Research Report

How Incentive-based Customer Acquisition Affects the Value of the Customer Base

USING VERY APPEALING INCENTIVES TO ATTRACT NEW CUSTOMERS IS A COMMON APPROACH IN THE FINANCIAL SERVICE INDUSTRY. WHILE THIS CERTAINLY LEADS TO MANY NEW CUSTOMERS, THE PROFITABILITY OF THESE ACQUIRED CUSTOMERS IS LARGELY UNKNOWN IN MANY BANKS.

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Introduction

Financial service providers often attract new customers by offering very appealing incentives, such as credit cards that are free of charge in the first year, a large bonus for opening a checking account, or high interest rates for saving accounts for the first months. Those incentives should increase the awareness among prospects and, ultimately, the number of acquired customers. Yet, most incentives provide only a benefit for a limited amount of time. Therefore, these incentives can attract especially deal-prone customers who are primarily fascinated by the incentive and not by the product offered. While the number of acquired customers is likely to be high, their higher churn and lower investment volume are also likely. The crucial question is whether ultimately these customers are really profitable.

Number versus Value

In many banks, the number of acquired customers is a commonly used metric to measure the success of customer acquisition activities. However, this success measure disregards the value of those customers. An important measure to evaluate long-term profitability of a customer is the customer lifetime value, which reports the net present value of all revenues and costs over the entire customer relationship.

The value of the incentive affects the customer lifetime value in three ways (see Figure 1). First, a higher value of the incentive leads to higher acquisition costs and, subsequently, to a lower customer lifetime value. Second, a higher incentive attracts more deal-prone customers who are probably less loyal. The resulting shorter duration of the customer-firm-relationship also yields a decrease in the customer lifetime value. Third, customers that are primarily fascinated by the incentive use the bank's products less intensively. Yet, this effect is likely not to occur for incentives whose value depends on the intensity of product usage.

To assess the overall profitability of incentive-based acquisition activities, it is essential to consider both, the positive effect on the number of acquired customers as well as the negative effect on the value of those customers.

Results of an Empirical Study

In our empirical study we analyze six acquisition activities of a major European bank regarding the offering of a savings account. New customers were offered a high interest rate for a few months, afterwards the interest rate dropped to the regular level. The acquisition activities varied in the value of the incentive, which is measured by the difference between the offered interest rate and the market interest rate. In total the acquisition activities led to several thousands of new customers.

We investigate the influences of the value of the incentive on the number of new customers and their customer lifetime value. In line with our expectations, we observe a positive relationship between the value of the incentive

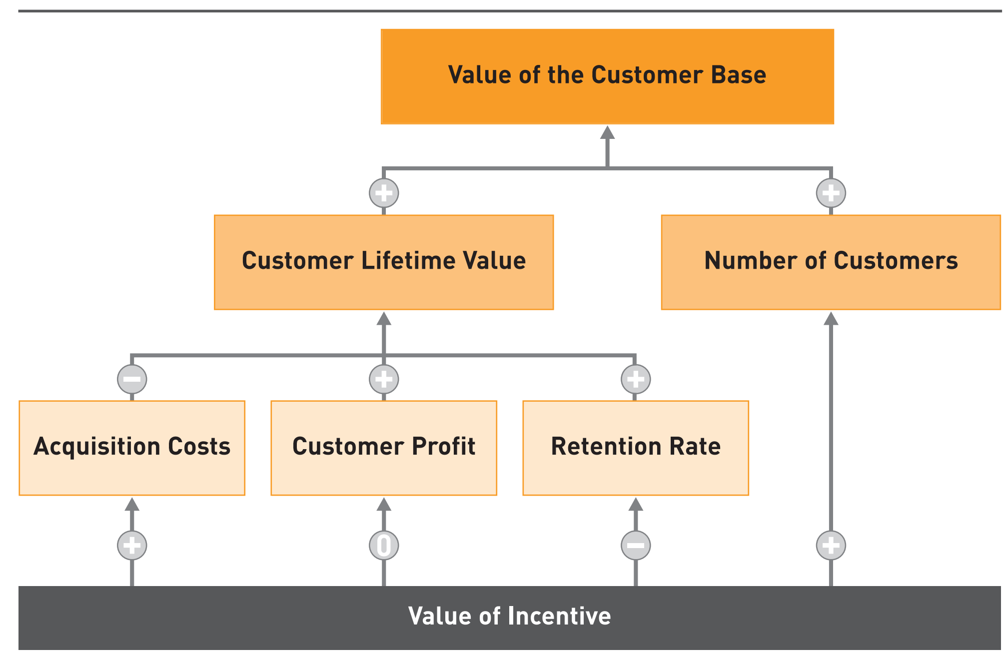

Figure 1: Estimated Effects of Incentive-Based Customer Acquisition

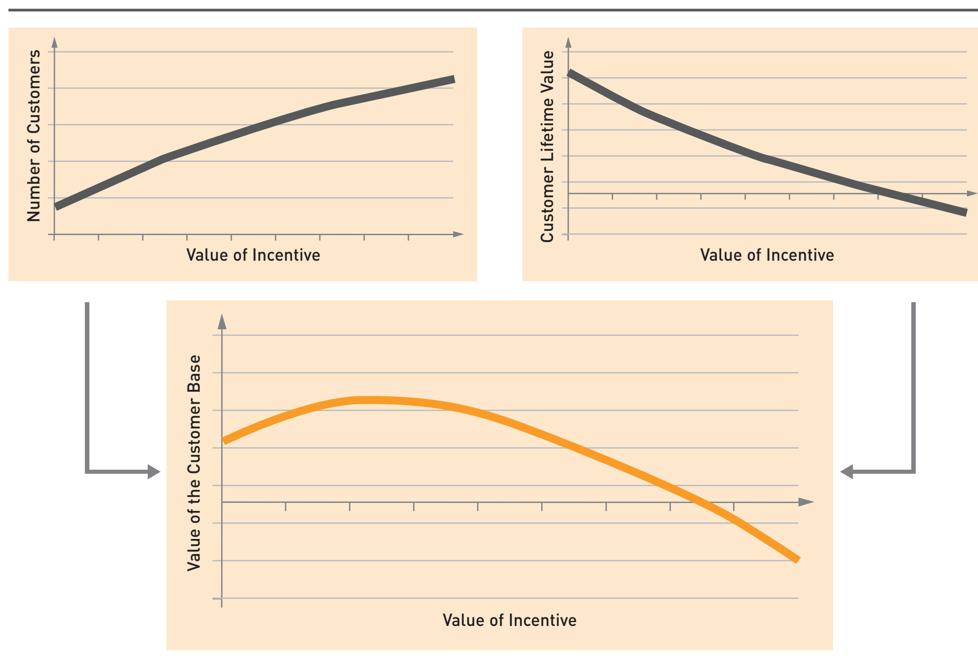

Figure 2: Effect of Incentive on the Value of the Customer Base

and the number of acquired customers, i.e. the higher the incentive, the more customers are acquired.

The effects of the incentive on the metrics of the customer lifetime value are different. Regarding the retention rate, we observe many customers who churn (i.e. cancel the relationship) right at the end of the promotion period, i.e. at the time when the interest rate drops to the regular level. Afterwards, we observe a nearly constant retention rate. The fraction of customers who churn right at the end of the promotion period is higher for higher values of the incentive. This effect is even stronger when we account for customers who do not churn, but decrease their saving volume to a rather low level.

Thus, we can see that the percentage of less loyal customers increases with the value of the incentive. However, we observe no significant differences in saving amounts for different values of the incentive so that the profit per active customer before acquisition costs is not affected by the value of the incentive. This result might be different for other kinds of incentives. In our empirical setting, the customer's utility of the incentive is linked to his saving amount. Therefore, even customers who are very likely to churn after the promotion period have no interest in decreasing the saving amount. Yet, deal-prone customers do not only have a higher probability to switch to another bank after the promotion period, but also a smaller probability to use other products of the bank. Therefore, customers acquired through a high value of the incentive have lower cross-selling rates than customers acquired with a small or even without an incentive. Nevertheless, customers who use more than one product at the bank are less likely to churn. This finding holds for customers who differ in terms of their cross-selling rate during the promotion period, but are acquired by the same value of the incentive. Customers who use additional products have significantly higher relationship durations.

Conclusion

On the one hand we can see that a high incentive is able to attract a higher number of new customers. On the other hand, financial service providers also have to consider the loss in the value of those customers resulting from higher acquisition costs and shorter relationship durations, possibly even accompanied by lower customer profits. Figure 2 shows the estimated relationship between the value of the incentive and the resulting value of the customer base. For low values of the incentive we find a lower number of acquired customers, but those customers have a relatively high customer lifetime value. In contrast, for a very high value of the incentive the negative effect on the customer lifetime value outweighs the positive effect on the number of new customers. Quantifying the influences of the value of incentive on the number of acquired customers as well as on the resulting customer lifetime values allows financial service providers to find the optimal value of incentive.

The negative effect on the customers' relationship duration may be lower for other financial products offered by incentives as switching costs are relatively low for saving accounts.

Due to the fact that cross-selling has a positive effect on customer retention, acquiring customers through high incentives accompanied by high cross-selling efforts may counteract the negative effect on the relationship duration.

Nevertheless, financial service providers need to account for the trade-off between the number of new customers and their value when determining the optimal value of incentive – in our empirical example the difference between the market interest rate and the interest rate offered to new customers – which maximizes the value of the acquired customer base.

References

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