Customers for Life

The customer who comes back—over and over

—is the customer on every insurer's wish list.

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Some customers are far more profitable than others. And the customer every insurance company dreams about is the one who sticks with the company for life—renewing old policies, buying additional products, and referring friends and associates to the company for even more sales.

The ideal customer, in short, provides lifetime value—the key to maximizing customer profitability. Customer lifetime value can be defined as a discounted cash-flow measure of the future profitability of a customer, based on anticipated policy renewals, up-sells, cross-sells, and referrals generated over the customer's lifetime.

How can insurers calculate the lifetime value of customers from different customer segments? And how can they use that knowledge to maximize profits?

Conjuring Profits from Thin Air

To answer those questions, let's start with a simple example from outside the insurance industry. Two publishers of investment magazines, Imprudent Publishing and Sophisticated Subscriptions, have been approached by two customers who want to know the price of a one-year subscription.

The cover price for 12 monthly issues of each magazine is $50, while production costs, including the costs of capital, amount to $40. How much of $10 profit margin profit are the companies willing to sacrifice to obtain the new customers' business?

For Imprudent, the answer is easy. It offers annual subscriptions for $41 each, figuring that a $9 discount will allow it to make a profit while increasing circulation.

Sophisticated, however, studies the matter a little more carefully, recognizing that there is a 50% chance that a subscriber will renew the subscription after the first year if he or she is offered a 10% discount at that point. If Sophisticated can win both new subscribers, the chances are that one will renew at a second-year profit of $5 ($50, less a10% price discount, less $40 in production costs).

Dividing this $5 equally between the two prospects means that Sophisticated can offer its first-year subscriptions for as little as $37.50 and still not lose money. The first-year loss will be recovered by renewal-year profits. So the company sets its price at $39.50, offering better value than Imprudent, while still making a profit that Imprudent thought impossible at that price.

Expanding the Concept

In making its analysis, Sophisticated undoubtedly took some additional factors into consideration as well. To begin with, the length of the subscription probably runs for more than two years, and the percentage of customers who are likely to renew will vary from year to year. Even for this single product, the entire "lifetime" of the customer may cover several years.

Sophisticated also may have considered the effect of "up-sells": the ability to migrate the customer up to a more expensive—and usually more profitable—product, instead of the one initially selected. In broad terms, a customer with potential for up-sell is likely to be more profitable than one who sticks with the original purchase. For example, a customer who buys the investment magazine mainly for its mutual fund performance rankings might be persuaded to move up to a weekly listings service, or to a service in which data is provided on-line.

Similar to the up-sell is the cross-sell. Here again, the customer is sold a different product—but that product is in addition to the first one, rather than a replacement. And since the customer who purchases additional magazines and responds to other offers is likely to be more profitable than the one who merely renews his subscription for several years***, even if this affects the renewal rate of the additional purchases,*** **(Alan: Bob added this. Is it meaningful?)** the company can afford to pay more to acquire that customer.

Yet another level of sophistication can be added to the customer lifetime profitability model by taking account of referral purchases. The magazine subscriber who persuades his friends and colleagues to take out subscriptions is generally more profitable than the one who does not. This opens up a whole new set of profitability calculations that could be added to our performance model, as we account for the profitability of those newly acquired customers.

A Powerful Concept

As this example illustrates, customer lifetime value—unlike more traditional approaches to profit measurement—focuses on customers rather than products. It measures and values relationships rather than transactions. And it examines profits and value over several years rather than over a single reporting period.

The power of customer lifetime value comes from its ability to reconcile apparently conflicting goals. It enables a business to retain its focus on customers while maximizing profits, and helps balance the need for short-term profits with the need to achieve longer-term profit goals.

Clearly, these concepts are just as applicable in insurance as they are in publishing. Indeed, to some extent the "repeat business" concept is already applied in pricing insurance products. In life insurance, for example, the actuary does not look merely at the likelihood that a claim will be filed in the first year. Instead, he extends his vision to the point at which a claim is likely to be made, and sets a yearly price accordingly. True, this is an example of setting *higher* prices up front because of expected future *losses*, but the philosophy is still the same.

In *personal lines (?)* property/casualty insurance, too, the more sophisticated carriers take account of the claims history of particular customer segments and set prices that allow the company to make a profit from individual policyholders over a long period of time. This is done as part of an overall effort to set prices that produce acceptable profits from a broader segment of individuals over a shorter time frame.

But few insurers use differing retention expectations as a factor in setting budgets for targeting particular customer segments. And even fewer take account of the profitability of other products that could be sold to the customer during his or her lifetime, or of the value of referrals that the customer might generate. As a result, many insurers not only are pricing themselves out of profitable business but are failing to spot opportunities for improving profitability down the road.

Calculating Lifetime Value

In practice, customer lifetime value is harder to model than these simple examples might suggest. To begin with, the most powerful use of customer lifetime value is to model the future profitability of particular customer segments under differing assumptions. Yet most of the real data available is historical, and as we all know, past performance is no guarantee of future performance. ***(How much of the failure to price aggressively is due to imperfect cost data on acquiring the additional sale, as opposed to data on customer behavior?)***

It is also essential to be able to take a "customer" view of the insurer's portfolio. Without a customer database to measure the behavior of a customer and his product holdings, an insurer cannot even begin to make the necessary calculations. A corollary of this is that the calculation has to be done for all of a company's relationships with a customer. That's because an analysis of the products sold by an individual business unit might overlook overlook the customer's value to other areas of the organization.

Moreover, to model the "deterioration" of a block of customers over time, ***(please expand)*** the company also needs product retention data for each customer. ***(Most insurers can measure product retention rates, but don't do so as a function of other products held. Is that what you mean? Pl. clarify. Bob)***

In practice, however, this data is often not easily accessible for the whole book of customers, necessitating some type of sample-based analysis.

Even when an analysis of product revenue by customer is available, data on costs per customer generally are not. A customer who files ten separate claims for $300 each in a given year is considerably more costly to service than a customer who files a single claim for $3,000, and the profitability of that customer will differ accordingly.

Unless the insurer’s costs can be reasonably allocated to the different customer segments served, the calculation of customer lifetime value will be flawed. Depending on the sophistication of the insurer's existing systems, activity-based costing may be required. ***(Define the type of data that might be desirable—both claim handling and acquisition costs of multiple products, which might vary, depending on how the customer is reached for “add-on” products.)***

To perform an accurate analysis, taking account of the “time value of money,” an insurer must assign all costs and revenues to an appropriate time period, (***Isn’t the issue how good the maintenance and acquisition cost allocations are? The introduction of the cost of capital seems a little out of place. Plus, it’s highly unusual to decompose a product’s cost and revenue flows and to use different capital costs for each. I’d argue against this on finance theory grounds.)*** usually a particular year, and discount the net cash flow by the company’s weighted average cost of capital. In cases where risk varies significantly between products, the insurer may need to apply risk-adjusted costs of capital to different elements of costs and revenues before calculating the net cash flow.

These complexities show that customer lifetime value modeling can be a complicated activity. Yet the effort involved in making the analysis are justified if the results are used to identify profit-enhancing opportunities.

Enhancing Profitability

The most valuable aspect of customer lifetime value modeling is that it not only analyzes the profit potential of various customer segments, but shows how the profitability of a segment can be improved.

In the end, the only ways to improve profitability are to decrease costs, increase revenues, or both. Customer lifetime value modeling enables an insurer to assess the impact of changes in any of the key variables that impact revenues and costs. As a result, the company can focus its resources on those variables that have most impact. For example, the company can:

- Lower the cost of acquiring customers by marketing and selling more efficiently and effectively to those customers who are most likely to buy and retain the additional product.
- Increase customer retention rates through the use of customer loyalty schemes, incentive programs, enhanced service levels, and additional sales.
- Implement programs to increase both up-sells and cross-sells, remembering that every contact with a customer contact provides an opportunity for additional sales.
- Increase the number of referrals through referral incentive schemes and other efforts.
- Introduce a more differentiated pricing scheme, one that sets different prices for certain customer segments, or offer different products to those segments, to the extent that regulatory requirements allow.
- Exit certain customer segments altogether, if appropriate.

Each of these tactics has the potential to significantly increase or decrease an insurer's profitability. Yet without customer lifetime value modeling, the company will not be able to gauge the impact of these actions. As a result, it will lose opportunities as well as customers.

Taking the Concept One Step Further

Once an organization has tapped into the power of customer lifetime value, the principles can be extended still further. Companies at the cutting edge are now moving beyond the lifetime value of individual customers. They are applying the same techniques to the customer's family and, in some cases, to the customer's workplace, in an effort to identify and exploit the most profitable customer environment.

The aim here is to understand the lifetime value of a group of customers whose futures may be intertwined. An insurer planning to take a hard line on settling a small auto claim, for example, might choose to take a less aggressive approach if the claimant's parent is a heavy purchaser of the company's annuities or mutual funds. If the potential loss of profit from losing the parent as a customer is greater than the potential saving on the claim, the insurer might make a business decision not to risk upsetting the family.

Similarly, an insurer that is using work-site marketing might benefit from knowing that a customer's employees or co-workers are also customers of the company. Such information would allow the insurer to factor in the possible loss of business from those under the influence of the policyholder when deciding how to handle certain business decisions. Such a strategy, now under consideration by some insurers, will become more feasible when work-site marketing becomes more widespread.

Whether done for individual customers or related groups, calculating customer lifetime value modeling is a challenging yet profitable exercise. The potential benefits are great. And insurers that ignore this fact will make the same costly mistakes as Imprudent Publishing did in pricing its magazines.