The Tiger is waiting

Introduction

All clients are created equal, but not all our attention and service is to be offered equally. Good old Pareto principle claims that 80% of our income comes from about 20% of our customers, but even merely based on our feelings we know that some are more precious, thus are to be treated with more care, or at least differently. The art side of business is to discover who they are. Recently, this art form becomes more and more practiced at companies under the name Client Segmentation.

In the case of an institution with a large number of clients, such as banks, the cost of segmentation may be huge, but such are the rewards - if we succeed. Segmentation mirrors who in fact our clients are and how they behave, as opposed to what we would like to see. Our costs and profits with them and other tendencies that so far we may not have realized will be directly shown. With its help, we will be in the position to decide whether and how we want to change what we saw in this mirror: who is our target and who is not? How many efforts are these groups worth? How can we better focus on our target? Segmentation often results in redefining the balance of client groups, products and services, and re-forming strategic business units.

Segmentation principles

How to segment

The process itself may be rather simple to read and but requires serious efforts to put in practice. First, decide who the ideal client is. We must define the value of a customer with the help of a few basic drivers, such as turnover, profitability, but even required service resources or future potential may be significant for us. This value may be quantified through rating, adding values to each factor. The factors themselves may be weighted by definition of maximum values. Now, put to practice: test the system on a few representative clients, modify the concept accordingly and apply to all. When all clients are rated, major groups must be defined, practically around 3-5, based on these scores. In order to make it a living and useable system, handling this data requires a sophisticated management system linked to the rating process. The segmentation data must not only be stored, but an update process is also necessary, in order to follow changes and to see new tendencies.[i] The result of segmentation not only shows what kind of clients you have but helps define your targeted customer and supports reaching them.

Basis of segmentation

The most common segmentation principle is turnover/profit with the client, however, it is worth considering other factors as well. Even within a strictly profit-oriented approach it is advisable to consider the client's total lifetime value with regards to all products and services. Besides the obvious income and property check, life stages may serve as the basis for sub-segmentation, age may be significant (consider the differences between a student and a pensioner, even if the profit they make us is the same), some banks even use profession as an important factor (for example, dentists, vets and other general practitioners, once completed their studies, automatically qualify for a certain segment).[ii]

After becoming more familiar with clients, new services/products may be set up, based on what exactly the different segments require (and are worth for us). Creating a matrix of services and products for each segment improves product offer and service, such as ABN-AMRO Bank found when they opted for using a system with one dimension referring to wholesale- commercial- private/assets management, the other indicating the offered products/services grouped according to segments. This approach to service also reflects in their global structure: besides including products and services, they included consumer and commercial segment in each country branch's structure. This way, they claim to have gained competitive advantage and improved profitability, both by attracting new clients and by better exploiting existing product capabilities.[iii]

Client behaviour may offer another segmentation aspect. A two-factor segmentation model presents a Client Segmentation Matrix[iv], resulting from multifactor segmentation.

	1 LOW INVOLVEMENT	2 INVOLVED & DIRECT	3 SOPHISTICATED
A	Annual Review Mid Year Review Seminar Generic Boardroom Lunch	Annual Review Mid Year Review Seminar Generic Seminar Specific Boardroom Lunch Monthly Research email Proactive offers	Four-Monthly Reviews Seminar Generic Seminar Specific Boardroom Lunch Monthly Research email Specialist investments Proactive offers
B	Annual Review Mid Year Review Seminar Generic	Annual Review Mid Year Review Seminar Generic Seminar Specific Monthly Research email Proactive offers	
C	Annual Review Seminar Generic		
D	Reactive service only		

Figure: 1 Client Segmentation Matrix (CSM)

Besides the traditional grouping into A, B and C clients (resulting from how much fee they pay), the level of involvement is also considered. "Low-involvement" clients do not want to be bothered with new offers or banking news, they just want to have their product (typically a single account) and their privacy. Other client groups may be more open or even demanding in terms of frequent contact, offers and attention. Since top priority clients do get special attention and offers anyways, extending it downwards for a bit less profitable client group may be a very cost-effective way of showing customer care (email newsletters are a common example).

New technologies offer new tools also for the clients to contact us. These new sales and service channels (such as online banking, mobile phone services etc) present an incredible complexity and variety of choices and pose structural challenges. Priorities have to be set, decisions are needed on the control and influence of the usage of these new tools, which leads to new definition of traditional client segments and may clash with present solutions. Thus, additional coordinational functions become required, such as content management, multichannel coordination and leads to redefinition of client management[v].

All the above reflected some form of the conventional „Profit Segmentation Model", which has been criticized for trying to serve all clients with similar processes, and then pick the profitable ones, serve them the usual way and expect profit. Profit-based segmentation aims to select clients who make profit under the existing conditions and products - and aims to keep only those who actually "match" the bank's processes. However, a critique of this method says, low-balance, single-product customers may also be a source of profit, given the proper products and service. Their suggestion is instead of focusing on present profitability, concentrating on customer needs, and form segmentation on this basis. The „Needs Segmentation Model", as it is called, aims to find out how to fulfill different customer needs and this way make all customer segments profitable[vi]. (Just think of the numerous credit offers for those rejected by the banks, a blooming business in Eastern Europe.)

Whatever the basis of segmentation is, some form of client relationship program is likely to develop from it. The most obvious aim is retention of existing clients (but some clients may be referred to elsewhere if the bank decides they are not targeted). Establishing a relationship-oriented service reflects that the importance of clients exceeds other business factors. Even recoveries may be seen as opportunities to reaffirm loyality[ii] – besides getting back the bank's money.

A special case of segmentation - Basel II

International financial institutions may act as the catalyst for re-thinking client segmentation. Basel II regulations require segmentation based on risk types, however, it does not merely imply a new way of risk management but an entire new business philosophy. One major novelty of Basel II accord is that it includes operational risk, the cause of a large number of defaults, in calculation. The point is about creating a stronger link between regulatory capital and risk, and thus strengthening market discipline.

Basel II segmentation regulations insist on the usage of tools which are confirm to the Internal Ratings Based Approach (IRB) and on avoiding all overlaps in segments. Segmentation shall be self-explanatory, and cherry-picking is forbidden: if a client qualifies as a member of one category it is a must to include them.

Basel II, however, does not imply any requirements in terms of the way customer groups are managed. Categorization into IRB-confirm customer groups is based on exposure categories, reflecting merely differences in risk. Segmentation is strictly regulated, meaning for example that Retail clients may not exceed 1 million € exposure, and may use only standard products.

Bank groups, subsidiaries

Basel II directives refer to the whole of an international bank group, meaning that all subsidiaries of the bank group must fulfill Basel II requirements. This leads to a change in the role of local authorities: they are entitled to examine the fulfillment of Basel II regulations besides local ones.

Supervision

Regular supervision is not only recommended but a must (at least yearly). This may be specially important in the case of SMEs, since they may fluctuate around the 1m€ exposure. If they are above the 1 m € limit for a significant time or with a significant amount, they shall be re-categorized as corporate.

Conflict of Basel II and business sector segmentation

Basel II risk-based segmentation is influenced by different criteria (portfolio size, borrower unit exposure, product, homogeneity) than business-driven segmentation. Conflicts do arise when the segment of a client of one business unit is altered to another due to risk issues, for example because of being the member of a borrower unit.

However, Basel II regulations do not insist on applying a homogeneous segmentation system, in fact, coordinating Basel II and business segmentation requirements is close to impossible, so banks are likely to use several segmentation policies parallel, with Risk Offices being responsible for IRB segmentation, whereas the Business side still determines business segmentation.

A common example of this clash are SME-s. Business-wise they are probably one group, but from risk point of view, they are not. They may either qualify as Retail or Wholesale, based on a limit amount (1 m €). However, SME exposures secured by real estates (homes) may be qualified as retail, regardless of the exposure. Another Retail condition is standardized client and risk management, thus if the product used by the SME is not standard or decision is not automatic, Corporate segment applies. From the bank's calculation point of view, qualifying as Retail is more advantageous, so authorities are likely to check the validity of such qualifications. In the meantime, business side may be completely untouched by these issues.

Another often problematic group is small-scale farmers. In certain countries they are numerous, but their segmentation also raises questions. Their activities focus on producing certain goods for commercial purposes, classifying them as corporate, however, typically they do not reach the 1 m € threshold, so, considering this they shall be seen as retail clients. Exceptions and controversial cases like these may be categorized as "other" category, whereas business may easily classify them.

In order to fulfill the Basel II regulations, it is maximized how much of a bank's portfolio may remain non- IRB covered (8%), and during supervision the size of this portfolio shall closely be watched. If, for example, the weight of "Other" category (including small-scale farmers, political parties, churches, etc) starts to rise in a bank's portfolio, a solution must be found to apply IRB-confirm tools for certain "other" sub-segments.

In the case of a bank group, IRB-conformity level refers to both the banks individually and as a group, so in case of an international bank, the headquarters' and all the subsidiaries' must be 92% IRB-covered, but the bank group's portfolio as seen together must also reach this value.

Segmentation in practice

Failures, challenges and benefits

Client segmentation is not always a success story. Here are some typical reasons why businesses fail when implementing client segmentation:

- too complex model

- being lost in details of customer data
- lack of enough time and attention in the course of day-to-day business

A typical source of failure is when the organization attempts to implement a good-looking, but too complex model. The aim to fit the model with the proposed complex service offerings and pricing can result in a system that is impossible to use and instead of giving a clearer picture, complicates even supposedly simple processes and structures. This may be linked to being lost in details: the extract level of required client detail is not easy to define and probably is the most difficult decision to be made. In order to avoid these pitfalls, a system must be set up in which everyday tasks do not overwhelm and segmentation gets enough resources. [vii]

In spite of difficulties, costs and efforts, client segmentation does pay off. Research shows that those companies that apply client segmentation, gain around 40% higher income and 20% more income per active client[viii]. No wonder that banks allover have planned to take steps into this direction for years. An international survey (with 180 banks from 44 countries, including 5 Romanian banks) showed that the majority of banks have been planning to regularly and systematically analyze client data, but the real steps taken still show room for improvement. In 2003, 57% planned such analyses, but a mere 20% has in fact done so in 2007. Usage of client segmentation doubled - which still means a mere growth of 7% till 2007. Although 80 % of banks claims to focus on gaining market advantage, usually it has not been specified how to realize such strategies. IT systems have been named as the key to such improvements, and they are also seen as the biggest strategic disadvantage: in 2004, 36% of banks called their IT infrastructure their weakness, in 2007 this number was 46%[ix].

Conclusion

For successful bank operation, client segmentation seems to be less of a choice than a necessity. International regulations define risk-based segmentation, but it is the bank's decision to define further segmentation factors and to apply them systematically. If enough attention and commitment is given, segmentation may lead to better understanding of your position on the market and provides the tool to strengthen or modify it. Remember the old Chinese saying about the tiger that you have to capture in your head before hunting? You as an organization have to define your own tiger – the rest is mere formality.

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[iv] Client Segmentation , The Foundation Stone For Your Business, FP Advance Limited
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[viii] How Client Segmentation Pays
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