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by

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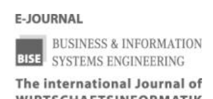

Trust and Switching Costs in the Financial Services Industry

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Abstract: - Especially in the Financial Services Sector we can see a strategic shift towards implementing Customer Relationship Management (CRM) strategies. The basic assumption of this strategies is that customers who are locked into a stable relationship will be willing to pay premiums and by this generate higher margins due to increasing switching costs over time. As a result of technological progress customers will be able to organize their personal data environment more and more on their own. By this switching from on financial service provider to another becomes more easy. Hence financial services providers have to develop new strategies for locking in customers. Based on the characteristics of financial services, building a trust relationship can be a successful way to do this. Trust-building activities are proposed and general conclusions are provided for financial services firms.

Key-Words: - Trust, Financial Services Industry, Customer Relationship Management, Switching Cost, Personal Data Environment

1 Introduction

The market for financial services is undergoing a major shift at the beginning of the third millennium. Mainly driven by information technology (IT) development, the market has seen a wave of mergers and competition has intensified. In this setting it is more important than ever for incumbents to have the right strategy in order to generate an adequate value for their shareholders. One of the most used buzzwords in this context in recent years has been that of "Customer Relationship Management" (CRM) – or eCRM, emphasizing the need for IT as an enabling technology to manage and maintain valuable customer relations. The real battle for the customer relationship has just began and companies are investing billions of dollars in order to individually service their customers according to their needs and objectives. In the remainder of this paper we will refer to CRM as individually and professionally manage customer accounts by keeping "economically valuable" customers and repelling and eliminating "economically invaluable" ones.

Most financial services providers currently already pursue or recently announced a strategy where the customer and his preferences, needs, and objectives is put in the center of interest and all processes are aligned around the customer. Such strategies are based on the believe that if a customer learns how to deal with the corporation and, even more important, the corporation learns how to best individually service its customers, the customer will maintain a long-term relationship with this company. Due to this relationship, it is believed that corporations will be able to charge premiums on their specially tailored solutions which often consist of a bundle of standardized product components (on mass customization see e.g. [13], [14], on individualization see e.g. [16]).

In this paper the general sustainability of the generic business model of such CRM strategies – investing in customers now, lock them in with CRM strategies in order to utilize them later in their life cycle – will be challenged with respect to the financial services industry. The authors argue why financial services firms should rethink their IT investments, anticipating the shift or power towards the customer and what strategy seems to be a promising response with regard to this likely evolution. Moreover, it will be argued why trust building activities may be a superior strategy in that context.

The remainder of this paper is organized as follows. In the next section, CRM and customer lifetime value concepts will be discussed in more detail and the main underlying assumptions for such strategies will be assessed. In section 3 the changing environment and the coming shift of power to the customer due to advances in IT are presented. The special role of trust in the financial services sector is discussed in section 4. Based on these findings, trust building activities in the financial services industry are identified and discussed in section 5. General conclusions and consequences on CRM strategies of financial services providers are discussed in section 6. The paper concludes with a brief summary of the findings and an outlook in section 7.

2 CRM Strategies and Underlying Assumptions

Figure 1 depicts the expected cash flows based on a successfully implemented CRM strategy. Obviously,

after a costly acquisition of a customer, constantly increasing positive cash flows are assumed (for a discussion of shareholder value implications of a customer lifetime value strategy see e.g. [17]). The cash flow is believed to increase due to several effects, such as utilization of cross selling potential, recommendation effect of satisfied customers, cost reductions on the side of the supplier, and an anticipated price insensitivity on the side of the customer.

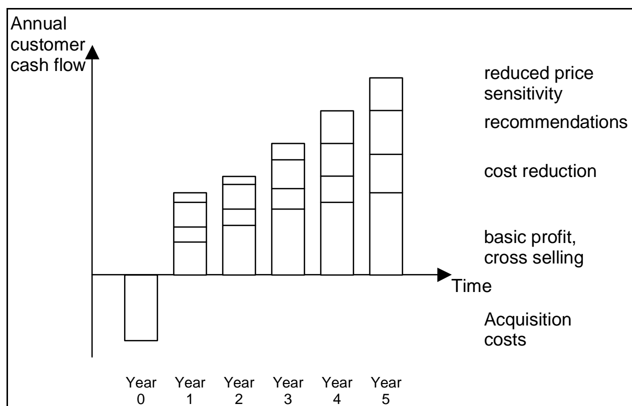

Figure 1: Customer Life Time Value (See e.g. [15])

Certainly, this sounds like an appealing concept and many customers would already be quite happy if both their financial services provider delivered the solutions they had asked for and they did not have the hassle of dealing with several parties. But this approach neglects some important features of human nature:

- First, a lot of people want to be able to compare their purchases with purchases of their peers. With individualized products and services this becomes increasingly difficult.
- Second, a lot of people ever more worry that companies which have a lot of information about them may misuse these data [11]. Therefore, people do not want a single financial services provider to have a complete overview on their financial status.
- Third, a lot of people exhibit variety-seeking-behavior, i.e. looking for variety inherently contains utility for the customer [4],[8].
- Fourth, changed income circumstances induce customers to switch a supplier [4],[8].
- Fifth, customers do want to keep some bargaining power and therefore maintain relationships to different financial services providers.
- Sixth, customers might not like to realize the fact to be locked-in, i.e. making a switch to a different supplier a costly venture.

Talking about the last issue, this is one of the basic underlying assumptions of current CRM strategies. The acquisition costs upfront to win a new customer relationship have to pay off over time. Building up high switching costs is one of the profit sources for companies pursuing such a strategy.

Switching costs can come in a variety of dimensions which are gathered in Table 1. (For the term switching costs see also [2].)

Dimension	Example
Economical	Opportunity costs of providing a company with address information.
Psychological	Positive emotional relationship towards supplier based on trust, tradition or image [8].
Social	Integration of the customer into corporate processes focusing on personal human relations [8].
Legal	Contractual long term agreements.
Technological	Proprietary interface for data exchange.

Table 1: Dimensions of Switching costs

3 New Technologies and Their Impact on Switching Costs

As we have seen there are some reasons why customers may want to have more than one financial services provider. In contrast to this for a long period we have seen only little fluctuation of customers in the financial services sector. It was common not to search for alternatives but to stay with the chosen financial services provider maybe even for a lifetime. In our view mainly due to the fact there simply was no alternative. In times before electronic (and telephone) banking for doing a transaction a customer was dependent on a branch office. By this the number of branch offices available for a customer was limited to the ones that could be reached without prohibitive costs [24]. The tremendous developments in IT – especially the development in Internet technologies – have changed this situation dramatically. Due to the market entrance of new and purely Internet based players like E-Trade or Charles Schwab customers are enabled to use financial services from wherever and whenever they like.

Customers jumped at the chance to use less expensive and often better services and by this the new players have gained a significant market share (for a more detailed description of the developments in banking enabled by the internet e.g. see [1]).

Based on the technological development specifically in applications to store and exchange information in a standardized format (e.g. XML may serve as such a standard for data exchange on the Internet) we now see a second wave of innovation which may have even a greater impact on the financial services sector. We observe a growing number of (web based) services that try to establish so called "personal data environments".

The idea behind this is to store all personal data into an application independent data warehouse from where it can be used whenever the customer needs it. As a prominent example the passport service of Microsoft

allows consumers to sign-in at Passport partner firms with just a single username and login without having to fill-in address fields for each company. MemIQ –founded early 2000 by German HypoVereinsbank AG and Vodafone Group plc. – goes one step further: It offers an intelligent electronic storage for personal documents accessible through the WWW. Another approach that should be mentioned here is the Platform for Privacy Preferences Project (P3P) by World Wide Web Consortium (W3C), which is an "automated way for users to gain more control over the use of personal information on Web sites they visit".

Already back in 1997, Hagel and Rayport announced this development by what they called "The coming battle for customer information". They predicted the emergence of "infomediary"-corporations that act as "brokers of customer information, marketing it to businesses on consumers' behalf while protecting their privacy at the same time" [4]. As a consequence of this developments it becomes very easy for customers to transfer personal information from one financial services provider to another.

Figure 2 schematically depicts the different utility curves for a customer who switches his supplier two times. In the traditional CRM approach, the quality of individualization and hence the utility of the offered solutions steadily increase over time due to the two-way-learning and -communication process between supplier and customer. However, once a customer decides to switch the supplier, this process has to start all over again. In the infomediary setting, the customer takes all relevant data with him and ideally provides the new supplier with all necessary data to carry on at the same level of tailored solutions as the old supplier. Obviously in this scenario it is assumed that the ability to generate optimal solutions based on a given set of data of a customer is the same for all suppliers, which will hardly be true in real world circumstances.

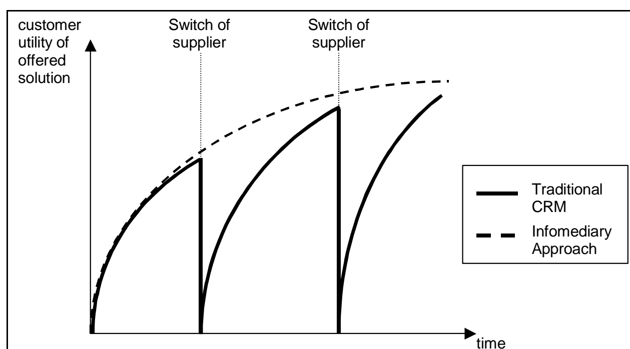

Figure 2: Customer Utility Curves for Traditional and Infomediary Approach

Coming back to the issue of switching costs (see section 2 and particularly Table 1) in the financial services sector, given the expected development of user-friendly applications that enable customers to maintain and continuously update their own profiles with relevant data along with the application development sketched above, we will see a significant decline in switching costs in the technological and economical dimensions. Moreover, most relationships of customers with their financial services providers are not based on contractual long term agreements. Even though, companies try to prevent the commoditization by providing not just the sheer commodity products but bundling several standardized product components into a financial solution along with consultation service, basically just the psychological and social dimensions remain to keep customers.

Thus trust – already one of the most important concepts in doing business – will get even more important and financial services firms should invest heavily in trust building activities to keep and win customer relations. In order to focus on trust building activities, the first step is to understand the concept of trust. Astonishingly, although every business transaction is somehow based on trust of the involved parties, a definition of the interdisciplinary concept of trust can hardly be found. McKnight and Chervany argue in a recent article "Because trust is so broad a concept, and because so many definitions have proliferated, a typology of trust constructs seems appropriate" [3]. Instead of trying to find an overarching definition, the conceptualization links trust influencing constructs and subconstructs together (see Figure 3). (For more literature on trust see e.g. [18], [19], [20], [21], [22] and references in [3].)

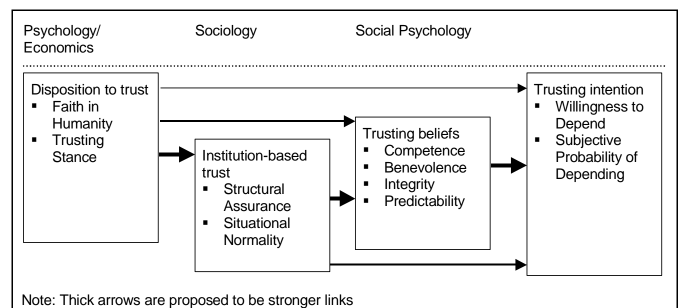

Figure 3: Interdisciplinary trust constructs model [3]

It should be mentioned at this point that trust is not a new concept. No business transaction can be performed without trust [20]. However, particularly with electronic sales channels, like the WWW, trust becomes ever more important. Trust is already important in interpersonal relationships. For an end-consumer to decide to place and pay for an order via an electronic channel which often implies trade across national borders, different currencies and legal systems, the consumer must first trust the retailer [21], [22]. Also, particularly on the Internet due to the leveling of distances the number of relevant suppliers for a given product or service has been exploding from the consumer's point of view [24].

However, since a web store-front can be built up relatively easy compared to a bricks-and-mortar store, it

gets very difficult for a customer to decide about the quality of an offered product or service upfront. Moreover, technically it is very difficult if not impossible to build up a personal relationship with a customer in electronic channels [23].

In result we have unsettled customers due to an explosion of relevant suppliers in conjunction with the problem on the one hand to decide about the quality of these suppliers and on the other hand the opportunity to switch suppliers easily. Furthermore, it is difficult to establish personal relationships in an electronic channel. The above described challenges are more of a general nature, however, trust in the financial services sector has a special role. This will be discussed in the next section.

4 The Special Role of Trust in the Financial Services Sector

As we have learned in section 3 the technological progress facilitates to switch the financial services provider because personal data can be transferred very easy and there a lot of new financial services provider that can now be reached at low cost using electronic communication channels. In order to find out what financial services providers can do to avoid their customers to switch we have a closer look at the special character of financial services and their impact on trust and trust building activities in this section.

One special characteristic of services in general is that the benefit of using them cannot be evaluated exactly ex ante. For instance, if a customer wants to get a hair cut and knows nothing about the haircutters' abilities he has to trust him. In the financial services sector a lot of services rely on lots of parameters and therefore are very complex and not easy to understand. In order to convince the customer, service providers try to signal their ability, e.g. with luxurious branch offices.

It is also characteristic for services in order to consume them the customer itself has to be part of the production process. Obviously this holds true for the haircutter example. But in the area of financial services the customer and his characteristics are often also an essential part of the production process, e.g. when deciding what kind of investment strategy is appropriate you need to know a lot about the customer's attitude towards risk. Theory broadly divides the process of producing a service into three parts [25]:

1) The provision and signaling of the ability of producing.
2) The production process with the customer as "external factor of production".
3) The result of the production process.

The more similar services are over time the more the customer is able to transfer his confidence about one result into general trust against the producer. So if one hair cut is good it provides strong evidence for the customer that the next ones (if made by the same person) will be good, too. So a successful production process is a very strong signal for the producers ability. Once a customer is convinced of the ability of a service provider there is little reason to look out for other potential providers of this service.

In contrast, financial services are diverse and highly different in complexity and necessary data. If a financial services provider is able to provide hassle free and affordable current accounts this is only weak evidence that the financial services provider is also a good investment manager. So when thinking about an investment strategy the customers chooses not necessarily the same financial services provider from which he purchased the current account. In the financial services sector the successful production of one service not stringently has to be a signal for the general abilities of a specific financial services provider. By being able to transfer personal data very easily there is basically not to much reason not to evaluate alternatives. Thus, without having appropriate strategies the possibility of loosing a customer to a competitor will increase. In order to avoid this situation, financial services provider have to develop new strategies that help to rise trust even though personal data may be transferred nearly without costs. This will be the issue of the next section.

5 Trust-building activities in the financial services industry

In this section we want to give some first ideas what components could contribute to increase trust in a financial services provider. As we have argued one of the main problems is that trust in services per se cannot be generalized in the financial services industry. However, besides that approach of selling individually tailored solutions to a customer instead of just selling products, there are a number of additional activities that potentially may help to foster the transfer of trust from one service to another:

- A personal financial advisor may act as a product independent trust „medium“ for the customer.
- Instead of selling single or bundled standardized financial products, focus should be on selling financial planning services. If there is trust in the financial planning approach, it might be easier to transfer that trust to the financial products themselves. Hence, product independent trust may be generated.
- While focusing on cross-selling approaches, financial services providers should try to cross-sell products in a way that due to some product similarities, the trust may be easily transferred.
- Financial services provider should focus on acting proactively. It may be a big advantage if customers

recognize that a financial services provider identifies latent financial problems of the customer instead of the customer has to identify them himself.

To summarize, financial services providers have to change their attitude towards business from being a seller of (only weak linked) products to being seller of individualized solutions based on a relationship approach.

6 Consequences on CRM Strategies

As we have seen, trust instead of high switching costs are key for long-term relationships between a financial services provider and his customers. So, are all the billons invested in CRM systems wasted money? Certainly most of it is not, but companies should rethink the balance of their investments. Two general major issues have to be considered here.

Firstly, firms should detour some money in trust-building services and marketing activities, instead of passively waiting until consumers are able to switch suppliers at virtually no cost. Besides the trust building activities already mentioned above, issues of interest for a potential investment in trust building activities can especially be found in the area of electronic commerce. For instance privacy policy, third party privacy seals (e.g. TRUSTe Privacy Program), information disclosure seals (e.g. WebTrust Seal), reputation and brand building activities, guarantees, return policies, reliability seals, security seals (e.g. VeriSign Secure Site Program), and site quality may foster customer trust in a website and thus in the owner of that website. The handling of private information about specific customers will be an issue of particular interest. Proactively announcing the privacy policy and offering/enabling customers to access their personal profile at the suppliers site might become common in a few years but today it would be a clear first mover advantage that should be exploited.

Secondly, and perhaps more important, financial services firms should not rely on cash flow structures as presented in Figure 1. Such a strategy could easily lead to profitability troubles in the long-term. Just imagine companies act on behalf of this cash flow structure: Investing in a relationship with high acquisition costs at the beginning – a decoy offer that does not generate any margin, thus no shareholder value – and expecting constantly increasing cash flows and profit contributions in the future ultimately will drive a company out of business. If consumers may switch suppliers at comparably low costs, they might tend to utilize several decoy offers at different companies instead of establishing a long-term relationship with one financial services provider. Hence, the initial acquisition costs will never amortize. Thus, focusing on the bottom line for every single deal will become more important in the future. Besides these two general conclusions and the trust building activities mentioned in section 5, there is a new business opportunity arising for the financial services providers. These companies generally already own a highly valuable asset that might be turned into a profitable business opportunity. Most financial institutions already operate for years in a market where privacy is essential. A lot of them have built up a good reputation and brand over the years. Since financial services firms have a lot of personal data about their customers due to bank transfers and the portfolio of securities – often even about the whole financial and personal life circumstances of a specific customer – naturally, consumers trust their financial services institutions more than any other company they are doing business with.

In light of shrinking margins, more transparent markets, and an increasing commoditization of financial products, turning this trust into a business opportunity might even become a vital contributor to a banks' profits in the future. Offering trust-based services – like the ones mentioned above of MemIQ – such as digitalization, management, and structuring of personal data to form an effective and efficient personal data environment as a service for customers might be in high demand in the future. The potential of such a service shall be clarified by an example:

A customer uses the personal data environment services offered by his financial services firm. At the end of the year the annual tax declaration may be performed on a single mouse-click since all relevant documents and data have been gathered in the database throughout the year. This service would save the customer a lot of time and effort or might save him the costs of his tax advisor.

This visionary example concludes the main body of the paper. In the following section the findings will be briefly summarized.

7 Summary and Outlook

The battle for the customer relationship in the financial services industry has just begun and many companies acknowledge that the customer and his preferences, needs, and objectives should be put in the center interest. Effectively applied CRM strategies might help to service the customer better and establish a long-term relationship. However, it has been shown that focusing on the acquisition of customers with heavy investments at the beginning of a relationship and charging premiums in the future because of the switching costs that have been built up by CRM methods may not be profitable in the long-run.

In this environment the concept of trust, especially in the financial services industry, becomes vital. Companies should proactively invest in trust building activities. Also, taking into account the bottom line of every single deal with a customer will gain importance. The financial services industry is in the convenient position of becom-

ing trusted infomediaries, because of the already established relatively strong trust relationships to their customers.

It remains to be seen whether advances in the IS development are fast enough to allow a customer already in the near future to conveniently manage a highly valuable asset – his personal information – on his own. With respect to the anticipated realizable scale effects, it seems to be more likely that infomediaries may offer their trust-based services successfully.

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