The New Era of Customer Loyalty Management

Opportunities to Create Profitable Growth

McKinsey&Company

Overview

We are now poised to enter a new era of loyalty management in which winning companies will move beyond measuring customer satisfaction and defection only to approaches based on a broader understanding of customer migration and attitudes. Marketers can capture this significant loyalty opportunity and influence migration and churn by as much as 20 to 30 percent by addressing three key opportunities of the new era:

Manage customer migration, not defection. Migration is a powerful leading indicator that allows early corrective action and allows companies to manage customers who are *increasing* their spending. Its value is more than 10 times that of defection.

Integrate attitudes, needs, and satisfaction to understand drivers of migration. Tracking satisfaction alone is not sufficient and is often misleading. But when combined with two other factors – loyalty attitudes (i.e., emotive, deliberative, or inertial), and needs and discretion – it can play an important role.

Tailor investments and loyalty approaches to the most critical parts of the opportunity. Capturing the opportunity is usually based on addressing one or more of five levers:

1. Pursue customers actively choosing to go or stay.
2. Build "emotiveness" into the customer base.
3. Make it easier for customers to stay, harder to go.
4. Reduce or eliminate sources of dissatisfaction.
5. Focus on customers' changing needs.

The importance of creating and maintaining customer loyalty is not new. Most corporate leaders live by the mantra "it costs more to find a new customer than to keep and grow an existing one." However, despite heavy investments in customer satisfaction efforts, rewards programs, and CRM initiatives and infrastructure, loyalty remains an elusive goal in almost every industry. For example, annual churn in the wireless industry has risen from 17 percent 5 years ago to 32 percent last year. Banking customers increased the average number of financial institutions they frequent to 3.4 in 2000 up from 2.3 in 1996. Even in core retail categories like department stores, primary providers' share of wallet declined more than 10 percent during a similar period. And with the continued growth of new competitors and the increasingly knowledgeable and demanding consumer, these trends do not appear to be reversing.

How can companies win back the hearts, minds, and wallets of today's ever more fickle consumer? Based on 2 years of research across 16 industries, including companies as diverse as airlines, telecom, and banking,[1] we believe that stemming today's decline in loyalty requires winning companies to move to a new era in customer loyalty management. This new era will build on key concepts of the past but will be distinctive in three important ways. First, it will shift the focus from defection to customer migration, a loyalty opportunity more than 10 times larger. Second, it will shift loyalty investments away from behavior and satisfaction alone to approaches based on a broader understanding

of attitudes, thereby focusing on customers who are *most likely to migrate*. Third, it will more closely tailor investments and loyalty approaches to the most critical parts of the opportunity.

Understand the Drivers of Customer Loyalty

The first era of loyalty management began in the early 1970s. The focus at that time was on understanding and managing customer satisfaction. By the 1980s and early 90s, a second era of loyalty management evolved to tie customer behaviors (chiefly defection) directly to economic value. While these concepts continue to hold value today, our research confirmed they are not sufficient to understand the nature and size of the customer loyalty opportunity. In fact, a focus on these concepts alone is one of the standard pitfalls we identified.

We are now entering a third era of loyalty management in which winning companies will build a new understanding of the underlying drivers of loyalty by combining two important principles:

Manage customer migration, not defection. Although defection is an important measure of loyalty, it misses most of the opportunity. Our research has shown that the total value at stake from customer migration – defined as significant changes in customer relationships up or down – is more than 10 times the value of defection alone.[2] Not only does "silent attrition" (i.e., customers who reduce their relationship but do not defect entirely) represent a value loss many times the size of lost customers, it is a key leading indicator that allows corrective action *before* defection takes place. Further, the causes of defection and migration are often different, so efforts focused on managing defection (e.g., defection surveys) may miss important loyalty drivers. Finally, focusing on migration allows companies to also understand the potential to manage customers who are *increasing* their spending, an opportunity that is typically just as large as managing downward migration.

Integrate attitudes, needs, and satisfaction to understand drivers of migration. Many previous approaches have focused on one specific dimension (e.g., satisfaction or defection) to understand loyalty. Our research and client work shows that combining multiple dimensions, starting with attitudes, gives a much more powerful guide to the nature of the opportunity and the actions that can make an impact. Three dimensions, in particular, are important:

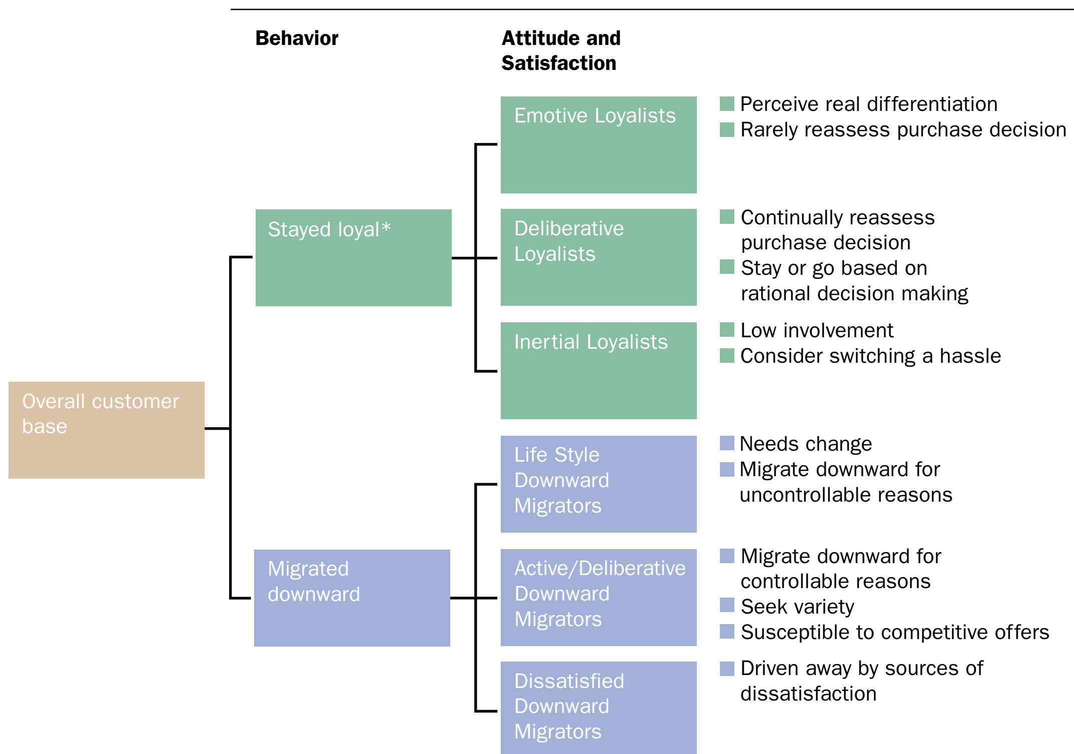
1. **Understand attitudinal drivers of loyalty.** Our research found that in most industries customers can be grouped by their underlying motives into one of three categories: *emotive* customers, who rarely reassess their purchase decision because they are convinced their current product of choice is best for them; *deliberative* customers, who frequently reassess their purchase decision based on rational buying criteria; and *inertial* customers, who rarely reassess their purchasing decision because of low involvement or the perceived cost of switching. In some industries (e.g., packaged goods and fashion retailers) we also observed *variety seeking* customers, who change for change's sake. The incidence with which these attitudes appear varies significantly by industry and company, and the mix among customers is an important determinant of your ability to capture the opportunity and the most powerful loyalty approaches to employ.

2. **Focus on changing customer needs and discretion.** Clearly some portion of observed behavior is due to changes in circumstances that may at first appear to be beyond a company's control. However, reasons for downward migration such as "My credit position changed," or "I moved to a city your company does not serve," or "My company's travel policy changed" are essential to understand and quantify because they shape the opportunity. Our research confirmed that by using the right set of tools and approaches, it is possible to address many seemingly "uncontrollable" factors. Furthermore, understanding changing needs can also be the key to unlocking upward migration, a critical untapped opportunity.

3. Recognize satisfaction is important but not sufficient. Satisfaction, the granddaddy of loyalty metrics, remains an important element of the new paradigm, but not the defining feature. Satisfaction on its own is not a strong indicator of loyalty, and can be misleading. Our research showed that satisfaction is often not correlated with migration nor is it actionable on its own. However, in specific situations or in combination with other factors, satisfaction does still play an important role.

Together, these principles define six segments that describe observed patterns in customer loyalty (see Exhibit 1). They are: *Emotive Loyalists, Deliberative Loyalists, Inertial Loyalists, Life Style Downward Migrators, Active/Deliberative Downward Migrators, and Dissatisfied Downward Migrators.*[3]

Exhibit 1 **Combining Behavior, Attitude, and Satisfaction Provides a New View of Customer Loyalty**



* Maintained or increased relationship

Use Tailored Tools to Capture the Opportunity

In our experience, leaders in this new era of loyalty have reduced churn and downward migration by 20 to 30 percent by tailoring the right loyalty approaches based on the nature and size of the opportunity. The following example illustrates the power of this approach: A typical consumer bank loses about 10 percent of its deposit accounts each year, amounting to about 3 percent of total deposits – seemingly not a big opportunity. But that same typical bank loses more than 25 percent of deposits to downward migration each year, with an equal opportunity from upward migration. Even assuming more than half these migrating flows are "uncontrollable," capturing 20 percent of the remainder will increase organic top line growth, currently in single digits, by 3 to 5 percentage points. Given the moderate price/earnings ratios in this industry and many others, increasing growth rates by 3 percent – a feasible target – can increase market capitalization by over 25 percent within 3 years.

Capturing this loyalty opportunity is usually based on one or more of five levers:

1. Pursue customers actively choosing to go or stay. For most companies, influencing the behavior of both the Deliberative Loyalists and Downward Migrators is the single largest opportunity, typically accounting for about 40 percent of the total opportunity. This opportunity is most significant in industries such as grocery or retail gas where brands are less distinctive, comparison is easy, and competitors differentiate primarily on price and other functional attributes.

It can also be the most complex opportunity. This is because even *within* one company's customer set, deliberatives reevaluate their decisions along different dimensions. These include *functional* benefits (i.e., product attributes, quality, and value); *process* benefits (how customers buy or get the service); and *relationship* benefits (the satisfaction derived from being a "preferred customer"). Therefore, identifying the attributes that influence deliberatives is the first step in designing the right set of tools.

Once these decision dimensions are understood, companies can choose one of several actions to improve their value proposition. The most basic approach is to address broad weaknesses in the offer, such as an uncompetitive price or the lack of multi-channel service. Increasingly sophisticated loyalty managers tailor changes to the base offer by segment, rather than "wasting" benefits on customers who don't value them or providing these benefits to less profitable customers. Another approach that can be powerful is to try to change the points of deliberation. Existing rewards programs are an excellent example of companies attempting to find less expensive avenues to differentiate than price discounts. The Hertz Gold program that differentiates based on service is also a good example of shifting away from purely functional benefits (e.g., price) to process benefits (e.g., speed of service).

Finally, companies must clearly communicate the benefit to target customers. Often this can create the highest impact. We have found that CRM can be highly effective in communicating existing or new benefits in a targeted way to deliberative customers.

2. Build "emotiveness" into your customer base. Turning inertial and deliberative customers into emotive customers should be an aspiration for all companies. Our research confirmed that loyal emotive customers in all industries, except banking, tend to award a higher share of wallet and to spend more than deliberatives. They are also much more protected, migrating downward at about half the rate of deliberatives. Our research also confirmed that emotives can be nurtured, given that individual customer attitudes are not consistent across industries, and that the actions companies take help define whether people become emotive about a category. Driving increased emotiveness typically accounts for about 20 percent – greater in some cases, less in others – of the overall opportunity.

We found that successful companies build emotive bonds in one of three ways:

Companies like Schwab or Loblaws (a leading Canadian grocer) adopted a coordinated set of actions including brand communication and brand delivery to address the two or three key aspects of the overall brand promise that must be delivered consistently and effectively. This did not necessarily mean more advertising, but it did mean communicating why the product or service was unique and then delivering on those points of differentiation throughout the organization, particularly at the front line. Companies like American Airlines or Neiman Marcus also built distinctly differentiated services or benefits for their preferred customer segments, supported by a recognized loyalty program and targeted CRM efforts. Finally, companies like credit card provider MBNA and U.S. Armed Services insurer USAA have leveraged affinity to others to build a type of emotive behavior for their product or service.

3. Make it easier for customers to stay, harder to go. Inertial customers are the hardest to budge. So why bother? Instead, why not make it easier for them to stay? Addressing inertial customers typically represents another 20 percent of the overall opportunity. The easiest way to do this is to increase process benefits, which increases switching costs for customers. These might include automating key interactions (e.g., bill payment), holding trusted information (e.g., keep credit card numbers on file to speed checkout) and developing learning tools to create added value for your service (e.g., suggest items based on prior purchases). Other adjustments to your base product offering can add more value for customers, thus decreasing the likelihood that they will move. For example, consider bundling product sales (e.g., cellular and paging service) or tailoring your products to work better with your other products than with those of competitors (e.g., offering integrated account statements).

4. Reduce or eliminate sources of dissatisfaction. The incidence of dissatisfied migrators varies greatly across companies and industries (e.g., 12 percent of wireless customers to 1 percent of apparel customers) but is typically small. Addressing sources of dissatisfaction in many cases accounts for less than 10 percent of the overall loyalty opportunity. However, there are still good reasons to take it seriously. In circumstances where service failures have led to serious dissatisfaction, it must be addressed head on. Even where this is not the case, it is important culturally. A company that is not concerned about dissatisfied customers sends a terrible message to its employees, especially at the front line.

At the same time, it is important to go after satisfaction strategically in order to avoid large uneconomic investments (which may divert resources from other higher-impact initiatives). For instance, understand the drivers of underlying behavior, not just aggregate satisfaction. Assess the cost of fixing those drivers and prioritize accordingly. Apply the concept of satisfaction breakpoints to avoid over- (or under-) investing. And if it is too expensive to address critical factors for *all* customers, at least address them for the highest-value customers. Finally, never forget the power of prompt and appropriate problem resolution. Client data repeatedly shows that customers who have a problem that they feel is resolved well are as satisfied – if not more so – than customers who do not have a problem in the first place.

5. Focus on customers' changing needs. The final opportunity revolves around meeting customers' changing needs and addressing their control over purchasing decisions. This includes understanding the impact of changes in product needs (e.g., debt versus investment products as consumers age), the impact of changing purchasing occasions, or changes in key decision parameters (e.g., moved). This lever typically accounts for about 10 percent of the total opportunity, but in some industries it can be significantly larger. Addressing changing needs is not as straightforward as the other four levers, but it can still go a long way to enhancing customer loyalty and is especially relevant for unlocking opportu-

nities for upward migration. In many cases it is possible to change the offer – perhaps as simply as broadening a product line or expanding a distribution network – to meet new customer needs. For example, Schwab has broadened its suite of products and services to serve multiple customer segments by providing investment planning through independent advisors and, more recently, acquiring U.S. Trust. By pursuing these approaches, Schwab is building the tools to keep its customers loyal as they travel through different life stages, from first job through retirement.

By focusing on migration, understanding the loyalty motives of each customer segment, and matching the appropriate loyalty tools, companies can move to a new era of loyalty management in which they fight back the challenges of today's difficult environment, create meaningful increases in customer loyalty, and drive profitable growth.

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[1] The May 2000 *Marketing Solutions* article "The New Physics of Customer Loyalty," based on research with 1,200 households covering 16 industries, first described how a combination of satisfaction, attitudes, and behaviors could unlock the key to customer loyalty. Our present article is based on additional research with the same panel in 2001 and on multiple client engagements combining the earlier market research methodology with internal customer transaction data.

[2] In "The New Physics of Customer Loyalty," we stated that the value at stake from customer migration is 2 to 4 times the value of defection alone. Our revised estimate of more than 10 times reflects further reasearch and the opportunity from managing upward, as well as downward, migration.

[3] These segments are described in "The New Physics of Customer Loyalty."

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