Consumer Finance Group

Customer segmentation: how to harness its profit-building power

PricewaterhouseCoopers

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Segmenting customers—a profitable pursuit

Financial institutions' customer acquisition strategies are taking a one-two punch as the economic turmoil shrinks both their customer base and marketing budgets. The troubled economy plays no favorites as it spreads job losses, delinquencies, and foreclosures across a formerly robust customer landscape. This changing economic outlook is testing the mettle of many banking industry professionals as they seek to attract and retain profitable customers and disengage with those that do not offer value under their operating model.

Unquestionably, if given the choice, financial institutions would hand pick those customers who offer the greatest long-term profitability and build mutually valuable relationships with these select clients. In fact, today's technology and information-sharing culture makes this once impractical scenario a reality that companies can achieve through the execution of a customer segmentation strategy.

By building long-term relationships with the most valuable customer segments, companies can win over a loyal—and profitable—customer base. Considering that the top reason customers leave one financial institution for another is because they are enticed by better offers,[1] segmentation not only makes business sense, it can create a competitive advantage. With the pressure to attract and retain customers who offer the greatest value more intense than ever, segmentation is the right strategy for today's marketplace.

Yet implementing a segmentation program that delivers both profitability and long-term sustainability often proves elusive. The catch-all approach to marketing is clearly outdated. But even so-called traditional segmentation strategies frequently fail to produce significant value. Undeniably, segmentation requires analytical know-how. But it also demands that companies break down existing silos that prevent them from truly understanding their customers. Furthermore, it should be approached as an iterative process, one that requires time and planning to cultivate the data that will ultimately enable companies to fine-tune their segments for maximum profitability. While each company's approach will be unique to their particular business needs, we have identified five steps that will help companies achieve the characteristics of a successful segmentation strategy: set your budget, prepare the foundation, analyze your data, make targeted offers, and refine your strategy.

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[1] PricewaterhouseCoopers, *Winning the battle for growth: Building the customer-centric financial institution, 2006.*

The goal of segmentation is to target high-value customers with product and service offerings tailored to their specific needs. To achieve this targeted capability, companies segment their customers into groups based on demographic information that provides insight into their purchasing behavior. For example, retired homeowners are more likely to be in the market for a reverse mortgage, while young families with children are more inclined to invest in a college savings plan or a bigger home to accommodate a growing family. Yet it's not only today's high-value customers that organizations should pursue, it's also those who represent the potential to add value in the future, such as younger borrowers who are in the process of building wealth.

Although customer segmentation is not a new concept to consumer finance companies, it has proven difficult for the industry to translate the theory into an actionable strategy. Some of the challenges include the existence of operating silos based on asset classes, fueled by legacy systems that do not communicate with each other; marketing departments that develop a segmentation strategy in isolation, without involving stakeholders to understand the needs of the customers or the business; and the perception that a segmentation strategy can be executed only by large corporations with significant time and money to invest.

Five steps to a successful segmentation strategy

As with any strategic undertaking, implementing a successful customer segmentation program requires careful planning and strategic decision making. The following steps will help create a segmentation strategy that addresses and overcomes the complexities and roadblocks that exist to achieve profitable returns.

Set your budget

At a time when financial institutions are competing for fewer customers, why aren't more companies employing a customer segmentation strategy? One reason is the perception that segmentation is costly. The fact is, organizations can implement segmentation strategies across a wide cost spectrum ranging from a robust, sophisticated program to one that requires a small up-front investment that expands over time.

Consider an example of a financial institution that slowly expanded their program. This company gathered customer data from existing systems and built a prototype using its current applications. Without having to invest in new technology, they developed pilot programs to increase customer retention rates. This approach helped them deliver tangible results to the more skeptical stakeholders in the organization. And by starting with a smaller-scale, phased approach, the organization enhanced the sophistication of its segmentation strategy over the long term.

The bottom line is that segmentation can fit virtually any budget. And whether the investment is large or small, segmentation has the potential to deliver commensurate financial returns, including:

- Increased profitability
- Higher return on marketing investments
- Higher customer retention rates
- Increased customer wallet share
- More predictability of the portfolio and earnings

Segmentation can fit virtually any budget.

Prepare the foundation

Knock down silos to better understand your customer

Many organizations, whether through mergers, consolidations, or simply everyday business operations, service their customers in separate business units, and on different systems. These operational silos prevent companies from understanding which products and services their customers have purchased across the enterprise. Because obtaining a holistic view of the customer is a critical early step in creating customer segments, these barriers must be deconstructed.

Fortunately, obtaining a top-down customer view does not require a system overhaul. It can be achieved with a universal client identifier—a unique customer identification number assigned to every account that a customer has across the organization. Regardless of whether a borrower has a student loan, mortgage, checking account, or any other product, management can use the universal client identifier to extract customer information from disconnected systems across the enterprise, creating an aggregate view from data that was previously compartmentalized in separate business units.

Achieving a customer-level view also lays the groundwork to obtain a household view of each customer. A household view, which aggregates information for all customers residing at the same address, enables companies to perform more sophisticated segmentation analysis by considering the client's financial needs in a broader context. Figure 1 shows an example of product-, customer-, and household-level views.

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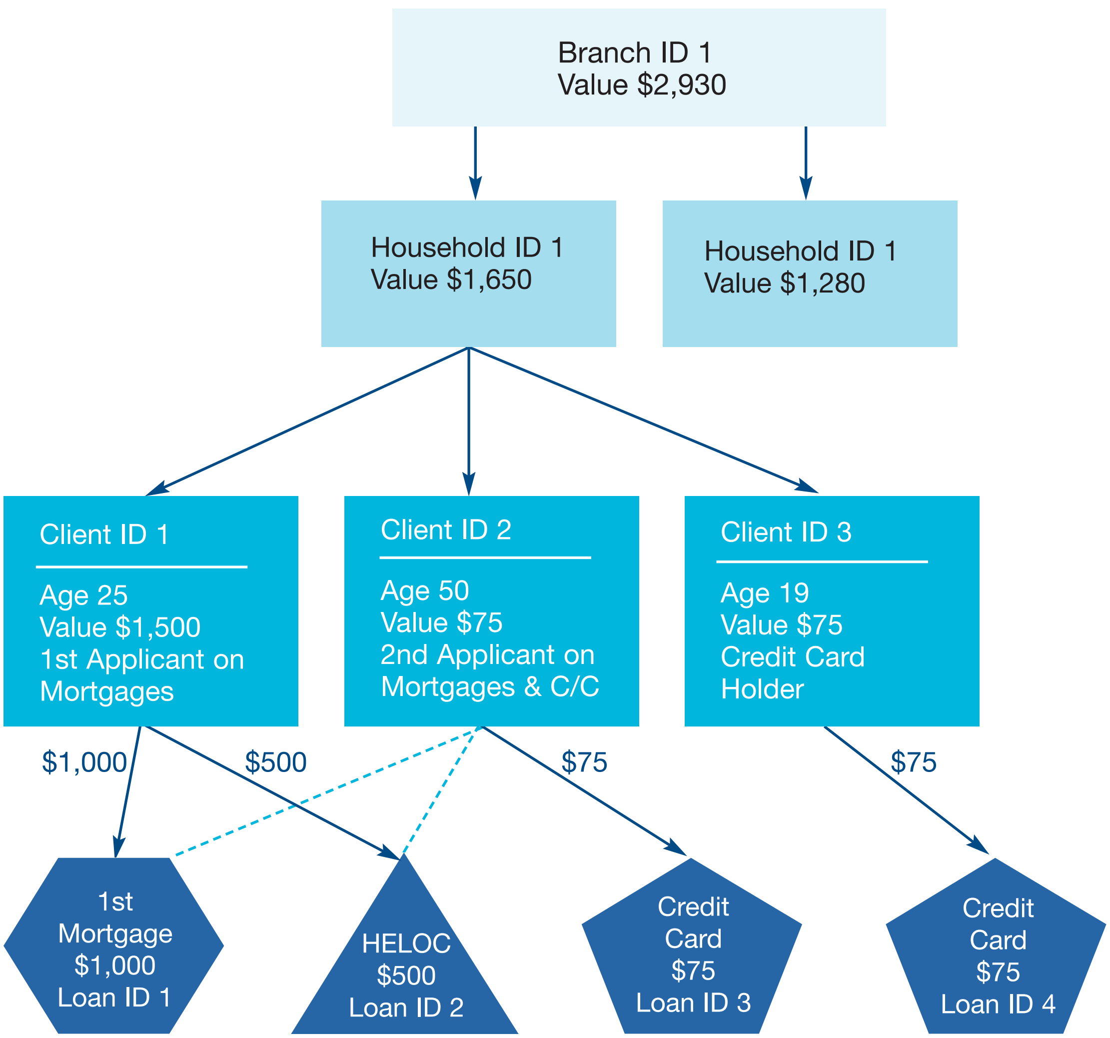
Figure 1: Product-, customer-, and household-level views



Gather the right data

At the heart of any successful segmentation strategy is the ability to identify and assemble the right data points—those that provide insight into customers' needs. Yet, we have found that the main criteria often used in segmentation—customers' current and potential assets[2]—have changed little over the years and, in fact, reveal few insights that companies can use to deliver targeted products and services.

Instead, information such as marital status, birth date, address, geography, number and ages of dependents, credit score, and loan-to-value ratio may be more reliable indicators of customers' needs. This data is typically captured during the application process and, once analyzed, exposes significant information about customers' purchasing habits, financial needs, and life stages—all factors that drive their expected purchasing decisions. The key is to identify the most useful data points, develop processes to confirm their accuracy, and move them into a centralized system where management can leverage them to their full marketing potential.

Avoid a common pitfall of segmentation by choosing data points that reveal customer insights.

[2] PricewaterhouseCoopers and the Economist Intelligence Unit, *Unprecedented opportunities, plan your approach*, Global Private Banking/Wealth Management Survey, 2007.

Analyze your data

With data gathered, management must now analyze this information to create like profiles (or segments), understand their clients' needs based on their individual or household dynamic, and pinpoint which segments offer the most value potential.

Creating segments – How data tells a story

With demographic data in hand, the work of segment creation begins by grouping together customers with similar characteristics. The following example segments customers based on income and marital status:

Segment 1 – This segment consists of single borrowers with income less than $30,000. They are young adults typically in college or entering the workforce. The average age of customers in this segment is 18-25.

Segment 2 – Borrowers in this segment are married and have incomes of $40,000-$75,000. These couples are building careers and possibly starting families. They have more income than segment 1, and would likely spend it on different pursuits such as home mortgages. The average age of this segment is 26-34.

Segment 3 – These single up-and-comers have incomes of $75,000-$100,000 and an average age of 26-34. They have amassed a sizable salary and have fewer financial obligations and more disposable income than their same-aged counterparts in segment 2.

Segment 4 – The borrowers in this segment are married homeowners with incomes greater than $200,000. These couples have established careers and substantial incomes. The average age of customers in this segment is 40-49.

Because the core driver behind segmentation is the assumption that customers with similar attributes will have comparable purchasing behavior, the creation of segments enables companies to move away from mass-marketing efforts and instead offer targeted products and services to customers in the same segment.

For example, products such as a home equity line of credit or a vacation home loan are likely to appeal to the high-income couples in segment 4, whereas new checking accounts or college loans are more likely to meet the needs of the young adults in segment 1.

Understand customer households

Each customer's household dynamic provides clues to their vastly different financial needs.

Assigning a unique household identification number to customers with the same mailing address enables management to analyze customers' household dynamic and obtain an even greater understanding of their financial needs. Consider an example of two borrowers, both 40-year old women, and both with three people residing in their household. The first customer is single with two teenaged children. The second customer is married, and her household includes an elderly parent.

The household with teenaged children may need student loans or a joint credit card product. In a few years, the dependents' change of address could indicate that, with the children no longer residing in the household, the customer now has more disposable income for pursuits such as home improvements or vacations, and could also indicate the need for wealth management service offerings. Conversely, the household with an elderly parent would be more likely to need investment, estate planning, or insurance products.

Each customer's household dynamic provides clues to their vastly different financial needs. Without this information, management could not target these two customers as effectively.

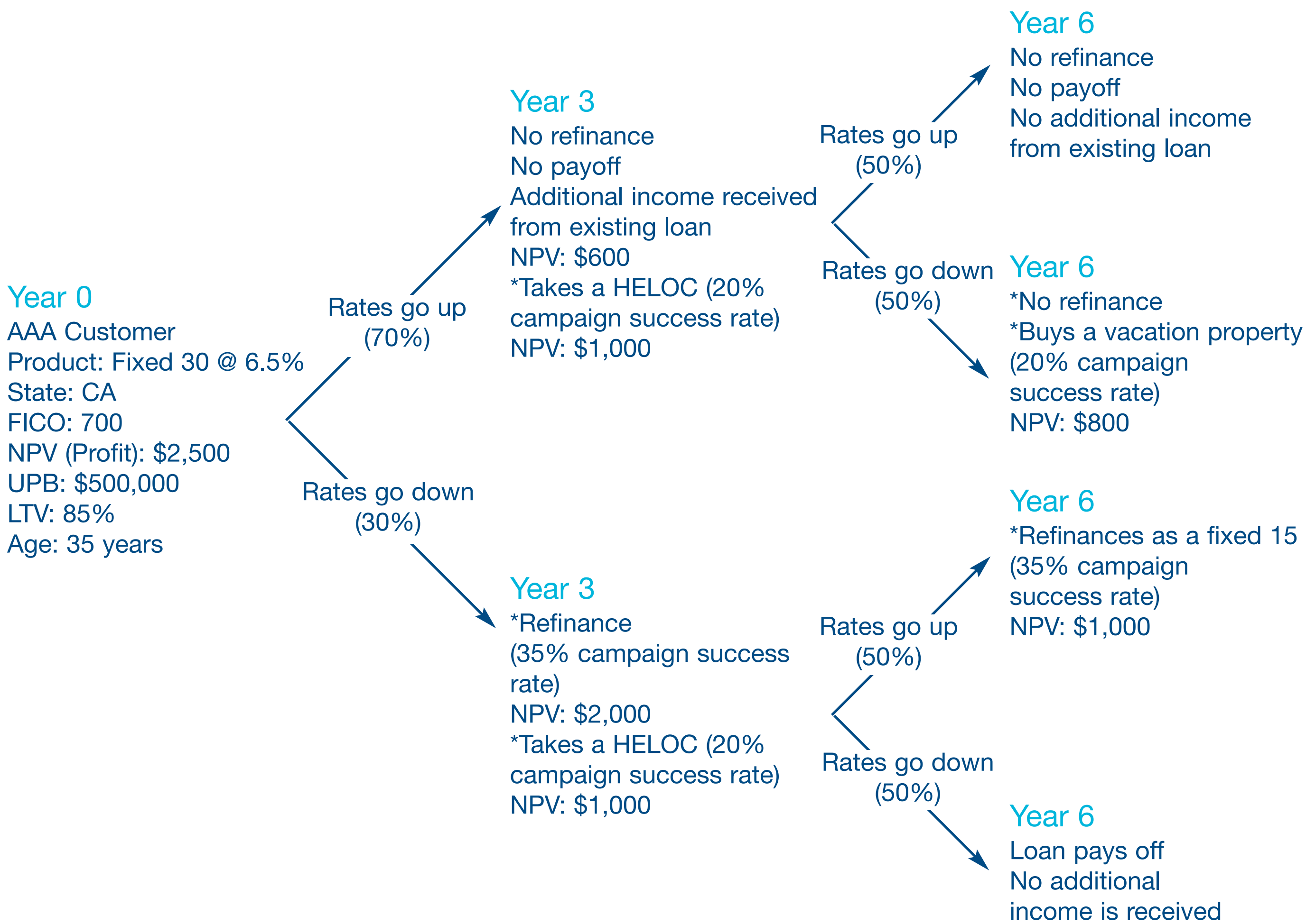
Consider your segments' value

Indeed, when it comes to profitability, not all segments are created equal. To determine the profit potential of each segment, companies must consider the segment's lifetime value, defined as the profit they expect to generate over the entire life of the customer relationship.

When calculating lifetime value, consider the value of not only the expected immediate gain that current loan products will generate, but also the potential value of future business opportunities that could arise from the existing relationship.

When contemplating changes to products, pricing, or cost structures, don't ignore the potential impact of the change on customer lifetime value. (See Figure 2). For example, a decision to increase certain fees to generate incremental revenue might bring additional profits in the short term, but this benefit could be more than offset by the revenue lost due to unsatisfied customers leaving the company.

Figure 2: Customers' lifetime value



NPV – Net present value
UPB – Unpaid principal balance
LTV – Loan-to-value

One of the challenges of calculating a segment's lifetime value is populating the model with probability assumptions, including the percentage of customers that will accept product and service offers targeted toward their segment, as well as the average duration for which they'll hold the products. A company can start with one year of historical information and refine the model each year as more data is collected. Although the information will not be useful in absolute terms during the first few periods, it can be used to compare segments on a relative basis. Over time, the assumptions that were used initially can be replaced with actual historical information, creating a more accurate and refined model.

Understanding and forecasting each segment's lifetime value enables companies to pinpoint those segments that offer the greatest profit potential and then make strategic decisions about product, service, and retention strategies to best serve the customers within those segments. It also enables management to redirect retention efforts and other expenditures away from the least profitable segments and focus these resources elsewhere.

Understanding and forecasting each segment's lifetime value enables companies to pinpoint those segments that offer the greatest profit potential.

Make targeted offers

Be careful to avoid a common pitfall of segmentation—spending too much time in the analysis stage in an attempt to obtain perfect data. The quest for perfection usually prevents companies from moving forward to develop products, services, and pricing because they become stuck in a perpetual cycle of analysis. Instead, target relative accuracy when creating segments and determining their lifetime value. Segmentation is an iterative process—it won't be perfect right out of the gate, but it should be reasonably sound and can be refined over time. Additionally, keep in mind that the most successful segmentation programs are agile and include the capability to monitor and adapt to inevitable changes in the business environment.

Yet, even after customer segments are determined and appropriately analyzed, we find it is not uncommon for companies to treat their top clients the same as their less profitable ones. It's here that organizations must be vigilant about developing programs to serve the needs of those segments they wish to attract and retain. One of the most powerful tools that companies should have in their segmentation arsenal to differentiate service to their top clients is a financial life cycle strategy.

Offer products and services based on customers' financial life cycles

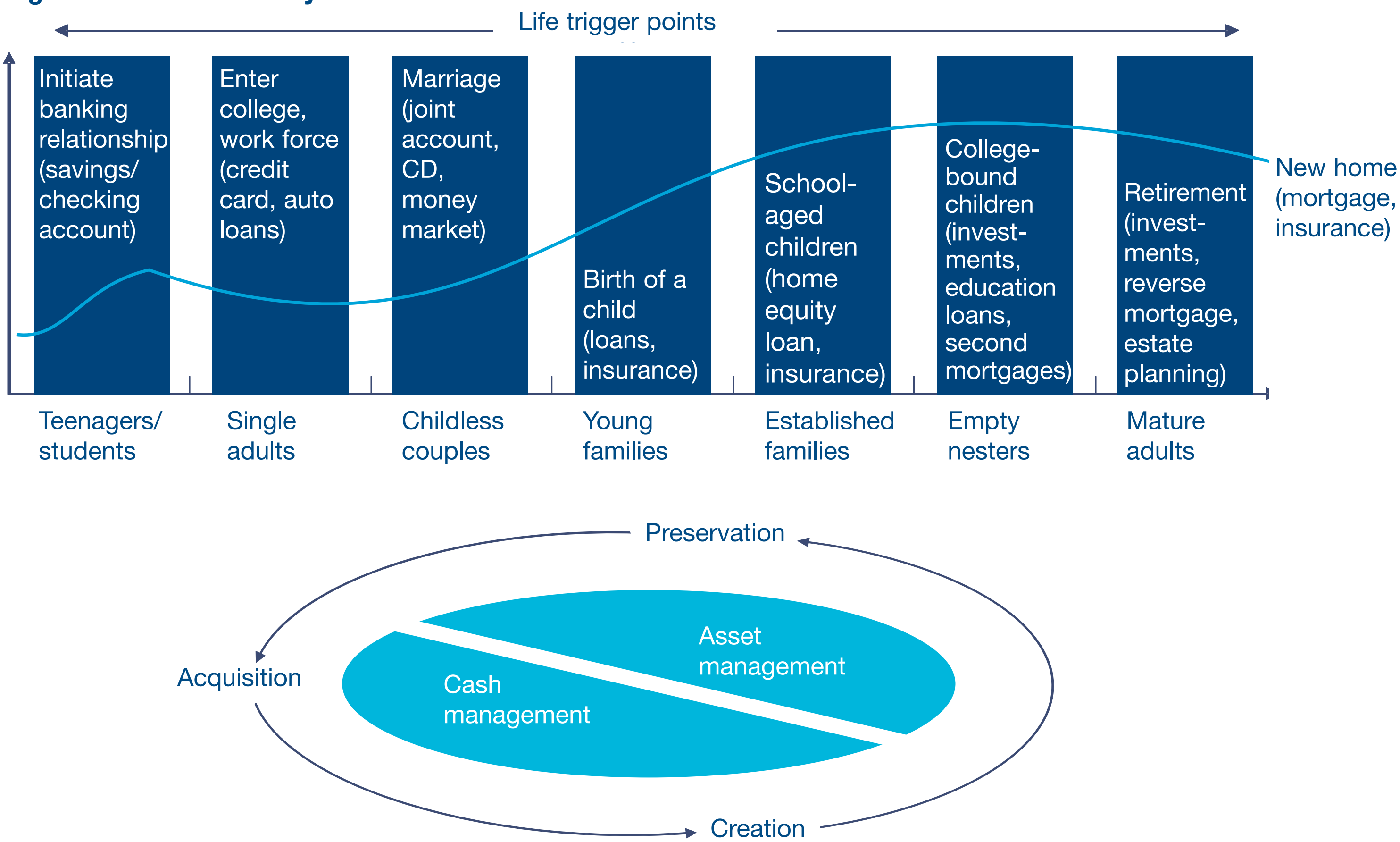
With its customer base sliced and analyzed, management now knows which client segments offer the most potential value. But to tap into that value, companies must understand what their customers want and when they want it. It's at this stage that the concept of financial life cycles becomes critical to the segmentation process.

Companies must understand what their customers want and when they want it.

Figure 3 illustrates the financial life cycle concept. As customers move through the various stages of their lives, their financial needs change based not only on their own circumstances, but also on those of the entire household. For example, young, single adults are likely to need new checking accounts, credit cards, and auto loans. When these singles marry, they are more likely to need a mortgage and might also be in the market for a savings vehicle such as a money market account. The birth of a child creates a new dynamic for the customer who might now be looking for life insurance or college savings accounts.

By understanding the financial life cycle of their customer segments, financial institutions can anticipate their customers' needs and proactively offer the products and services that will help these clients address the financial questions they face.

Figure 3: Financial life cycles



Refine your strategy

Segmentation is a cumulative pursuit. It's simply not realistic for most companies to start out with a large-scale, complex segmentation strategy. Instead, begin by identifying a manageable number of segments and developing the operational processes necessary to support them. Over time, expand on the segments' size and complexity to achieve the desired level of sophistication. The more refined the segments are, the better companies can tailor product development, marketing campaigns, pricing analysis, and service delivery strategies.

One way to obtain greater sophistication is by creating subsegments. For example, consider the borrowers identified earlier in segment 2—married, 26-34 years old, with incomes of $40,000-$75,000. Although this segment does not currently have a high net worth, their relative youth suggests that some of these customers could substantially increase their incomes over time. What if there was a way to identify a subsegment of these customers who might experience significant income growth? One strategy is to pinpoint traditionally high-income professions, such as doctors, and create a subsegment of customers who are medical and dental students or interns. This cash-poor subsegment is faced with costly tuition bills and steep expenses associated with their new practices. Although they are currently struggling financially, they will likely develop a high net worth over time. Financial institutions can establish long-term relationships now via offers for medical school loans or personal loans to finance equipment and other costs for their new practices. Targeting this subsegment helps these clients meet their current financial obligations, and also establishes relationships with individuals who are likely to become profitable customers in the long term.

Segmentation is a cumulative pursuit.

What this means for your business

Segmentation—the right strategy for competitive advantage

As the distressed economy looms large, banks are battling for wallet share from a dwindling customer base. The race is on to identify, attract, and retain those current and prospective customers who offer the greatest promise of long-term profitability.

Segmentation is a proven, yet still emerging strategy that offers benefits to both financial institutions and their customers. And perhaps that is the beauty of it. While companies establish competitive advantage by building stronger, longer-lasting relationships with their most valuable customers, these very customers are on the receiving end of specialized offers that provide solutions to their financial needs at competitive prices.

Most organizations develop a long-term segmentation strategy that they implement over a period of time. When planning a segmentation strategy, keep in mind the following guidelines:

- Consider the initial set of customer segment insights as the beginning of an ongoing effort to further build out segment knowledge.
- Allow each segment's long-term value to drive organizational priorities.
- Explore incremental growth opportunities by identifying and targeting emerging segments that are currently not represented in the portfolio.
- Set detailed financial development objectives for each priority customer segment. For example, affluent segments should have specific targets for credit growth and profitability.
- Develop strategies to achieve these financial development objectives that include service differentiation, pricing strategies, and communication approaches.
- Understand customers' life cycles and stay updated on each segment's change in life stage and buying habits.

It is also important for companies that have already embarked on a segmentation effort to assess their program's level of maturity using a segmentation maturity matrix. (See Figure 4).

Segmentation is a winning approach with the potential to help companies maximize profits and create a competitive advantage. And in today's turbulent and competitive marketplace, it's no longer a nice-to-have, it's a way forward.

Figure 4: Maturity matrix

	Level 1 – Traditional Strategy	Level 2 – Hybrid Strategy	Level 3 – Leading-Edge Strategy
Organizational structure	• Marketing is the only group involved in the definition of segments. • Some information is shared with customer service and new product development.	• Marketing, new product development, and operations groups are actively involved in segmentation discussions. • Updates to the segmentation strategy include feedback provided by loan officers and account executives.	• Customer strategy becomes an independent group that interacts with marketing, strategic planning, and credit risk management. • Segmentation strategy is refined on a periodic basis and includes feedback from front-office and back-office functions. • Customer profitability and retention become key drivers of compensation.
Segmentation drivers	• Company primarily segments customers by product and credit score. • Additional customer data points might be captured at origination, but are not used.	• Company uses product attributes (credit score, lifetime value, etc.) as well as basic customer attributes (age, marital status, income) to define segments. • Third-party information is also incorporated into the segmentation model.	• Company uses product and customer attributes to define segments, but also incorporates psychographic elements (client dynamics depending on the household composition). • Several customer data points are captured at origination, but are also updated on a periodic basis. • Customer retention information becomes a critical part of the segmentation efforts.
Strategy	• A different segmentation strategy is executed for each asset class. • Profitability is calculated based only on actual results and on a product (not customer) basis. • A cross-selling benefit might be assumed, but it is not measured. • Segmentation information is not shared with any C-suite executives.	• Actual profitability numbers are calculated on a customer basis. Information is extrapolated to calculate a customer lifetime value that can be used for relative comparisons across segments. • Some information is shared with C-suite executives and starts to be used for new products/markets/ service offering decisions.	• Segmentation information is actively used by the credit groups to analyze the capacity and willingness to pay, as well as to assess the overall risk exposure of a particular segment. • Segmentation profitability and risk results are shared with senior executives and the information is used to make pricing and other strategic decisions.
Technology	• Companies with different origination/ servicing platforms (e.g., mortgage, credit cards, student loans) do not have a single view of the customer (portfolio of products, profitability, tenure), so all the analysis is performed on an ad hoc basis. • Company has not actively implemented a universal customer identifier.	• Legacy systems might still prevent the creation of a universal client identifier. But company starts tracking customers' activities across the enterprise through the creation of a customer data repository. • Customer information is available on a monthly/quarterly basis and not on a real-time basis.	• The universal client identifier is part of all the origination and servicing systems. When a client applies for a new product or service, the account executive has access to all current and past information on products obtained by the customer. • Information is updated daily or on a real-time basis.

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PricewaterhouseCoopers' Consumer Finance Group has extensive experience helping financial services companies develop and implement customer segmentation solutions that are tailored to their business needs. To learn more about how segmentation can help you achieve your strategic targets, please contact:

Roberto Hernandez
(940) 367-2386
roberto.g.hernandez@us.pwc.com

Martin Touhey
(206) 790-8751
martin.e.touhey@us.pwc.com