; fees, margins and financial products. Each type of revenue is easily traced directly to customers, and all revenue will be included in the new CPA model. This was not so with customer costs.

The bank will not be including some indirect costs in the new CPA model. The exact nature of these costs could not be determined but it was ascertained that extraordinary and abnormal items from the bank's balance sheet would be excluded from the new CPA model. The effect of excluding indirect costs on customer profitability must be considered, particularly when many authors note its importance (Dale, 1991; Storbacka, 1993; Foster et al, 1996). This is definitely an area for further investigation and it is discussed in detail in chapter 9. The treatment of risk in the model is an important, yet still undecided issue.

The bank is having difficulty finalising the treatment of risk in the new CPA model. It was recognised that risk needs to be included in the model, however the bank's main concern is that the riskiness of a customer will be hidden by the customer profitability information. The current CPA model does not include risk, however relationship managers use *"creditworthiness"* information, in conjunction with customer profitability information, when reviewing customer relationships. To alleviate confusion, and the potential misuse of the new CPA information, the bank should consider treating risk separately as it currently does. Whilst this goes against the literature (Rose, 1991; Hartfeil,. 1996) it may resolve some of the problems the bank is facing regarding the inclusion of risk in the proposed CPA model. The implications of the bank's treatment of customer risk are presented in chapter 9.

This section has described CPA at the bank. Hartfeil (1996) believes that the end result of a CPA system is information. It provides accurate measures of the profitability of customer relationships, "supports closer management of the firm's resources and enables the firm to position itself correctly for profitable operations in a highly competitive industry" (Stuchfield & Weber, 1992, p. 73). The following chapter describes how the bank will use the customer profitability information from its proposed CPA system, to support its relationship marketing strategy.

Chapter Seven: Research Results - Customer Profitability Information

7. Research Results - Customer Profitability Information

7.1 Introduction

Due to the lack of CPA information from the bank's existing CPA system, none of the suggestions from the literatuer were currently in use at the bank. However, the bank does have proposed uses for the CPA information from the new CPA system. These intentions are described and discussed in the following sections. The primary use proposed for the information from the new CPA system is customer segmentation.

7.2 Customer Segmentation

Customer segmentation occurs in the middle business, rural and home loan areas of the bank.

> *"yes we do segment our customers";*

> *"the basis of our segmentation is income".*

As already mentioned the bank uses income as a proxy for profitability. This is particularly evident with regard to customer segmentation:

> *We have made an assumption that there is a correlation between income and profitability. Because income is easily definable and an easy to manage parameter, we use that as the basis of our segmentation.*

The rural sector noted:

There are farmers with million dollar incomes who borrow millions and put millions on deposit. When you look at their product profile the correlation (between income and profitability) *is very strong.*

As already discussed, the bank assumes the correlation between income and profitability because, *"income is at the core of a customer's ability to purchase products and services"*. This belief arises because of the lack of CPA information from the current CPA system.

In the middle business area customer segmentation is currently based on gross income. Information from the new CPA system will be used extensively for customer segmentation. To gain a better understanding of how customer profitability information will enhance the middle business area's customer segmentation, the current customer segmentation strategy is described and then contrasted with the proposed customer segmentation strategy.

The middle business area currently has three income segments:

- *Tier zero is customers with incomes in excess of $5 million,*

- *Tier 1 is income between $500,000 and $5 million and,*

- *Tier 2 is income between $100,000 and $500,000,*

These three income segments are further segmented on the basis of transaction type:

- *Advanced transactors - customers with a very high volume of transactions;*

- *Mature domestics - customers whose main banking need is borrowing, and,*

- *International traders - customers who are importers or exporters.*

The bank uses a matrix (see figure 2.) to identify the segments and identify the business needs of the customer.

Figure 2. Current Middle Banking Segmentation Matrix

	Advanced Transactors	Mature Domestics	International Traders
Tier Zero $5 million			
Tier 1 $500,000			
Tier 2 $100,000			
Small Business[47]			
Managed by:	Payment Services Specialist and Relationship Manager	Relationship Manager	International Business Manager and Relationship Manager

Each segment has very distinct needs, and the bank uses the segmentation model to tailor the services they provide for each customer. Whilst the segmentation matrix is currently used to support the relationship marketing strategy, its current focus is customer satisfaction through appropriate relationship management. The bank recognises that this model has limitations.

As previously discussed, the bank has identified three groups of customers based on transactional behaviour; partners, traditionals and access seekers. When the new

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[47] Small Business is business less that $100,000. It is not managed by the Middle Business area, but is included in the middle business matrix, as customers migrate between the small business segment and the Tier 2 segment.

customer profitability analysis system is introduced, the segmentation model will be modified, and the income segments will be further segmented into levels of service requirements; partners, traditionals and access seekers. Furthermore, the customer profitability information obtained from the new CPA system will also be included in the segmentation model. Figure 3 depicts the proposed segmentation matrix.

Figure 3. Proposed Middle Business Segmentation Model

	Partners	Traditionals	Access Seekers	
Tier Zero				**Profitability to be Shown on this axis**
$5 million				
Tier 1				
$500,000				
Tier 2				
$100,000				
Small Business				

Level of Management:	High level of Management	Moderate level of Management	Low level of Management

This is clearly exhibits the main features of the customer segmentation matrix advocated by Smith (1995). As recommended, the matrix contains customer types and customer profitability information. The new segmentation model will enable the bank to tailor the appropriate level of relationship manager involvement that will best suit the customer. Furthermore, it is predicted that it will enhance customer profitability by reducing unnecessary relationship manager involvement with customers, particularly in the traditionals and access seekers segments:

> *We believe that "one size fits all" service is not appropriate in the banking industry. We do talk to all our borrowing customers and see them once a year to review their requirements. However, some customers would like to see us more often and for others it is way too much. But there are minimum things we can do and maximum things and we need to understand our customers so we can serve them better. If we're spending time unnecessarily with a customer then that frees up time. If we're not spending enough time with a customer, do they warrant more time? Are we going to get more value out of them? This is where the segmentation is leading us.*

This demonstrates strong support for the literature (Smith, 1993), however the rural area does not exhibit the same evidence.

Like the middle business area, the rural area also segments customers on the basis of income. There are three main customer segments[48] in the rural area; premiere, high value traditionals, and low value traditionals.

The main thrust of the segmentation in the rural sector, is meeting the needs of the farmer, not reducing costs as was mentioned in the middle business area. The reason for this was not explained, but it was mentioned that:

> *"The key differentiator in the premiere segment is the quality of the relationship management. We give our top customers the very best we can"*

This infers that costs are a secondary issue, behind meeting the needs of the customer by providing a top quality service. With the introduction of the new CPA system it was undecided if the segmentation strategy would be altered to accommodate profitability of customers. The implications of this view are discussed further in chapter 9.

Customer segmentation also occurs in the home loan area, however unlike the middle business and rural areas, the basis of the segmentation was not clear. There was one segment, *"high value customers"* which was once again based on the income of the

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[48] The Rural customer segments are described earlier in this chapter.

The primary reason for the collection and analysis of consumption and behavioural information was to minimise costs and therefore increase customer profitability. This is not entirely in accordance with the literature, which suggests that customer behaviour should be analysed in conjunction with CPA information and used to optimise customer profitability and customer retention (Smith, 1993; Smith & Dikolli, 1995). However, the bank does have justification for its analysis of customer behaviour.

The bank believes that increased customer profitability is achieved in two ways. Analysing past product consumption and behavioural traits allows the identification of customers who use inefficient and/or costly methods of transacting. Once identified, these customers will be encouraged to change their consumption and/or behaviour to improve their profitability[50]. Due to the lack of CPA information from the current CPA system the relationship between customer behaviour and profitablity is not proven. Information from the new CPA system will be used, in conjunction with behavioural information, to ascertain the relationship between customer behaviour and profitability and also to modify customer behaviour. This will occur because identification of customer's behavioural characteristics will allow the bank to adjust the service levels they provide customers:

> *We are looking at what a customer actually wants out of a relationship from a behavioural viewpoint. Whether they are after a very close working relationship and want our advice and want us to be proactive, or whether they say "no, you guys are useless, just stay out of our face, give us the money and only contact us when you really have to, but we will ask for service when we want it".*

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[50] The techniques the Bank will be using to modify customer behaviour were not disclosed.

Customer profitability will be improved by *"not wasting relationship manager's time servicing customers who don't want it"*. Furthermore, *"giving the customer exactly what they want"* will strengthen the customer relationship.

Whilst strengthening the customer relationship and promoting customer satisfaction are indicators of customer retention, the use of behavioural information and CPA information to achieve this is not documented in the literature. However the bank firmly believes this to be the case.

Through the analysis of customer behaviour, the middle business area has identified, *"three core product group needs"*:

- *Access seekers - customers that do not need a high level of involvement from the relationship manager. They want to be left alone to carry out their business, and will come to us for help or advice, if they need us;*

- *Traditionals - customers that want an interactive relationship with the Bank, and*

- *Partners - customers who really value the business advice we can provide and they want us to help them.*

These three customer groups have already been discussed in the middle business area's segmentation strategy. However it should be re-iterated that the middle business area will be incorporating customer profitability information with demographic and behavioural information to provide a sophisticated matrix which will be used to manage customer relationships.

The relationship between customer behaviour and customer profitability is also a concern in the rural banking area: *"we have a project right now that is looking at customer's transacting behaviour"*. The primary reason for analysing past product consumption and behaviour is cost:

Obviously there are many different ways a customer can transact. There are branch transactions, EFTPOS[51], PC Banking[52], telephone banking, etcetera. All these different channels have different costs, and if we can think of ways to minimise transaction behaviour that is very costly, then we will encourage them (the customers) to change their behaviour.

It was further explained:

It is no secret that customers from all banks are voting with their feet and staying away from the branch network in their droves as new technologies emerge. Whilst we want to give our customers a choice in transacting, we do not want to drive up costs by giving them unlimited access to the expensive channels. By understanding how customers are transacting we can adjust our service and product delivery accordingly.

Once customer behaviour and product consumption is understood, the information will be passed on to the rural relationship managers along with customer profitability information from the new CPA system. Rural relationship managers will then be able to discuss with customers, ways to change their transacting behaviour so that it is less costly. However, it was acknowledged:

If we find that one of our very valuable customers is transacting in an expensive way, we may decide that, given their value to us, we are prepared to wear that cost on the chin. At the tail end, if we find a transaction behaviour is reliant on the expensive channels, we will clearly look at options to recover those costs.

This view supports the literature which notes that CPA information should be used to analyse customer behaviour. However, the primary reason for the analysis of customer behaviour in the rural banking area was to recover cost and not to enhance customer retention or strangthen the customer relationship as recommended it the literature (Smith, 1993; Smith & Dikolli, 1995).

In the home loan area, analyses of customers' past buying behaviour and consumption preferences were carried out mainly to strengthen the relationship. However, there

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[51] Electronic Funds Transfer at Point Of Sale

was no mention of improving customer profitability through the analysis and/or modification of customer behaviour. An analysis of customer behaviour was undertaken primarily to *"understand customer's needs"*. Unlike the middle business and rural areas, the home loan area did not mention the costs of product and service delivery. It is unclear if this is because the home loan area does not view costs as a major issue, concentrating instead on relationship strength and service delivery, or, if it is because costs are not related to consumption preferences or customer behaviour in the home loan area.

This is an interesting view given the popularity in the literature regarding the use of CPA information when analysing customer behaviour (Howell & Soucy, 1990; Storbacka, 1993; Booth, 1994; Smith & Dikoli, 1995; Hartfeil, 1996; Jeffry & Franco, 1996). This area is worthy of further investigation and is discussed further in chapter 9.

Analysing customer behaviour involves the identification of the products and service a customer uses and how they use them. Having achieved this, relationship managers can then highlight which products a customer does not use and take advantage of cross-selling.

7.4 Cross-Selling

The bank actively attempts to cross-sell to its existing customers:

> *"Yes, most certainly";*

> *"Yes, we do";*

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[52] Rural customers can do all of their own banking transactions on their computer, via a modem.

"Definitely ".

The bank has two reasons for cross-selling to existing customers. Firstly it deepens the relationship; *"the more products they* (the customer) *have the stronger the relationship ".* Secondly. The bank believes that the cost of attaining and selling to a new bank customer were greater than the cost of selling to an existing bank customer. This occurs because the bank must put more effort into pursuading a potential customer to bank with them.

Despite the literature (Petro, 1990; Storbacka, 1993; Morris, 1994; Hartfeil, 1996) the bank does not currently use CPA information to cross-sell to existing bank customers. However, with the implementation of the new CPA system, customer profitability information will be used for cross-selling, particularly in the middle business area:

> *Once it is up and running, our new customer segmentation matrix will include customer profitability information. We will use this to tailor our service delivery to each individual customer and this will most certainly include meeting customer's needs, and the flow on from that is offering extra products that will meet those needs*

This view is in accordance with the literature. Cross-selling by using CPA information improves customer staisfaction and customer retention whilst at the same time improving profitability. The middle business area, acknowledged that there were less costs associated with cross-selling to existing customers. The main reason for reduced costs was the existing knowledge of the relationship by both parties. In a lending situation,

> *It is a lot easier to lend to someone you have a complete history of, rather than trying to understand a new customer's business needs, obtain all the information you need from scratch, convince our credit control people it is a good proposition, as well as try and convince the potential customer to leave their current bank.*

It was also explained that convincing a potential customer to leave their current bank and *"come on board with us is difficult and time consuming"*. The primary reasons for this are exit barriers such as the costs involved in changing securities and a lack of knowledge and trust by a customer.

In the rural area, two reasons for actively cross-selling to existing customers were prevalent:

> *First and foremost is revenue. We aim to diversify the revenue base, as all banks do. We are not just a lending institution anymore, we provide a full range of financial services including, insurance and risk products.*

Whilst the bank strongly believes that diversifying its revenue base improves bank profitability, this belief is largely unsubstantiated. Each customer contributes to bank profitability and the lack of customer profitability information means this belief remains unproven. With the implementation of the new CPA system it is hoped that this belief will be substantaited.

Secondly, as with the middle business area, cross-selling to existing customers is thought to be cheaper than selling to a new customer:

> *To acquire a customer you would have a relationship manager spending a lot of time and effort. The relationship manager has to go out and visit that farmer and work through all the greasing [sic], and gain the confidence of the farmer. The whole credit process has to be worked through - get copies of the farmer's accounts, do all the administration and sign off all the paper work.*

This was contrasted with an existing customer:

> *You have all the information about that customer already. All the credit information, the farmer's financial details, you have his or her trust...If a customer phones up and says "hey, my neighbour is selling up, I want to buy, I need $800,000 and I need it by next week". All the information is there on the relationship manager's PC. We look at it and can give an answer usually within 24 hours.*

Using CPA information to cross-sell to customers was not seen as a way to strengthen customer relationships. This contradicts the literature (Smith, 1993; Smith & Dikolli, 1995) and the implications of this are discussed in chapter 9.

Like the rural area, the primary reason for cross-selling to existing customers in the home loan area, is the positive effect it has on profitability:

> *It is all about profitability at the end of the day...it's all about trying to get as much of their business as we can because it costs so much more to have customers leaving and new customer joining.*

This view is similar to that expressed by the rural sector, but once again it is largely unsubstantiated, due to the lack of accurate customer profitability information.

The additional effort, and associated costs, required to acquire and sell to a new customer were also noted. It was recognised that the costs involved in obtaining a new customer and opening an account were high, *"the time taken with an existing customer is shorter. The time is where your costs are"*. The reason it takes less time and hence less cost, to sell a product(s) to an existing customer is *"because they are already established in the system. All the information we need is already sitting there"*.

The bank has no evidence of the effect of cross selling on customer profitability and one respondent stated, *"it (customer profitability) is a tricky aspect"*. Rather, it was *"strongly believed"* to be the case:

> *I think that the profit from a customer who has a range of products, is better than the profit from a customer who is operating a single transaction account unprofitably. We are better to try and cross-sell and deepen that relationship by finding out what they are using, what they need and whether they can utilise other services that we offer.*

It is hoped the new CPA system can substantiate this belief. Recall that all direct customer costs will be incorporated into the new CPA model. When implemented,

the new CPA system will reflect the reduced costs associated with existing customers and their resulting profitability can be compared to new customers.

Whilst cross-selling promotes customer retention by deepening the customer relationship, it was recognised that it was sometimes necessary to terminate customer relationships and/or negotiate prices.

7.5 Price Negotiations

The middle business plans to use the CPA information to negotiate prices and/or exit customers:

> *The other side is the projection side. It is a "what if" capability. It means taking a customer's performance and trying to predict what the impact will be if they leave. We will know what the impact of price negotiations on fees and/or margins will be on profitability so we can negotiate to keep the customer or let them go.*

This was also evident in the rural sector. Recall that:

> *If we find that one of our very valuable customers is transacting in an expensive way, we may decide that, given their value to us, we are prepared to wear that cost on the chin.* .

The use of CPA information when negotiating prices is consistent with the literature (Storbacka, 1993; Booth, 1994; Hudson, 1994). CPA information enables relationship managers to confidently negotiate prices and maintain customer profitability. An interesting point to note is that CPA information will also be used to discontinue relationships. Whilst this appears to go against the bank's primary relationship principle of total customer retention, it is in keeping with the literature (Smith, 1993; Smith & Dikolli, 1995). The implementation of the new CPA system and the resulting customer profitability information may result in a redefinition of the bank's relationship marketing strategy to recognise that total customer retention may not be in the best interests of the bank. This supports the literature which suggests

that firms should not aim to retain all customers only those who are profitable or potentially profitable (Carol, 1992-1993; Johnson, 1992; Storbacka, 1993).

This chapter has described how the bank will use the information from the new CPA system to support its relationship marketing strategy. A chapter summary follows to reinforce some of the points raised in this chapter.

7.6 Chapter Summary

Due to the lack of CPA information from the bank's current CPA system, no recommendations from the literature regarding the use of CPA information were evident. However, with the implementation of the new CPA system some of the recommendations from the literature regarding the use of customer profitability information to support a relationship marketing strategy were found.

Customer segmentation is currently based on customer income in all of the areas investigated. The middle business area will use the new customer profitability information to enhance its customer segmentation matrix. The basis of the customer segmentation will change from income to customer behaviour, with sub-segmentation based on customer profitability. Furthermore the matrix will be used to redefine the bank's customer retention strategy. This demonstrates strong support for the literature (Smith, 1993). The rural and home loan areas did not intend to integrate the new CPA information into their segmentation strategy.

The bank aimed to use CPA information to analyse customer behaviour. However, the primary reason for doing so was to improve customer profitability. This goes against the literature which argues behavioural analysis, based on CPA information can be used to optimise customer retention as well as improve customer profitability.

All areas of the bank recognised the importance of using CPA information to cross-sell products to existing products. This occurs because of cross-selling's positive effect on customer retention, and the reduction in customer costs. All areas at the bank were very aware of the costs associated with selling to existing customers as opposed to new customers. The exclusion of some costs in the new CPA model could be significant. A more in-depth discussion of this potential problem can be found in chapter 9.

In accordance with the literature, CPA information will be used to negotiate prices (Storbacka, 1993; Booth, 1994; Hudson, 1994), and to discontinue unprofitable relationships (Carol, 1992-1993; Johnson, 1992; Storbacka, 1993).

This chapter has described how a bank will use customer profitability information to support its relationship marketing strategy. Chapter eight provides an overview of the findings of this research and offers some concluding remarks.

Chapter Eight: Concluding Remarks

8. Concluding Remarks

This thesis has described the relationship marketing strategy and the current and proposed customer profitability analysis systems of a bank. To achieve this research a case study was conducted at a a major retail bank in New Zealand. Information is crucial to support a relationship marketing strategy. The customer profitability information that will become available to the bank following implementation of the new CPA system will be used to support and enhance the bank's relationship marketing strategy.

The bank follows a typical relationship marketing strategy as described in the literature. The primary focus of the relationship marketing strategy is to build long term mutually beneficial relationships with customers.

To enable the determination of profitable customers the bank currently uses a first generation customer profitability analysis system. This system was recognised as being out dated, due to the cost data being five years old. To overcome the limitations of the current system, the bank is currently designing and implementing a new CPA system. The new CPA system will be implemented in the first half of 1998 and will exhibit many of the characteristics of a second generation CPA system, most noticeably the recognition of the "lifetime" value of customers.

The bank is struggling with the treatment of risk in the new CPA system. It was acknowledged that risk was currently used separately in the form of creditworthiness

reports on customers. Furthmore, these creditworthness report were *"easily understood"*. Despite the recommendations in the literature for the inclusion of risk within a CPA system, it may provide an easier solution to exclude risk from the customer profitability calculation. Should this be done it is imperative that customer risk be considered alongside the CPA information to accurately evaluate customer relationships.

The new CPA system will produce customer profitability information that the literature suggests can be used to improve profitability and strengthen the customer relationship.

In some areas of the bank, the use of customer profitability information has not been finalised. However, the middle business area will be using customer profitability information to supplement its segmentation matrix.

The rural and home loan areas are not so decided about how the customer profitability information will be used. The most likely use for CPA information would be for customer segmentation.

Currently segmentation in all areas of the bank currently revolves around customer income. The literature does not recommend income as a surrogate for profitability. However, the bank believes there is a strong correlation between customer income and customer profitability because income is at the core of a customer's ability to purchase products. This belief is unsubstantiated, once again due to the limitations of the current CPA system. It is hoped that the implementation of the new CPA system will prove the correlation between income and profitability.

Customer profitability information is also used to analyse customer behaviour particularly in the middle business area. Customers will be segmented on the basis of profitability and their behaviour will be modified if necessary, to improve customer profitability and optimise customer retention.

The bank also recognised the benefits of using customer profitability information in price negotiations. The middle business and home loan areas were planning to use customer information from the new CPA system for this purpose.

This thesis was an exploration into relationship marketing and customer profitability analysis. The "cross over" between marketing and management accounting research is an emerging area, yet to date it has received scant attention (Foster & Gupta, 1996).

Some evidence of the incorporation of management accounting and marketing was discovered, as has been called for in the literature (Johnson, 1992; Foster et al, 1996). This evidence however, was by no means extensive. Several areas were highlighted for further investigation and these are discussed in chapter 9.

The results of this thesis have extended the body of knowledge in both management accounting and relationship marketing. The evidence has provided insight into the issues that arise when designing a CPA system and has also provided an interesting account of the incorporation of customer profitability analysis into a relationship marketing strategy in a New Zealand context.

The choice of the case study method to conduct this research stemmed in part, from the predominance of case study research in both management accounting and marketing. This research however, was not without limitations. The following

chapter highlights some of the limitations of this thesis and suggests areas for further

research.

Chapter Nine: Limitations and Suggestions for Further Research

9. Limitations and Suggestions for Further Research

9.1 Introduction

This thesis examined the customer profitability analysis system and the relationship marketing strategy of a bank. It explored contemporary business practices in a New Zealand context and as such concentrated on what was happening at the research site. It did not seek causal factors to explain the issues raised. As such, a number of issues were uncovered that deserve further investigation. These are presented in this chapter.

In order to place this research in perspective, it is first necessary to understand the limitations of this case study.

9.2 Limitations of the Research.

9.2.1 The Limited Number of interviews.

This study interviewed six senior staff members at the bank. The bank imposed this restriction due to the availability of staff. Many of the staff, who could have provided a greater depth of insight into areas such as the CPA system, were unavailable due to work commitments. Whilst the team leader of the CPA project was knowledgeable in all areas of the development of the system, it was felt that a greater depth of information could have been obtained from the personnel directly responsible for certain areas of the system. This was particularly evident in the definition of customer

A copy of the bank's annual report was obtained to substantiate some of the information obtained from the interviews. This information particularly related to the three areas that were examined. Also, the same question was often asked at different stages of the interview. The responses were then matched for accuracy. These are all accepted methods of triangulation (Yin, 1992).

9.2.3 Tape Recording Interviews.

Richardson et al (1965) argue that tape recording interviews can be threatening to an interviewee. All interviewees were asked if the interview could be tape-recorded prior to the commencement of the interview. No negative responses were received and all interviews were tape-recorded. Some interviewees did not answer some questions, with the most common response being *"I can't answer that, it is commercially sensitive"*. It cannot be determined if the presence of a tape recorder initiated this response. Whilst the use of a tape recorder greatly facilitated the collection of information, it must be considered a limitation.

Despite these limitations, this research has contributed to the body of knowledge, surrounding management accounting, and relationship marketing. In doing so, several areas for further research were identified.

9.3 Areas for Further Research

During the course of this research a number of areas requiring further research were highlighted. These are now discussed beginning with the CPA system.

The proposed CPA system at the bank will be introduced in six months. Re-visiting the site in the future after implementation of the new CPA system would provide an

interesting insight into the effectiveness of the new CPA system. It would also provide an insight into how the bank resolved the implementation and design issues highlighted in this research, particularly those of risk, cost allocation, and drivers of customer profitability,.

Customer profitability drivers were undefined at the bank and all areas noted different profitability drivers. The rural areas believed it was a customer's gross income, whilst the home loan area believed it was fee revenue. The importance of identifying and understanding customer profitability drivers has been noted (Berry & Britney, 1996; Hartfeil, 1996). The implications of the apparent confusion surrounding customer profitability drivers could be a significant issue in the accurate determination of customer profitability. One interviewee expressed an interesting view regarding what drives customer profitability at the bank, namely that customer profitability drivers are unknown, and suggestions from the literature are *"fallacies"*. The implications of this view on the design of the new CPA system are unknown, however given the respondent's high position on the CPA system design team the ramifications of this view cannot be discounted. Further research into the effect of personal biases and opinions on the design of management accounting systems could prove fruitful.

There are still some undecided issues in the design of the new CPA system, the major one being the treatment of risk. The bank acknowledged that risk is an issue, and that *"we have our resident expert working on it at the moment"*. The main concern with the treatment of risk was that the final outcome of the new CPA system could show risky customers as more profitable due to higher margins. The bank did use a

measure of customer risk[53] with CPA information from the current CPA system, however they have discontinued this approach. This seems alarming given that the bank understands customer risk profiles[54]. An investigation into why the bank has discontinued the recommended treatment of risk (Hartfeil, 1996) would provide a valuable insight into the complexities of risk in a CPA system and how customer profitability information is used to support a relationship marketing strategy.

Another area of risk not yet resolved is the treatment of delinquency costs. Hartfeil (1996) argues that delinquency costs and the costs of early closure can be directly traced to the customer. Whilst this can occur after delinquency or closure, it is another issue of risk that should be taken into account. This is because the likelihood of a customer defaulting or leaving the bank is a function of the risk profile of that particular customer. Further investigation into the treatment of risk in CPA in banks is warranted.

Despite recommendations in the literature (Foster & Gupta, 1994) the bank will not be including all customer costs in its new CPA system. Some general corporate costs, in particular extraordinary and abnormal costs, will be specifically excluded. All costs to the bank effect customer profitability and the exclusion of some costs may not provide a true picture of customer profitability. Further research into this issue is necessary and would provide further insight into the difficulties associated with incorporating all costs into a CPA system.

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[53] Recall that creditworthiness is combined with the CPA information at the account review.

[54] Recall this comment from the description of the bank's customer retention strategy "...*the decision is based on their risk profile because that is what we understand*"

The bank's use of income as a substitute for profitability is not advocated in the literature. This arises due to the lack of customer profitability information from the current CPA system. Following implementation of the new CPA system, it should be possible to prove the correlation between customer income and customer profitability. This knowledge would certainly enhance both COA and marketing literature.

Furthermore income forms the basis of the customer segmentation strategy of the bank. The middle business area intends to use the customer profitability information from the new CPA system in conjunction with behavioural segmentation to redefine its customer segmentation strategy. Whilst this supports the literature, unfortunately the literature is predominantly anecdotal. Revisiting the bank in the future to determine the success of incorporating customer profitability information into the customer segmentation strategy would be an interesting and informative study and strengthen the research in this area.

The Home Loan area, is the only area of the Bank that did not segment customers on the basis of income. Instead segmentation appeared to be based around products. This seemed to cause a problem when products were being developed. It was explained that a balance was necessary between profit and customer demands. This statement acknowledges the importance of using CPA to support a relationship marketing strategy. Despite this acknowledgement, the home loan area expressed no intention of using the customer profitability information to supplement its segmentation strategy. Should the home loan area include customer profitability in its customer segmentation, the attainment of the correct balance between profit and customer demands could be easier. Once again a post implementation study to

discover exactly how the customer profitability information is being used in the bank's segmentation strategy would provide a useful addition to the current literature.

There is very strong support in the literature for using customer profitability information to analyse customer behaviour (Howell & Soucy, 1990; Storbacka, 1993; Booth, 1994; Smith & Dikoli, 1995; Hartfeil, 1996; Jeffry & Franco, 1996; Anonymous, 1996). The home loan area failed to follow the recommendations from the literature. It was not clear why this was so and further investigation is needed to ascertain why many aspects of the published literature, particularly that relating to the use of customer profitability information are not being followed.

Stuchfield and Weber (1992) note that customer profitability information "does not clearly exhibit one of the identified sources of strategic advantage - switching costs, or exit barriers" (p. 62). These costs can cause unprofitable customers to continue to do business with the firm, despite management's efforts to either improve the profitability of the relationship or discourage the relationship.

Exit barriers were evident at the bank[55]. The outdated data in the current customer profitability system means that reliable customer profitability figures are not available. Therefore, it was not possible to determine whether customers who remain with the bank, despite being unsatisfied, are profitable or unprofitable. The implications of this issue for firms that have a relationship marketing strategy and aim at customer retention are unknown, but must intuitively be detrimental to profitability. This was not investigated at the bank as it is outside the scope of this research. The

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[55] See Chapter 4.

effect of exit barriers on customer profitability is an area that would benefit from further investigation.

9.4 Chapter Summary.

This research has limitations. These include the limited number of interviews, the possible introduction of interviewer bias, the short time period taken to complete the research and the use of a tape recorder during interviews. Thus the findings of this research must be considered within the context of these limitations.

Despite these limitations this research has provided valuable insight into the relationship marketing strategy, the customer profitability analysis system and how customer profitability is used to support a relationship marketing strategy. During the course of this research several areas requiring further research were identified. Many of these stem from unresolved issues regarding the design of the new CPA system and confusion surrounding the use of customer profitability information. Some of this confusion has arisen because of the inadequacy of the current CPA system to provide customer profitability information to help the bank support it's relationship marketing strategy.

The combination of management accounting and marketing in one case study is both innovative and interesting. As management accounting evolves, the inclusion of marketing research will enhance the evolution, widening the scope of management accounting. This will provide management accountants with a broader understanding of how management accounting information systems can be used by firms operating in highly competitive industries.

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Appendices

Appendices

Appendix A.

Interview Questions

1. Does your organisation follow a relationship marketing/ customer retention strategy?

2. How do you define a customer relationship and a retained customer?

3. Why did the Bank implement a relationship marketing strategy?

4. Do you build networks of customers?

5. How does your organisation interact with customers?

6. Do you strive for customer satisfaction

7. Do customers whom you know are unsatisfied, remain with the Bank?

8. Do you aim to cross-sell to customers?

9. Why do you aim to cross-sell to customers?

10. Do you find existing customers generate referrals?

11. Do you identify which customers will buy certain products?

12. How do you do this?

13. Do you keep a database of customer information?

14. What information do you gather in this database?

15. Do you use previous customer buying behaviour to predict future customer buying behaviour?

16. Do you segment your customer database?

17. How do you segment your customer database?

18. Do you tailor certain products and/or services to particular segments?

19. Do you track your "best" customers in any way?

20. How do you define these "best" customers?

21. How do you track your "best" customers?

22. Do you try and anticipate customer needs?

23. Do you use segment information from the customer database to develop products?

24. Do you direct most of your marketing efforts to any particular customer segment?

25. Do you monitor transactions with customers?

26. Do you interact with customers prior to transactions?

27. Do you know if your retained customers are profitable?

28. Do you know if it costs less to sell to an existing customer than it costs to sell to a new customer?

29. Do you de-market unprofitable customers?

30. Do you concentrate on the top 15% of customers?

31. If not what percentage, if any, do you concentrate on?

32. Does your organisation have a Customer Profitability Analysis (CPA) System?

33. On which customers do you conduct CPA?

34. How do you conduct CPA analysis?

35. How do you define revenues?

36. How do you define costs?

37. Do you include non-financial transactions in the anaylsis?

38. How do you assign corporate costs to customers?

39. Are there any costs you don't assign to customers?

40. Why do you not assign these costs?

41. For what time period do you calculate revenues and costs?

42. How do you do this?

43. Does the system show which customers are profitable and which are not profitable?

44. Do you have cost pools?

45. What cost pools do you have and what costs go into them?

46. Do you have an activity based costing system in your organisation?

47. Is this used for product, costs or both?

48. What drives profitability at the Bank?

49. Do you use averages to analyse profit drivers?

50. Do you calculate customer revenue on a product basis?

51. Do you focus on higher risk products/ customers?

52. How do you define these higher risk products/customers?

53. Do you include account origination/set-up costs and/or delinquency costs in the CPA?

54. How do you use the CPA information?

55. Has your organisation identified a link between customer satisfaction and profitability?

N.B. Where questions elicited a yes or no answer, exploratory questions such as "how" or "why" were then asked to illustrate the phenomena.

Appendix B.

Schedule of Interviewees

The following staff at the Bank were interviewed:

Marketing Department:

A Senior Manager

Middle Business Sector:

A senior Manager

Rural Sector:

A Senior Manager

Home Loans Sector:

A Senior Manager

Finance Department:

A Senior Financial Analyst

Research Department:

A Research Analyst