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Session 88L
Developing Customer Intimacy

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Recorder: CARL E. MEIER

Summary: Based on his research at the Stanford University Graduate School of Business, Professor Lattin discusses the concept of a sustainable competitive advantage and why it is critical to success in a competitive market, such as the one for financial services. He then develops the concept of customer intimacy as a way to maintain a viable position in a competitive market. Finally, he covers the information, product/delivery, organizational, and performance measurement strategies that a company should follow to achieve customer intimacy. The presentation focuses particularly on a case study involving a firm within the financial services industry.

Mr. Carl E. Meier: On behalf of the Nontraditional Marketing Section, I would like to welcome you to this presentation by James M. Lattin, associate professor of marketing and management science and director of the marketing management program at the Graduate School of Business at Stanford University. Mr. Lattin holds an A.B. degree from Dartmouth College and a Ph.D. in management science from the Sloan School of Management at MIT. He has been at Stanford since 1984, where he has taught courses in marketing management and data analysis in the M.B.A. and Ph.D. programs. During that time, he has twice received special recognition for his teaching from the students in the M.B.A. program. Jim has also taught extensively in the executive education programs offered by the Graduate School of Business.

His research interests include choice behavior, database marketing, and the impact of information technology (IT) on marketing management and its implications for marketing organization. His research has won him awards from *Ad Week*, the American Marketing Association, *The Journal of Retailing*, and *The Journal of Marketing Research*.

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†Mr. Lattin, not a member of the sponsoring organizations, is an Associate Professor of Marketing and Management Science at Stanford University in Stanford, CA.

Note: The charts referred to in the text can be found at the end of the manuscript.

In addition to his academic pursuits, Jim has done consulting for a number of companies, including Adobe Systems, Microsoft, and Eli Lilly. He is also an advisory board member of several start-up companies. Clearly, he comes to us extremely well qualified, and I'm sure you will enjoy this presentation.

Mr. James M. Lattin: Carl has indicated that this session is sponsored by the Nontraditional Marketing Section. That is very appropriate, because in a few years, all marketing will be nontraditional marketing. We are in a time right now when technology development is causing the old rules about marketing to be rewritten. I'm going to talk about the ways that people are starting to think differently about marketing. A paradigm shift is taking place, and we're going to spend a little time looking at some of the forces causing the changes.

I am not an actuary, nor I have spent a lot of time studying the insurance industry, but I have done some research in the area of financial services. Many of the comments that I have today will be related to financial service institutions: banks, credit unions, etc. I presume that most of the sessions that you are attending at this meeting are about technical aspects of actuarial science and insurance. I would like to provide you with an opportunity to think about some things that are outside of that technical arena. I think some of these lessons are quite relevant to the many changes that you have seen in your industry.

I would like to begin by talking briefly about my philosophy regarding the role of marketing management and what I think marketing management is responsible for doing. I've spent 16 years teaching in M.B.A. programs, talking about marketing management, and I want to share my conclusions on those responsibilities with you.

Next, I'm going to talk a little bit about strategies for sustaining a company's position in a competitive marketplace. The big question is, how are you going to continue to maintain the position that you have achieved in the marketplace? The strategy that I will focus on has to do with forging customer relationships, building on them, and holding on to them over time.

I'll discuss a strategy for developing customer intimacy. This is especially important, I think, given the changing nature of financial services. I'll talk about why this strategy is particularly relevant in the financial services industry.

Next, we'll discuss the components of such a strategy. If you are convinced that customer intimacy is a viable option for sustaining your position in the marketplace, how do you actually do it? We'll talk about four components of the strategy for developing customer intimacy, and I'll give you some examples of what companies are doing in this regard and how they are coping with the challenges that they are facing.

Finally, I'll cover a short case study involving the Stanford Federal Credit Union. We'll look at how that organization is dealing with these changing conditions, how it is attempting to develop a strategy for customer intimacy, and what it is learning in the process.

Marketing managers have two primary responsibilities. The first is to create mutually beneficial exchanges with customers. A value proposition must be created such that your customers are willing to exchange what they have of value for what you provide to them in the way of products and services. That's an incredibly challenging thing to do. It involves creativity, as well as insight into what your customers need and want. It takes a lot of research to understand how customers see the world and how they go through life. Meeting that challenge is not enough.

That is because, as soon as you create that mutually beneficial exchange, somebody else is going to come along and try to take it from you. And they will try to take it from you by trying to do the same thing that you do, only they will do it quicker, cheaper, or better. After a marketer has put all of this work into creating those relationships, he or she also has to develop a strategy for sustaining those relationships with the company. That is a difficult and challenging thing to do as well, especially in a world where competition is getting faster, bigger, and more global. That is what we're going to focus on—strategies for sustaining that mutually beneficial exchange.

When I think about strategies for sustaining position, I like to organize them under three headings. These headings come from a book written by Michael Treacy and Fred Wiersema called *The Discipline of Market Leaders*. (There is also an article in the *Harvard Business Review* that appeared a couple of years before the book, which is a very abbreviated version.) One of the things the authors did was to identify three different generic strategies for sustaining your advantage in the marketplace. I'm going to go through these briefly so that you have a sense of what they are.

The first one is operational excellence. The idea behind operational excellence is that you focus on price and convenience. You are the fastest to market with the lowest price in the market. You are constantly taking the rewards from that cost-leadership position and reinvesting them to further drive your costs down or to increase the convenience of doing business with you.

Operational excellence is one viable strategy for sustaining your position. You can constantly make it more difficult for the competition to keep up with respect to your costs. But you have to remember that such a strategy can be a doubled-edged sword. A strategy focused on driving costs down also is one that emphasizes standardization. As a result, a company can get locked into standards that may be difficult to change when, all of a sudden, the paradigm shifts.

Let me give you an example, although it does date back a few years. In 1927, Ford Motor Company had operational excellence; they were without question an unbeatable leader at providing low-cost automobiles. But things shifted; suddenly people were buying automobiles for reasons other than the cost. Ford had to shut down its plants for a year to retool so that it could compete with General Motors, and it took Ford about 50 years to catch up.

Another strategy is product leadership. Here you are the most innovative company on the block, and you are constantly providing the most innovative solutions to your customers. Now your focus is on state-of-the-art products and services. I must tell you again that this is challenging, especially when the things that you come up with are easily copied. More and more, with technology, it is possible to get around patent protection. With financial services, the combination of things that you put together may be easy for your competition to replicate. If that's the case, then this strategy comes down to being a fast mover. You must constantly be first with the introduction of new ideas, as well as a good marketer, bringing those ideas to customers first and foremost.

The third strategy is the one that Treacy and Wiersema labeled "customer intimacy." The idea here is that you know and understand your customers so well that they're not going to go anywhere else. They have no incentive to try elsewhere. You create a barrier to their switching by virtue of the confidence that they have in their relationship with you as the provider. That's a tall order.

Treacy and Wiersema were the ones who coined the term "customer intimacy," but a term I like almost as well is "learning relationships." This latter term was first suggested by Joseph Pine, Don Peppers, and Martha Rogers in an article in *The Harvard Business Review*. Pine is the author of the book *Mass Customization: The New Frontier in Business Competition*, while Peppers and Rogers wrote the books *The One-to-One Future* and *One-to-One Marketing*.

If there is one recommendation which I would like you to take away from this whole presentation, it is that you read Peppers and Rogers's first book, *The One-to-One Future*. It has a range of very interesting ideas and new paradigm kinds of thinking about marketing.

The interesting thing is that the term "one-to-one marketing" turns some people off. Their response is, "Interacting with my customers on a one-to-one basis could never be cost-effective for me. They must be talking about somebody else, some other company, some other industry, not me." I think that's short-sighted. Although we may never achieve the ideal of one-to-one marketing, the ideas in that book have to do with understanding customers and creating a dialogue so that you can capture information from them and use it to better serve them. Whether that's done one by one or in small groups, the ideas are still the same, and so I highly recommend that book.

Some companies want to follow all three of these strategies at once. In their book, Treacy and Wiersema stated that they believe the formula for success is to pick one strategy and then try to do it better than anybody else. You have to meet minimal standards in the other strategies, of course, but you have to decide on one thing that you will do extremely well. I'm not prepared to say things are that simple. I don't think the way to success is that black-and-white. I would argue that at different stages in the life cycle of products or services you have to do different things well.

I'll give you an example of good customer intimacy. In the early stages of an industry, when you're going through product development and trying to create a product category, you have to create what is almost a collaborative relationship with your customers. You want the kind of relationship that allows those customers to help you develop and commercialize your products. What you're trying to do is to literally blur the boundaries between your organization and the customer's organization so that, together, you can take technology and create a solution that can be commercialized.

What is the route to success later on in the life cycle, as growth is beginning to slow, competition has come in, and products have begun to standardize? I would argue that again it comes down to customer intimacy, but now that may mean being able to customize the products to their needs and to do it cost-effectively. You have to understand micro-segments and how to serve them.

If you try to pursue all three of these strategies to the extreme, you won't have sufficient focus. However, it's not so simple as saying that one strategy will always work forever and ever either. You should constantly be looking ahead and trying to understand which strategy is going to be best for making it to the next step.

Now that I've covered the range of strategies, I'd like to focus on the strategy of customer intimacy and, in particular, on this idea of a learning relationship. Let's talk a little bit about the key activities in building relationships with customers. For a long time, marketers have talked about the four P's—product, price, promotion, and place—and the appropriate mix of these elements. I believe that before you talk about the mix of these elements you have to talk about what it is you want to accomplish. If the goal is building learning relationships with customers, then you have to understand the stages involved in those relationships.

I usually divide things into three stages, although some people limit it to two. In any case, there's a beginning stage in which your goal is to find customers. You have to somehow tempt them to get information about you, to sample your wares, and to try you out. That is the process of customer acquisition—the process of taking people who are prospects but don't know much about you, making them aware of what you have, and giving them the opportunity to try your products. Once you've done that you have acquired a customer.

As many of you who are working in this area probably know, not all customers are created equal. This is especially true for financial services and banks. Banks bleed a lot of money for a large proportion of their customer base. For some reason, those people end up using more resources than they provide. Remember how we talked about mutually beneficial exchanges? A mutually beneficial exchange means that it's profitable for the company to engage in the relationship, too. The truth is, sometimes you find people who aren't profitable as customers.

Once you have acquired these customers, the second stage in the process is understanding what it takes to make them profitable. Some of them start out that way, but not all of them do. There's a process of development that takes place in which you bring the marginally profitable and unprofitable customers into a position of profitable exchange.

Once you've brought them to that point, you want to keep them around. Retaining those profitable customers is the third stage of the relationship.

Each of these things are key activities for a company; each of them is an objective for a firm that wants to build learning relationships with its customers over time. You have to be thinking in terms of building relationships when it comes to these customer-intimate strategies.

In each of these different stages, you have to ask, "What is it that we're trying to accomplish?" There are some key questions that come up as you move from a focus on customer acquisition to a focus on customer retention. Although we'll be going into them later, I just want to highlight some of these questions for you.

In the customer acquisition stage, it's important for you to understand "How much is it costing me? What's my ROI?" Let's contrast this approach to the traditional advertising approach. Traditionally, companies that are making decisions about spending money on advertising and market communications have concerns such as how this year's budget compares to last year's, what the mix of the different media that they will use is, how they're going to accomplish the objective of so many exposures to so many people in certain segments, etc. I would argue that that sort of plan says nothing. It gives no information about objectives with respect to each of these stages.

Let me ask a rhetorical question. For those of you who spent money on advertising last year, presumably some of that spending was to make new people aware of the company and to bring in new customers. Exactly how cost-effective was your advertising for customer acquisition? Very few companies can come close to answering that question.

Do you know where they're beginning to be able to answer it? On the Internet. Because now when you place marketing communication in different places on an IT network, you can trace the effects to where the people are. Now you know how cost-effective your spending is.

I got some information on this subject some time ago from InsWeb, which is a provider of information and price quotes on insurance. InsWeb needs to know where its customers are coming from and what advertisements are working. The company doesn't want to know just the number of people who showed up at its site; it wants to know how many of them actually clicked through to ask for specific information, to get a quote, contact an agent, whatever. InsWeb is able to trace its marketing activity on the Internet. What it found is that the company was getting the best return on its investment from advertising on *USA Today's* online site. Actually this information is probably about eight months old, so things may have changed by now. The point is that InsWeb is gathering this information and reviewing it on a regular basis.

Here is a company with acquisition in mind that is beginning to track the cost of acquiring customers through different means. And even though it may not be completely sure how profitable these customers are, it knows how responsive they are. InsWeb is willing to allocate more of its resources to the sources of the more responsive customers.

When it comes to customer development, you need to be able not only to identify whether customers are profitable or unprofitable, but also to determine the best method for converting those who are unprofitable to being profitable. How do you develop the right mix of products and services to offer to these people, or price things appropriately so that they move through your system and become profitable?

Finally, regarding customer retention, you need to be able to answer the question, "What is the distribution of customer lifetime?" You also need to know your "churn rate"—how fast you lose customers—and why. What can you do to decrease the likelihood of a customer's departure?

All of these questions deal with objectives that are quite specific to the various stages in a company's lifetime relationship with the customer. Keep in mind that attaining those objectives is crucial.

Having done all of that, you then need a metric that can be used through all of these stages. You need to have something that enables you to say, "How am I doing? How are my efforts at customer retention affecting the bottom line?" In the past, many companies have focused on measures which are either division- or product-specific. The problem is that, if your objectives are specified with respect to customers and your measures are focused at a product or division level, there is a mismatch between the two. Therefore, companies have to develop better measures at the appropriate level to tell them how they are doing with respect to their actual objectives.

As a result, companies are experimenting with ideas such as the lifetime value of a customer. A company has to be able to determine this value for various customer segments. This allows it to look at customer profitability over the long term. Then the company can try to build a plan that will enable it to increase this profitability over time.

Chart 1 illustrates how the various activities map onto the trajectory of lifetime value of the customer. What is depicted here is how the profitability of the relationship with the customer might be expected to vary over the duration of that relationship. Certainly, these are idealized curves, more of a company's expectation, and a bit smoother than would actually be the case. And, as both curves show, with many customers things figuratively fall off a cliff as the relationship comes to an end.

What companies are finding, as the lower of the two curves illustrates, is that customer acquisition costs can cause them to start the relationship significantly in the hole. It costs real money to bring in new customers.

For example, how much are telephone companies now spending to acquire a new cellular phone customer? Do you have any idea? Right now, it's probably in excess of $300 per customer. The idea is that this acquisition cost is balanced off against the future profitability of that customer over time. However, in many cases, the companies are finding that they are paying more and more, while the value of the new customers they're acquiring is becoming less and less. The people who were the first to adopt cellular telephone service are the biggest users. People who are coming into the fold now not only use the service less, but are also coming in at lower rates. This means that their value to the companies is going to be realized over a much longer period of time. That means that the companies must keep their churn rate down, or they'll find that they are paying to acquire customers who will never stay with them long enough to pay off the customer acquisition costs.

If you practice relationship management, as opposed to traditional marketing, your focus is on these three objectives: acquisition, development, and retention. The top curve illustrates the effects of this focus.

Improving the cost-effectiveness of your acquisition strategy lowers your acquisition cost per new customer. That means you pay out less per new customer in the beginning and have less cost to amortize over the life of the customer.

Better development shifts the curve up and also increases the slope. By identifying the correct path, the right mix of products and services for your customers, you can have a faster route to profitability.

Improved retention shifts the curve out to stretch the profitable area over a longer period of time so that you can benefit from the profits that flow from this relationship further into the future.

These three goals—lowering the cost of customer acquisition, speeding up the time until they become profitable, and increasing customer retention—are the keys to increased profits over time.

Why is a customer-intimate strategy particularly appropriate for the financial services industry? The answer is that a real sea change has been occurring in the organization of the industry and its relationship to its customers.

Once upon a time, people expected to go to different financial service providers for different financial service products. If you wanted a checking account or a savings account or you wanted somebody to manage the ebb and flow of your money, you went to a bank. You didn't go to a bank for insurance. You went to an insurance company to get insurance or maybe an annuity. You didn't go to either a bank or an insurance company to help you trade stocks or to manage a portfolio.

Largely because of regulation, this industry was organized in a silo fashion, with each silo responsible for a different product/service package. Banks competed with other banks for the same set of customers to provide them with the same limited range of services. The situation with insurance companies, brokerages, and the various other financial services organizations was similar. For the customer, this meant dealing with a whole host of different people, each providing different and very limited financial services. That's the way it was for a long time.

A good example of how things have changed is a company named Intuit. Intuit developed a financial software package called Quicken and built a very loyal customer base. There are 6–8 million people who just love that product. They use it to manage their finances, balance their checkbooks, etc. Intuit asked itself the question, "What else can we provide to this incredibly loyal set of customers?" Since these people have already shown an inclination to use software to manage their checkbook balance, what else might they be willing to use software to do? One of the things that Intuit decided was a good possibility was tax preparation. And so, Intuit acquired the TurboTax software package. This allowed Intuit to sell to its existing customer base a complementary product that extended the functionality of the financial management services it provides. The company literally broadened its mission from helping people balance their checkbooks to helping them keep track of their financial past, present, and future.

Now, Intuit has redefined itself and its role in the industry around a base of existing customers who want it to perform that kind of work. Having started with a financial service package, Intuit then asked, "What more can we do for our customers?" The company's answer this time was more far-reaching: "Why don't we just handle the transactions for these customers? We're already helping them balance their checkbooks. Why don't they just write the checks with us? We'll clear the checks and we'll do the processing." That would add significantly more functionality to the services Intuit provides.

That was the point at which Intuit found itself on a collision course with the banks. The banks said, "Wait a minute, we're doing that." The banks were coming to the realization about that same time that they could also go beyond the narrow product definition within which they had been operating and more broadly serve their customers' financial needs.

As a result of deregulation and IT that is allowing greater product integration, companies throughout the financial services industry are beginning to develop their strategies around their customer base. They are looking to see what range of products and services those customers want.

Now integrated financial service providers are coming into the picture. Why is there such a fight over this? The goal is to own the relationship with the customer. Each wants the customer to think of this provider as *the* one on whom he or she can count on to provide a broad range of services for his or her financial needs.

What Intuit wanted to do, and what it found it didn't have the capabilities to do, was to take the place of the banks as the trusted financial provider. The banks, meanwhile, had come to the realization that they needed to move beyond their traditional operational focus on simply providing transactions. They needed to gain a better understanding of the range of products and services that their customers wanted which they could provide.

That is the sort of shift that has taken place. I suspect that you could tell me a similar story about what has taken place in the insurance industry. Aren't you, all of a sudden, seeing a significant increase in competing channels for the distribution of insurance? Aren't all of those nicely defined boundaries of the past beginning to break down? What's happening now is that the established companies are redeploying their resources around their existing customers. Their efforts are being directed to retaining their existing customers and to further building that customer base. To accomplish this, a company cannot stop at a single product or service for those customers; it has to find all those things that are necessary to keep them happy.

If this is a viable strategy, you might then ask why a company should stop at providing only financial services. Why couldn't it decide to provide a much broader array of products and services and become a real one-stop source for just about everything? There are at least two limitations that you must keep in mind.

First, what happened to Intuit when it decided to go up against the banks? Has it succeeded in essentially replacing banks as people's financial service providers? No. The reason is that, despite having done a great job of developing customer intimacy, there is still a need for operational excellence to survive. Intuit tried getting into the clearinghouse business. It turned out the company couldn't do it very well, and it was very expensive. The first reason is that your capabilities will limit the range to which you can extend.

What about Amazon.com? You may think of Amazon as an online bookstore, but the company wants to be much more than that; that's just where it started. Amazon's mission—and its actions are consistent with this—is to become the e-commerce provider for people who are shopping on the Internet. It doesn't have to be just books, CDs, or movies; Amazon plans to leverage its existing customer base by serving a broader and broader range of those customers' needs. That builds barriers that keep those customers happy and feeling that they can always go to Amazon.com to meet their needs. Part of a company's success in how far it can extend the boundaries of what it provides, then, is a function of the goals it sets. But no matter how ambitiously those goals are set, the results will be limited by the capabilities the company can build to provide service. Even an Amazon will not be able to extend its reach to every possible transaction in which people might want to engage. E-commerce in products with a fixed price, which are easily shipped and nonperishable, is where they are going to make their mark.

Some of you may question how far a company can go in extending the boundaries of what it provides before concerns begin to be raised about things such as whether it has become a monopoly. Look at what's going on right now with Microsoft, for example.

In the current Microsoft case, I think a big part of the problem is that many people believe that the company has used its incredible power in operating systems to extend into other businesses in an anticompetitive way. In other words, it has abused its tremendous market share. I don't believe, however, that simply extending what you do to provide your existing customers other services that you know they need because of how well you understand them is likely to be adjudged as acting in restraint of trade.

Also, it would seem that the more you broaden the range of services that you offer, the less the likelihood of your being branded a monopolist. What causes a problem is if you are doing something that's very narrow and you have a big market share there. That's when concerns about a potential monopoly are raised, whether or not you actually exert monopoly power. Consider Amazon though; as they broaden what they do and go beyond just books online, they're much less likely to be viewed as the only provider for those different products and services.

If you don't hold your customers captive to sell them other things, which is what some people contend that Microsoft has done, then I don't feel that you are in the same danger as Microsoft. I'd have to say that holding customers captive is very antithetical to the idea of customer intimacy. You want them to think of you as being on their side, not as holding them captive.

Another argument sometimes raised against extending your offerings is that, while you may do a great job with your first product or two, as you add others it's likely that there eventually will be other sellers who are doing a better job on some of them than you are. Since you can't be the best at everything, don't you run the risk of the whole package becoming mediocre? And how do you compete against people who specialize in only one or two components as opposed to the broader array you have chosen to offer?

I believe the answer to these questions is that, to be successful with a broader range of offerings, there must be some value to the customer in the integration of all these things that you are providing. In dealing with a bank, for example, isn't there value in having one entity to handle your checking account, your deposit savings, and so on? If you lose that integration, you lose a functional value that's added by that relationship.

That doesn't mean that you can just add products and not pay attention to doing a good job at them. The question an organization must ask itself is, "Can we develop the capabilities to do a good job of providing both service A and service B to our customers?" If the answer is "Yes," and if people value the integration of those two services, then I would argue that somebody providing a better service B will not necessarily pull your customers away from you. That is because those customers view B and A together as what they need. The challenge to marketers will be to convince people that integration is what they really need, and that you are the one to satisfy that need.

Do we always have to create the products or services we market ourselves, or can we go out and assemble things from the offerings of other manufacturers? Actually, that is a part of the lesson Intuit learned when it went up against the banks. Intuit realized that it was simply not going to be able to replace what the banks could do with all of their infrastructure. The company decided that it would have to work cooperatively within that infrastructure. As a result, Intuit now exists both as a Web site and as financial software that can be offered by banks to their customers. Banks have elected to offer Intuit's products and services through their own e-commerce online banking solutions. Why? Because the banks couldn't figure out how to put the right software package together.

Intuit, as an organization, couldn't build the capabilities it needed to reach everyone and do everything on its own. The two sides entered into a partnership. People doing online banking are sent to the Intuit Quicken Web site when they need some information that's not otherwise available. And the people who are signing up for banking services find greater utility as a result of having access to these easy-to-use software packages.

I can't offer any good solid rules of thumb as to when a partnership makes sense and when it doesn't. One of the problems with partnerships is that you sometimes enter into them with people who are competing with you online. I'm sure that in the insurance industry, as you're considering new distribution channels, you may find the channels that are your partners are also potentially your competitors. That happens; all I can say is that you have to balance the trade-offs. You have to ask whether it's something you can build the capabilities for yourself or whether it's something that's better to provide through a partnership.

Let me talk a little bit now about the strategies and components for developing customer intimacy. In producing a marketing plan, you have to address the development of the product, the pricing of it, the promotion of it, and the distribution of it. Those are the elements that make up the marketing mix.

When you are trying to put a customer-intimate strategy in place, there are also four things that you have to address. You have to have a strategy for information systems, for production and delivery, for organization, and for measurement. Measurement, as we touched on earlier, is the metric you use to determine whether or not you're making progress. Let's talk about each of these in turn, and then go through an example that should help illustrate what I mean.

You need to create a dialogue with customers. It allows you to reach them with information, and it allows you to capture information from them, which may reveal something about their behavior, their preferences, their wants, and their needs. Why has there been so much talk about one-to-one marketing and customer intimacy lately? We've always been capable of doing these things, but it used to be very expensive because you had to do it person-to-person.

A direct sales force was usually the best source of information about your customers. Some companies employed direct marketing using the U.S. mail. They would get information, deliver something to people, and then get information back as to whether or not they liked what they received. With the advent of the Internet, however, and with information systems and networks that extend across organizations this has become incredibly cost-effective to do. You can pinpoint the person and address that you want to deliver a special message to, or you can find out what he or she is doing. When he or she comes to your Web site, you can find out how much time he or she spends, what he or she clicks on, and what he or she is interested in. When that person returns, you now have the option of delivering to him or her something different from what you provide every other visitor to your site.

You need to create a big database because not only do you need the information, but you also have to analyze that information to tell you what to do. There are two different ways of leveraging that information, and I want to make the distinction between them clear. The information may be used either intracustomer or intercustomer.

To understand the intracustomer use, let's consider the example of a bank. A customer walks in, goes up to the teller, and asks the teller for travelers' checks. Without any other information about the customer, all that teller can do is complete the travelers check transaction. However, that customer could fit either of two profiles (among many other possibilities). He or she could be somebody who's essentially skating along with $50 in his or her checking account and all sorts of late fees piling up, or he or she could be somebody with $100,000 in the bank, as well as a home-equity line of credit.

If the teller doesn't know who that customer is, how is he or she going to know the appropriate course of action? An intracustomer system allows the teller to identify that customer and improve the bank's marketing to that specific customer. That's the technology that allows Amazon to make recommendations to you about books. Knowing what you've just bought and what you've bought before, Amazon.com can suggest other books that might be of interest to you. One of the most important intracustomer uses, and we'll talk more about this in a little while, is being able to identify profitable and unprofitable customers.

The real challenge, I think, is intercustomer use. How can you use the information from one set of customers to improve your marketing to another set of customers? This can be particularly valuable when it's necessary to deal with people who are not as cost-effective to reach on a one-to-one basis. If you know, for example, that many of the people who are lured by a free checking account are very expensive to you down the line, you may develop a fee-pricing structure that helps you either develop those customers and make them profitable or encourage them to leave.

Putting information to work on an intracustomer basis requires only good IT. Applying it on an intercustomer basis requires IT and human resources: the analysts, the insight, and the capability to look for patterns and to extend those patterns to predict the future behavior of other customers.

Of all the companies that I could use for examples, a great one for both this strategic component and the next one is Capital One. This company started out as a direct marketer of credit cards. However, it also engages in more direct marketing research and experimentation than almost any other company. Last year alone, Capital One conducted 3,000 different experiments with its customers. A typical experiment might involve trying to determine the best response to make when somebody calls up to say that he or she's going to switch from a Capital One credit card to one from another provider.

In any given situation, there are usually a number of different policies that could be put into place. However, there's often uncertainty between whether policy A or policy B works best. Capital One is always testing different policies on a randomized basis and collecting response information that helps it to make decisions in the future. The company tests policy A versus policy B over a fixed horizon. If one does better than the other, it uses that one for all subsequent customers down the line. As a result, the company is literally refining its marketing activity in a dynamic way as it goes along. It is constantly collecting updated information in controlled test environments to improve its understanding of its future customers and to better market to those customers.

To recap the information strategy, the emphasis is on dialogue; there has to be this two-way street. You must have the technology to be able to capture information on customer preferences.

Do you see why Intuit considered the stakes to be so high when it came to competing with the banks? It was because Intuit wanted to be the intermediary; it wanted to be closer to the customers so it could capture all of the information about them—how they write checks and what they do over time. Intuit would then use that information to better serve those customers and to develop products and services that they need. That's what Capital One is doing. They have information about all of your credit card transactions. They can use that information to design better products and services and better marketing programs to meet your needs.

The next thing a company must have, in addition to an information strategy, is a production and delivery strategy. It needs to be able to deliver to its customers those different things to meet their needs. Earlier I made a distinction between different stages in the life cycle of the company/customer relationship—between the introductory phase and maturity. In both stages, a customer-intimate strategy is appropriate, but what you need to do is very different between those two stages.

I'll give you an idea of what I mean. I said that Intuit engaged in collaboration with its customers. It developed a product that worked. It then literally followed the customers home, sat down with them, and watched how they used the package. That information came back and was integrated into subsequent product development. Intuit did a very good job of establishing that exchange of information and getting people to help it develop the products.

As things progress to a more mature stage, though, products become standardized. In this stage, the company must find ways of meeting the needs of customers differently through some form of cost-effective customization. Often this involves bundling together additional services or products in a unique way that meets one customer's needs.

Intuit is working on this. They have a Web site, Quicken.com, which generates 200 million page views a month. This is about the same as what Yahoo does, but Quicken provides financial service information. Quicken has a huge customer base, and, once people register online, it's possible to present custom information as people arrive. If a company can recognize a client when he arrives, why give everyone the same thing? Why not start by telling them what they had done the last time they were there, and then offer a button that will bring them to that exact spot again immediately?

When it comes to retailing, brick-and-mortar retailers are stuck with the store format that they have; it's not easy to change around. With an e-store, you can decide as the person walks in the door how the store should be organized to best meet that individual's needs. If this customer searches in a certain way, why not provide information in that same way? Have you ever had the frustration of going into a Blockbuster and wondering why they have the movies organized the way they do? It doesn't matter what you want, you can't find it. There is no need for that to happen if you shop electronically. The retail environment is an excellent example of how you can take the product that you offer people and customize it by using the right skills.

The next strategy for customer intimacy is organizational strategy. The deployment of resources to manage customers and capabilities is a big challenge. Executives from all industries are perplexed by this. "How should my company be organized in order to be able to do this?" is a common question. "People tell me we need to be customer-focused. We try to be customer-focused, so at the level closest to our customers we are organized in a way that makes sense for them. But we still have to develop products, and so somewhere in the organization we still have to be organized to accomplish that." This duality presents a real challenge.

The American Express company has had to deal with this challenge for a long time. For those of you who have an American Express card, have you ever noticed all of the things that are in the envelope with your monthly statement? There are all sorts of offers and, every once in a while, merchandise that you can buy using your American Express card—things like designer plates or compact stereo systems. Here is a compact stereo system for $699.95 or 50 payments of $14.95 per month on your American Express card. You say, "What a great idea. It's so convenient, I'll sign up right now." You buy it, it arrives, and you're very happy with it. That is, you are until you go down the street to Circuit City and see the same thing for $499.95.

The decision to make that purchase may have been a very profitable one, from the perspective of the group that is evaluated on how well they do selling merchandise to American Express Card customers, because they sold something for a $200 greater margin than would have been available otherwise. In a global sense, however, it may prove to be very unprofitable if the buyer, who is a person who was rolling over $10,000 of charges on the American Express Card every month, decides that he or she has been ripped off and cancels his or her card. An organization that is solely product-focused can make myopic decisions with respect to the profitability of one product, which turn out to be very short-sighted with respect to the profitability of the company as a whole.

What is needed is an organization that can manage this duality. In their book, Peppers & Rogers suggest something called a "customer by capabilities matrix." This is something that American Express has begun doing. It involves overlaying their product organization with groups that keep track of different segments of customers. As a result, they know the consequences of what the product organizations do for the various customer segments. That's one way of doing it.

I think companies are also looking increasingly at virtual organizational solutions using IT. They can now use systems that allow groups to share information on the impact of what they decide to do across customers. Such systems for customer relationship management will allow groups to make jointly optimal decisions with respect to the products that they design and the prices that they charge without necessarily requiring a matrix-style organization.

Managing a matrix organization can be quite frustrating, so I think many companies will welcome the idea that it may not be necessary to reorganize. It may be sufficient to create the systems that provide information across groups. I think incentive plans are important, too. You have to move incentives away from product profitability and more toward customer or group or segment profitability so that you can do things that are in the right interests of the firm rather than just the myopic interest of a particular product group.

Finally, let's talk about measurement strategy. As I said before, you need to move away from measures that are product-focused and more towards measures that are customer-focused. One of the first, and most famous, examples of focus on customer satisfaction was Xerox. They were a company that adopted customer satisfaction as their number one performance measure. They've moved on over the years because they found that customer satisfaction wasn't perfect, but none of these measures is an absolutely perfect solution.

For Xerox, the experience was an absolutely transforming event. This was because, when they adopted customer satisfaction as their measure, they discovered that their organizational structure didn't enable them to deliver improvements on customer satisfaction. If they wanted to improve satisfaction, they would have to reorganize to fit the needs of their customers.

The problem was that Xerox, like many companies, was functionally organized. They had sales, production, installation, and customer service. When a customer came to Xerox with a problem, all he or she cared about was that something didn't work and it needed to be fixed. What happened was that the salespeople would say, "That's not really our problem; it was the installation people." The installation people would say, "No, we think that was really a problem in production." The problem just got kicked around and nobody was there to close the loop. Each department was focused on only one aspect of the customer's problem. Not until Xerox developed a team solution for bringing all of the pieces together to correctly identify and solve the customer's problem could they move ahead to customer satisfaction.

This reorganization into teams was like layering the organization. Xerox empowered the customer service area with all of the different functions of the company and made that area responsible for managing the company's relationship with the customer. Xerox changed the way they deployed their resources, but they didn't abandon the functional organization. They augmented it to make sure that their people were focusing on the customers.

For several years after that they systematically improved customer satisfaction. Then they moved on from there to try to understand loyalty and share of a customer. They did this because they needed to know why some of their satisfied customers were leaving them. Satisfaction wasn't a measure that allowed them to discriminate between happy customers who stayed and happy customers who left. They went on to different measures to try to continue to improve their performance.

Charles Schwab is another example of a company with a terrific system for customer profitability. They identify the customers, they know how much the customers are worth, and they use their information to track the effects of different marketing initiatives.

Now that we have reviewed the components of these various strategies, I thought it would be useful to walk through a case study. Let's take a look at an organization that's facing these issues, the Stanford Federal Credit Union. You might want to consider some of these same issues with respect to your own company. Identify the problems and the issues you are facing. What are the strategic components that you think need to change in order for your company to move in the right direction?

The Stanford Federal Credit Union hasn't been around for very long. It was founded in 1960. It has 40,000 members and total assets of $265 million. That may sound small to many of you in this room, but for me it's just right. An organization with one million members would simply overwhelm the computer system that I use.

While it may be small, this credit union is not a backward organization. It was the first credit union in the U.S. to offer Internet banking. It has to be fairly sophisticated because it serves a Silicon Valley clientele that have high expectations with respect to the online services that should be available to them for managing their money.

Is this credit union in an industry and in a position where it needs customer intimacy? Once upon a time, it wasn't really that important. Chart 2 shows a matrix that illustrates when a customer-intimate strategy gives a company good leverage. It depends on the heterogeneity of two different things: customer needs and the valuation that customers place on those needs, that is, how much they're willing to pay to have those needs met. This diagram, being only a two-by-two matrix, is an extremely simplified version of reality in which customer needs are either all very similar or extremely different. Likewise, the customers' valuation of having their requirements met is either very similar, with everybody willing to pay about the same amount, or very different.

Once upon a time, all credit unions really did was make car loans. People came to the credit union when they needed a loan, and the vast majority of those loans were car loans. Some of these customers did a better job of paying back their loans, but their needs were about the same and overall their valuations weren't dramatically different. In such a situation, an organization doesn't really need customer intimacy. A standardized marketing program with a standardized set of products and services is the most cost-effective way of providing for the needs of such a group of people.

What's happened over time is that credit unions have begun to experience all of the things taking place elsewhere in financial services. They're finding that to hold on to their customers they have to provide those customers with a broader range of services. They are now faced with meeting the needs of a much more diverse customer group, but a group that is willing to pay very different amounts for the different things they require. For any company that is experiencing a move up (the diagonal in Chart 2), a customer-intimate strategy becomes increasingly imperative.

Chart 3 will give you some idea of the heterogeneity with which a credit union such as the Stanford Federal Credit Union is faced. The y-axis of the graph shows the total profitability of the credit union, while the x-axis depicts the distribution of members, sorted from most profitable to least profitable. As you can see, the curve begins to turn downward at about 30% of the way through the membership. Put another way, 70% of the credit union's membership is currently unprofitable; they currently do not even cover the variable costs associated with meeting their needs.

Notice the point where the curve in Chart 3 first crosses the x-axis. That point represents less than 5% of the total membership. Less than 5% of the members are providing 100% of the profitability of this organization. The credit union likes those people; it likes them a lot. It wants to make sure that it holds on to them.

But the credit union also wants to do something about the 70% of its members who are unprofitable. It needs to develop that group so that they are profitable. Otherwise, all of the additional profitability provided by the group that falls between about 5% and 30% of the membership is negated by that 70% group.

Therefore, the credit union must set some objectives. If it is thinking in terms of customer intimacy, then its objectives should be set with respect to the stages of its relationships with its customers: acquisition, development, and retention. The first goal that the Stanford Federal Credit Union came up with was to make sure that those profitable people stayed with it. It didn't want to lose those people. And because they're so profitable, an organization can afford to deploy a lot of additional resources focused on the individual needs of these people. That was what this credit union decided was its first and foremost objective.

Secondly, the credit union had to determine how it was going to deal with all of those members whom we would call "below zero" members. It couldn't afford to keep them as members if it meant losing money year after year. How could it bring these members closer to the break-even point without a loss of future profitability?

Interestingly, despite its sophistication with respect to online activity, this organization really knows very little about the history of its members—where they came from and how they became members. It definitely needs to know more about where the profitable people come from and which of its acquisition efforts have brought the highest return. And it needs to know how it can be more successful in acquiring profitable customers in the future. This is what I mean by setting your objectives and goals with respect to the different stages of the relationship-building process.

Once those goals and objectives are set, it's time to put your plans into place. Those plans follow along the lines of the four strategy components we talked about —information, production and delivery, organization, and measurement. The Stanford Credit Union realized that until it could measure the profitability of each of its customers and identify them by their profitability it couldn't make any progress on its first objective—the retention of the most profitable customers. What the credit union did was to build a model that gave it information about the current profitability of its members. Actually, the model is a bit short-sighted because what the credit union really wants to know is the expected future profitability of those members. It wants something that will tell, given a person's current situation, what sort of future returns it can expect from this individual.

This organization hasn't gotten that far yet, but it's the next logical step to take. The more the credit union studies the transaction histories of its customers, the better it will be able to project from what it knows about a customer today to what that customer will do in the future.

To get to where it wanted to go, the credit union needed an information system that would allow it to deliver on these plans. The back-office system that was in place just wasn't up to this task, which meant investing in a new system that would deliver information about a customer's profitability to the point of purchase. If the credit union could identify the customer's profitability level, then when that person walks in and says, "Travelers checks, please," the teller could automatically be instructed as to what to do. He or she would know whether to ask that person to pay the fee normally associated with travelers checks or to waive that fee and thank that customer for his or her business. That is just one way to leverage the intracustomer information that such a system can provide an organization.

Of course, this goes beyond credit unions. Call-center systems will become more and more sophisticated in terms of their ability to identify people as they call in. Capital One systematically screens calls so that customers at the top profitability level can be handled by more experienced agents. If a company can use technology to identify those people, that may be one of the best uses of that information—to provide them with a higher class of customer-service representatives to better serve their needs. The systems necessary to do this are not inexpensive, but we can do things cost-effectively now that were not even possible just a few years ago.

The credit union now is working on developing a product strategy so that it can bundle the right products together. Some form of bundled pricing is probably necessary because, as people use more and more of the services of the credit union, serving them becomes more cost-effective. The credit union wants to hold on to those customers and is willing to charge them lower rates overall to bring them in to the membership. This requires a change from thinking about how to manage share account products, loan products, etc. Rather, the question becomes, "What's the right bundle of services for us to assemble to meet the needs of this set of customers?" Pricing becomes more complicated, but through the use of information systems a whole range of product bundles with different prices can be developed, and people can then choose from that menu.

In measuring customer profitability, a question arises as to how the measure should be expressed. For example, should customer profitability be measured on a dollar basis or a percentage basis? Obviously, not every customer has the same overall profit potential, so what do you do? The model of customer profitability that you put together should be very specific to your objectives. You want it to be something that you can use as a metric to measure your performance toward these goals. The Stanford Federal Credit Union, as an example, has access to credit history information and credit reports. This means it can look at all of the loans that a customer has had and determine what percentage of those loans originated with the credit union. That might be one measure it chooses to use; a person may not have had a lot of loans, but if the credit union has had a 100% share of those loans, then that's a solid customer, and one who is less likely to defect. It may decide it wants to treat that customer in a different way than somebody whose loan business it is trying to acquire. What you want to accomplish should drive your choice of the unit of measurement to use.

Proctor & Gamble uses a measurement called "share of customer." Of all the different cleaning products a customer has on his or her shelf, what percentage are Proctor & Gamble products? Is it 20% or is it 80%? One of Proctor & Gamble's goals is stated in terms of share of customer, and it studies different customer segments to find out how to improve its share of what is on that shelf.

Before developing a product strategy, it is important to remember that you first need to go through the previous steps. You need the input from your customer profitability model, and you must be able to identify your customers by profitability level. This information then provides the basis for setting the policy for your bundled products and prices.

The Stanford Credit Union doesn't have a good customer profitability model yet, but it's working on building one. This is a difficult job because it requires looking at the interdependencies of all of these different products and transactions across people.

One of the things that we're looking at is the differences in people's histories of using online transactions versus telephone human interaction. Clearly, a group who is more willing to use online transactions is more cost-effective to serve. They also like different kinds of products. That suggests a bundling opportunity and a lower fee structure that can be provided to those people. It keeps them happier and, from a cost standpoint, they break even earlier. Furthermore, this information has intercustomer utility, in that it can be applied in serving people acquired online to better develop their profit potential. The information from the first group of customers allows the credit union to better market to the second group.

What actions has the credit union taken as a result of what it has learned so far? It's doing a lot of partnering with other organizations. It's not unusual as you pursue such a strategy to find that there are many capabilities that you need help in developing. The credit union, in particular, is a pretty small organization without a lot of technical expertise. One of the credit union's partnerships is with a Canadian company called Prologic, which has developed a system used by Canadian banks and credit unions, and is now trying to gain entrée into the U.S. The credit union and Prologic are co-developing this product. They are working together to define the needs of the credit union's customers, and Prologic is learning how to build and commercialize its system for U.S. credit unions and banks. By the way, this system will also give the credit union the opportunity to identify its members at the point of transaction.

The credit union also has a partnership with a start-up company in Silicon Valley called Honeycomb Systems. This firm is involved in data mining. It has a system that can process vast amounts of transaction-based information and look for patterns in those data. For example, it can determine shifts in departure of members or reductions in the level of service they utilize. The system looks for early-warning signs so that the credit union can identify those people based on the characteristics of members who are susceptible to departure.

Finally, the Graduate School of Business is also working with the credit union to do some model building. Our ultimate goal is to help them determine the "right" bundled pricing for customer acquisition. Doing that involves investigating all sorts of different data, and trying to find out how they relate to the behavior of customers.

I would like to conclude this presentation by sharing with you some of our modeling results. One of the areas we investigated was the impact of the total account balance on the probability that a customer will leave the credit union. The credit union has a long history of information that allows us to do this. We have found that the level of the account balance is significant. The larger the balance, the less likely somebody is to depart over time, all else being constant. What is more interesting is that there's a further interaction with the tenure of membership. The longer the credit union keeps a customer, and the more that customer is utilizing the services of the credit union, the probability of losing that customer is even less. This suggests that policies that encourage people to hold high balances and utilize more services will result in longer retention of customers. If the credit union can accomplish this result profitably, it will increase the expected lifetime value of a customer.

Could it be, however, that the reason people with high balances tend to remain in the credit union is that the credit union already pays more attention to them? Could we be confusing cause and effect? The fact is that, up until recently, the credit union didn't know this information, so it had no basis for making any distinction in the way it treats different members. It was an organization based on transaction processing. Its goals involved being proficient solely in that arena, handling people's statements and balances as efficiently and error-free as possible.

Now things are changing, and we're going to have to incorporate those changes into our models as well. The Prologic system will be able to capture people's responses to marketing offers. If, for example, a teller notices that someone has a loan elsewhere, offers to consolidate that loan at a lower rate of interest, and gets a negative response, that will be recorded. The credit union can then use this information either to improve the kind of offer it makes in the future or just to note that this particular customer isn't interested in that type of service.
In conclusion, here are a few main points that I hope you will take away from this presentation:

- First, customer intimacy is a means to an end. You still have to create exchanges of value with your customers. Once you've achieved that goal, customer intimacy is a way of protecting what you've achieved. Think of it as the route that you'll follow to sustain those relationships you've built.
- Second, when you're setting your objectives with respect to marketing in the future, think in terms of the stages of relationship building. Are your objectives specific with respect to what you hope to accomplish with acquisition, development, or retention? Being specific here will help you in formulating your plans.
- Third, as you formulate your plans and design these strategic components, keep in mind:

- The information systems that will be necessary;
- How product strategy will allow you to deliver the right things to the right customers;
- The appropriate deployment of organizational resources or, at the very least, what sorts of information it will be necessary to share about customers throughout the organization; and
- Some metric that allows you to assess your performance in achieving your goals.

CHART 1

INCREASING CUSTOMER PROFITABILITY

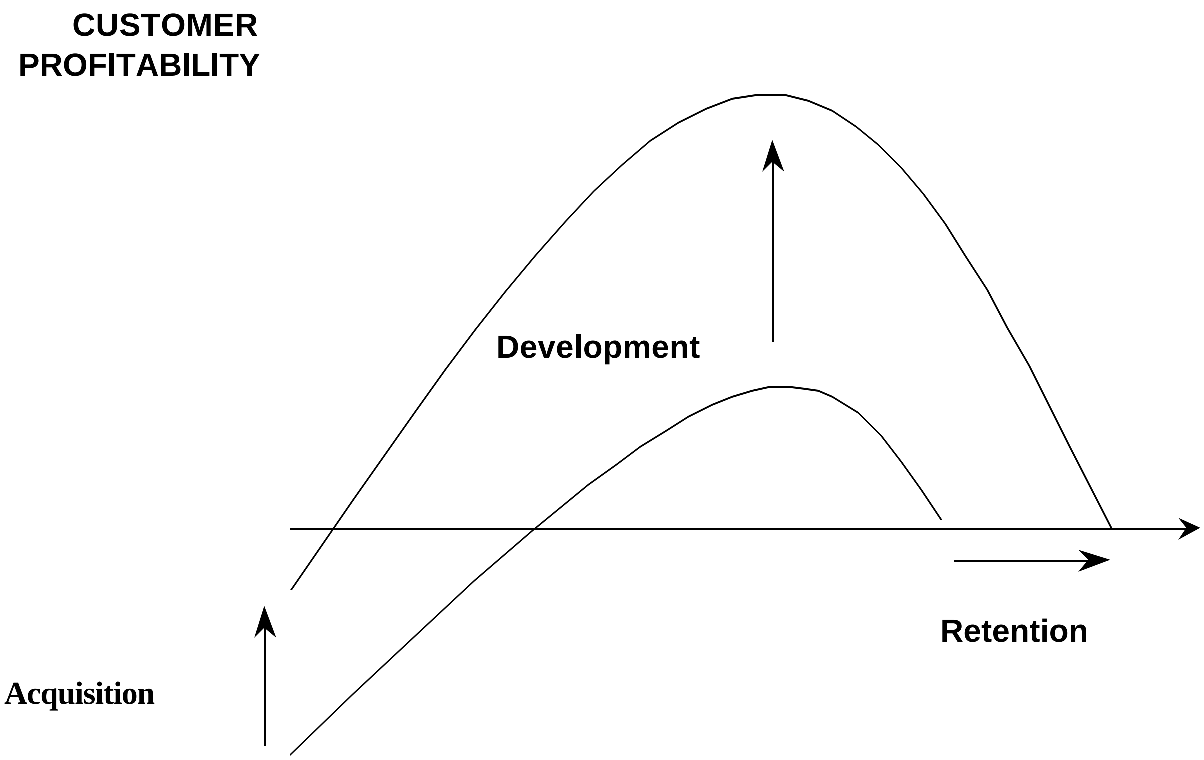

CHART 2

NEED FOR CUSTOMER INTIMACY?

Look at SFCU transition:

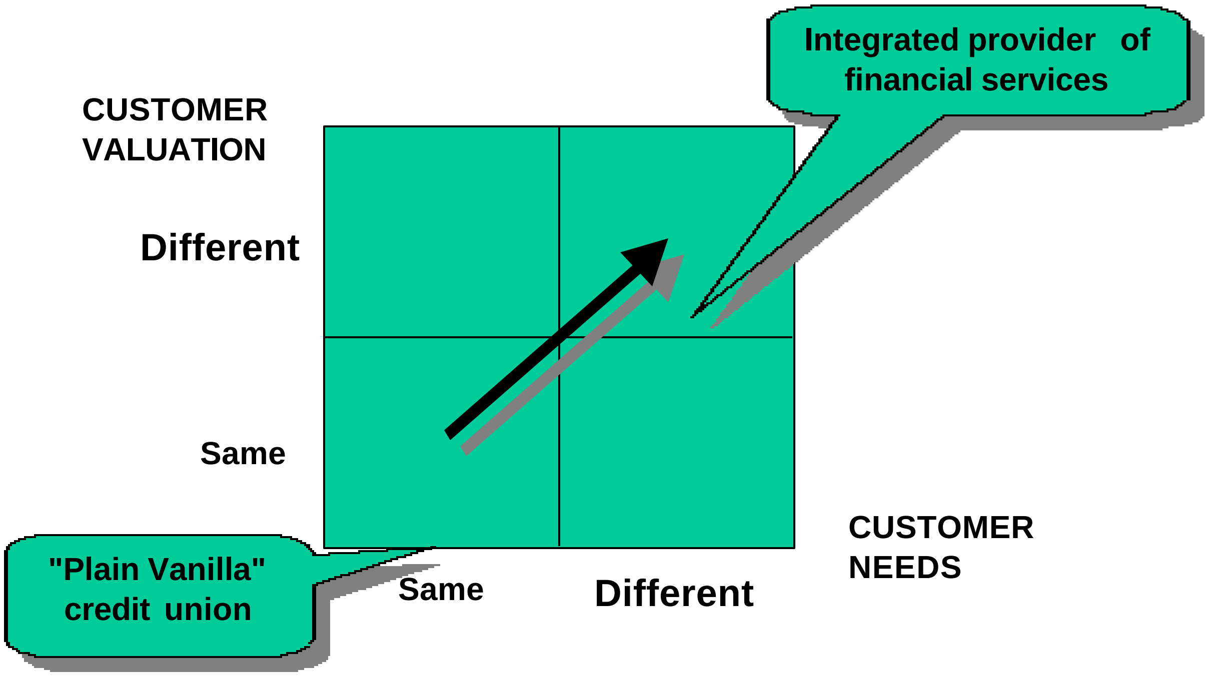

CHART 3

DISTRIBUTION OF MEMBER PROFITABILITY