

Learning from Customer Defections

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On average, the CEOs of U.S. corporations lose half their customers every five years. This fact shocks most people. It shocks the CEOs themselves, most of whom have little insight into the causes of the customer exodus, let alone the cures, because they do not measure customer defections, make little effort to prevent them, and fail to use defections as a guide to improvements. Yet customer defection is one of the most illuminating measures in business. First, it is the clearest possible sign that customers see a deteriorating stream of value from the company. Second, a climbing defection rate is a sure predictor of a diminishing flow of cash from customers to the company—even if the company replaces the lost customers—because new customers cost money to acquire and because older customers tend to produce greater cash flow and profits than newer ones. By searching for the root causes of customer departures, companies with the desire and capacity to learn can identify business practices that need fixing and, sometimes, can win the customer back and reestablish the relationship on firmer ground.

A climbing defection rate is a predictor of a diminishing flow of cash from your customers.

But if so much useful information can be wrung from a customer loss, why don't businesses learn or even try to learn from customer defections? In ten years of studying customer loyalty, customer defections, and their effects on corporate cash flow and profits, I have uncovered seven principal reasons:

- Many companies aren't really alarmed by customer defections—or they're alarmed too late—because they don't understand the intimate, causal relationship between customer loyalty on the one hand and cash flow and profits on the other.
- It is unpleasant to study failure too closely, and in some companies trying to analyze failure can even be hazardous to careers.
- Customer defection is often hard to define.
- Sometimes *customer* itself is a hard thing to define, at least the kind of customer it's worth taking pains to hold onto.
- It is extremely hard to uncover the real root causes of a customer defection and extract the appropriate lessons.
- Getting the right people in your organization to learn those lessons and then commit to acting on them is a challenge.
- It is difficult to conceptualize and set up the mechanisms that turn the analysis of customer defections into an ongoing strategic system, closely supervised by top managers and quickly responsive to changing circumstances.

Loyalty and Profits

In general, the longer a customer stays with a company, the more that customer is worth. Long-term customers buy more, take less of a company's time, are less sensitive to price, and bring in new customers. Best of all, they have no acquisition or start-up cost. Good long-standing customers are worth so much that in some industries, reducing customer defections by as little as five points—from, say, 15% to 10% per year—can *double* profits.

CEOs buy the idea that customer loyalty matters; they would prefer to have loyal customers. But without doing the arithmetic that shows just how much a loyal customer is worth over the whole course of the customer life cycle, and without calculating the net present value of the company's present customer base, most CEOs gauge company performance on the basis of cash flow and profit. They rarely study the one statistic that reflects how much real value the company is creating, the one statistic with predictive power: customer retention.

What keeps customers loyal is the value they receive. One of the reasons so many businesses fail is that too much of their measurement, analysis, and learning revolves around profit and too little around value creation. Their CEOs become aware of problems only when profits start to fall, and in struggling to fix short-term profits, they concentrate on a symptom and miss the underlying breakdown in the value-creation system. They see customer issues as subsidiary to profits and delegate them to the marketing department. In the most egregious cases, years of continuing defection can mean that former customers—people convinced by personal experience that the company offers inferior value—will eventually outnumber the company’s loyal advocates and dominate the collective voice of the marketplace. When that moment arrives, no amount of advertising, public relations, or ingenious marketing will prop up pricing, new-customer acquisitions, or the company’s reputation.

Although some executives do realize that profits are really a downstream benefit of delivering superior value to customers—and that customer loyalty is therefore the best indicator of strategic success or failure—they lack the tools they need to focus their organizational learning on this most basic building block of profitable growth. They make the most of standard market research, including customer-satisfaction surveys, but such tools are simply not up to the task. (See the insert “The Satisfaction Trap.”) And yet the message that relative value is declining—and all the information a company needs to make sense of that bad news and design possible remedies—is available from the day trouble starts. Defecting customers have most of that information. They are always the first to know when a company’s value proposition is foundering in the face of competition.

The Satisfaction Trap

Many companies that use satisfaction surveys to learn how happy their customers are with their products or services often mislead themselves. What matters is not what customers say about their level of satisfaction but whether the value they feel they’ve received will keep them loyal. As tools for measuring the value a company delivers to its customers, satisfaction surveys are imperfect. As tools for predicting whether customers will purchase more of the company’s products and services, they are grossly imperfect.

In Search of Failure

The lifeblood of adaptive change is employee learning, and the most useful and instructive learning grows from the recognition and analysis of failure. A first step in getting the people in your organization to focus on failure analysis—in this case, customer defections—requires overcoming their preoccupation with success. Of course, success has lessons to teach. But businesspeople today are obsessed with success—and sometimes more obsessed with other people’s success than with their own.

Satisfaction surveys have two principal problems. The first is that satisfaction scores have become an end in themselves at many companies but scores mean nothing unless the satisfaction they purport to measure translates into purchases and profit. The second problem is that satisfaction surveys are often poorly conceived and conducted. They measure the wrong activity or the wrong customers; they are easy to manipulate; they encourage companies and employees to invest time and money unproductively.

In many organizations, good satisfaction scores are considered a higher goal than profits and have a more immediate effect on compensation. The automobile industry pioneered the use of satisfaction surveys and probably spends more money on them than any other industry. When General Motors committed itself to reversing the inroads of foreign competition by concentrating on customers, it tied a portion of management bonuses to improvements in satisfaction scores. In the 1980s, satisfaction scores went up, as do most measures included in management bonus calculations, but market share and profits continued to go down. Nevertheless, most automakers continue to track satisfaction scores with great statistical rigor and use them in incentive and recognition programs for a wide range of employees. Today, as a result, more than 90% of industry customers report that they are satisfied or very satisfied. But repurchase rates remain mired in the 30% to 40% range. How can that be? There are several reasons, all having to do with the second problem, the way satisfaction surveys are designed and carried out.

Benchmarking has become a feverish search for the nation's or the world's lowest costs, highest volumes, fastest growth. Academics, consultants, and executives scour the globe for approaches that have led to big profits in one situation so they can apply them in others. Yet this quest for best practice has created much less value than one might expect, and the people who study systems can tell us why: When a system is working well, its success rests on a long chain of subtle interactions, and it's not easy to determine which links in the chain are most important. Even if the critical links were identifiable, their relative importance would shift as the world around the system changed. So even if we could point to the critical links and more or less reproduce them, we still could not reproduce all the relationships or the external environment in which they operate.

What *can* help is the study of failure. The people who build, fly, and regulate airplanes understand this. Airline performance in the United States, as measured by the fatality rate, actually exceeds six sigma—3.4 defects per million opportunities—which is the demanding standard of quality many manufacturers pursue but probably don't reach. When a plane crashes, investigators retrieve the flight recorder and spend whatever it costs to find out what went wrong. The result is that in a vastly complex and extremely dangerous operating environment, accidents have become rare events.

Whenever rewards are based on satisfaction scores decoupled from repurchase loyalty and profits, the result is unproductive behavior. Employees naturally seek the easiest ways to improve scores, not necessarily the most profitable ways. One Toyota dealership offered a free auto detailing to any customer who agreed to return a survey marked “Very Satisfied” in all categories. The dealer even provided a printed copy of the survey showing how to check it off. At another dealership, a salesman pleaded with a customer to fill the form with favorable responses. “I’ll lose my job here if I don’t get high scores,” he said. Auto companies like to advertise high marks on J.D. Power and Associates satisfaction surveys, so they’ve also learned how to manipulate the scores. Calling customers immediately after they’ve bought a car and asking about the experience is one way to keep scores high but probably won’t lead to increased loyalty.

A second reason surveys don’t work is that they almost never provide the information that managers need to pick the investments that will maximize customer value and, in turn, cash flow. Early successes with satisfaction programs are often a matter of picking low-hanging fruit. A car company’s surveys might identify easily remedied sources of dissatisfaction—mechanics wearing dirty uniforms, customers not getting their cars on time. Once a company has made the obvious improvements, however, it’s likely to find that the next level of satisfaction enhancement requires a real investment. Is it worth \$10 million to retrain all the service managers? Is it worth \$10 million to increase the average satisfaction score from 85% to 90%? Is it worth \$100

One of the world’s consummate investors, Warren Buffett, reached a similar conclusion in his very different field. In 1991, he gave a speech at the Emory Business School in Atlanta, Georgia. He told his audience, “I’ve often felt there might be more to be gained by studying business failures than business successes. In my business, we try to study where people go astray and why things don’t work. We try to avoid mistakes. If my job was to pick a group of ten stocks in the Dow-Jones average that would outperform the average itself, I would probably not start by picking the ten best. Instead, I would try to pick the 10 or 15 worst performers and take them out of the sample and work with the residual. It’s an inversion process. Albert Einstein said, ‘Invert, always invert, in mathematics and physics,’ and it’s a very good idea in business, too. Start out with failure, and then engineer its removal.”

In addition to their preoccupation with success, there is another reason companies make so little use of failure analysis. Psychologically and culturally, it’s difficult and sometimes threatening to look at failure too closely. Ambitious managers want to link their careers to successes; failures are usually examined for the purpose of assigning blame rather than detecting and eradicating the systemic causes of poor performance.

Defining Defection

million? These questions are basic to delivering the best value, but satisfaction surveys cannot answer them.

A third drawback is that surveys ignore critical distinctions among customer segments. Companies should pay less attention to what customers say and make a greater effort to track lifetime purchases. What makes this effort so important is that it forces a company to channel its consumer-satisfaction investments toward customers with the highest potential value, whereas satisfaction research conducted broadly across the entire customer base—the correct approach statistically—will necessarily show the influence of unprofitable customers. For example, a bank's branch manager might hear many complaints about long teller lines, but it's perfectly possible that the branch's most profitable customers do most of their business by phone, mail, and ATM. Investing in more tellers may inflate satisfaction scores but actually deflate profits by improving service levels and increasing costs in areas that the best customers don't care about.

The Baby Bells are another example of companies using satisfaction surveys as they grope for the right management tools in an increasingly competitive environment. Most have developed surveys to help focus their organizations on customer service. But few have built systems to analyze lifetime purchases and profits from different types of customers. Those that do this analysis find that the top 10% of their customers are worth 5 to 10 times as much in potential lifetime profits as the bottom 10%. Telephone companies that try to manage through increasingly refined customer-satisfaction systems are likely to suffer the automakers' fate. While they work at raising broad satisfaction

Some customer defections are easier to spot than others. Customers who close their accounts and shift all their business to another supplier are clearly defecting. But what about customers who shift *some* of their purchases to another supplier, and what about those who actually buy more but whose purchases represent a smaller share of their total expenditures (a smaller share of wallet)?

The story of MicroScan—then a division of Baxter Diagnostics and now of Dade International, recently acquired by Bain Capital—is illustrative. In mid-1990, MicroScan was neck-and-neck with Vitek Systems in a race for market leadership in automated microbiology. Both companies made the sophisticated instruments medical laboratories use to identify the microbes in patient cultures and determine which antibiotics will be most effective. Both companies were growing rapidly, converting customers from manual testing and edging out other manufacturers of automated equipment. MicroScan had worked hard to improve quality and was thinking about applying for the Malcolm Baldrige National Quality Award.

Perhaps because diagnostics was its business, perhaps because competition had heightened its quality awareness, MicroScan was intrigued with the notion of failure analysis. To make itself an even stronger, more profitable competitor, the company decided to seek out defectors and use them to uncover and correct shortcomings. It began by asking its sales force to identify customer defectors. The sales force

scores, competitors will lure away their best customers by delivering outstanding value to precisely these most profitable segments. Diminished cash flows will then make it more difficult to deliver good value even to average customers.

Yet another weakness of satisfaction surveys is that an increasing number of customers are tired of being surveyed. A Cadillac dealer tells this story: “One of my customers cornered me at a charity board meeting and told me, ‘I got a call after I picked up my car, asking if I was satisfied with the sales experience. Then I got a call after the car was serviced, asking if I was satisfied with the service experience. Finally, someone called to check if I was happy with the ownership experience. So when am I going to get a call asking if I’m satisfied with the satisfaction-survey experience?’” One leading auto company admits that customers can get as many as six surveys in a year. Imagine how much this costs the company, to say nothing of customers’ wasted time.

Companies serious about measuring the value they deliver to customers do not rely solely on satisfaction surveys. They recognize that satisfaction is an inherently unstable and temporary mental state and therefore is tricky to measure. Instead they track repurchase loyalty to determine the true value of their products and services relative to competitors’. When customers don’t return for service, or when they buy another brand—these are incontestable signs that they are unhappy with the value. In business after business, 60% to 80% of lost customers reported on a survey just prior to defecting that they were satisfied or very satisfied. Some companies respond by trying to increase the sophistication of their satisfaction measures. Most automakers have chosen

assumed that the company’s executives meant total—that is, complete—defections and responded that there were almost none. A few customers had gone out of business, but in automated microbiology as in many other industrial businesses, total defections are relatively rare. Once companies have purchased equipment, they continue to buy consumables and service for many years.

State Farm’s core customers are good drivers who value service.

But the sales force was ignoring the fact that defections can be partial. A customer may buy *some* equipment, *some* consumables, *some* service from other suppliers, and these fractional defections have meaning. MicroScan was not getting 100% of subsequent sales on all its accounts, and given the hotly competitive environment in which the company found itself, management chose to use this more demanding standard to measure failure. As it happened, the sales force was ignoring another fact as well: Systematic analysis of billing records revealed that, in fact, there were quite a few total defections among *small* customers.

The company interviewed every one of the lost customers and a large number of the partial defectors, searching for the root causes of each defection, especially when customers had defected to alternative microbiological testing

this approach, but they still see 90% of their customers claiming to be satisfied and 40% coming back to buy again.

The exception is Lexus, a consistent winner of auto satisfaction awards, which refuses to consider surveys the best measure of satisfaction. In the words of Dave Illingworth, the first general manager of Lexus, “The only meaningful measure of satisfaction is repurchase loyalty.” Illingworth knows that the gap between satisfaction scores and repurchase loyalty can be enormous. Drive by a Lexus dealership and you’ll see a satellite dish on the roof. It keeps the dealer in constant touch with Lexus headquarters and maintains a steady flow of information in both directions about customers’ auto and service purchases. Lexus knows which customers are coming back for more and which are not, and it can analyze the differences between dealers who are earning superior customer loyalty and those who are not.

In depending so heavily on broad-based satisfaction surveys, companies are letting too many defectors slip through the cracks. There is a better way. To know how much companies can afford to spend to satisfy specific customers, they need to measure the return on their investment. The only way to do that is to study lifetime purchase patterns. But since they have to track purchase patterns to determine customer profitability, why not simply use this information as their satisfaction index? Customers’ repeat-purchase loyalty must

equipment. The picture that emerged was clear, instructive, and painful. The customers interviewed were concerned about the reliability of MicroScan’s instruments. They had complaints about certain features of the equipment and felt the company was insufficiently responsive to their problems.

There is always a strong temptation to rationalize these kinds of complaints: Those weren’t good customers to begin with; it’s not our fault that the customer’s technical staff is not sophisticated enough to use our instruments; customers that use our hot line all the time aren’t profitable anyway. But rationalization is just a way of failing at failure analysis, and MicroScan’s managers overcame their natural impulse to explain complaints away. Instead, they listened, learned, and took corrective action. They shifted R&D priorities to address the shortcomings customers had identified, such as test accuracy and time to result. Having learned that their line of instruments was too expensive for many small labs, they accelerated development of a low-end model and brought it to market in record time. They also redesigned their customer-service protocol to make sure that they gave immediate attention to equipment faults and delivery problems.

MicroScan’s ability to learn from failure paid off. Two years later, the company pulled away from

Vitek to achieve clear market leadership, and it now enjoys the bottom-line benefits that go with it. Tracking and responding to customer defections, however uncommon—and they are now less common than ever—have become central to the way MicroScan does business.

Core Customers

In the process of deciding how it wanted to define customer defections, MicroScan had to make two critical judgment calls. The first involved the size of the unit of failure. Managers tightened the definition of defection: It no longer meant the total loss of a customer but rather the loss of any portion of that customer's business. Then they defined just who the company's core customers really were, recognizing that small labs were indeed important customers. Giving core customers good reason to stay loyal was, in the long run, what made the decisive competitive difference between MicroScan and Vitek.

Unfortunately, identifying core customers is not always as easy as it looks, especially in industries where the competitive landscape is changing. But the effort is well worth it. In fact, defining core customers can be one of the most critical strategic processes a CEO ever sets in motion. Although it may uncover an unexpected well of uncertainty and inconsistency, it will lead to a deep, animated discussion of the company's basic mission and its ultimate goals.

The most practical way to get started is by answering three overlapping questions. First, which of your customers are the most profitable and loyal? Look for those who spend more money, pay their bills more promptly, require less service, and seem to prefer stable, long-term relationships. Second, which customers place the greatest value on what you offer? Some customers will have found that your products, services, and special strengths are simply the best fit for their needs. Third, which of your customers are worth more to you than to your competitors? Some customers warrant extra effort and investment. Conversely, no company can be all things to all people: Customers who are worth more to a competitor will eventually defect.

The answers to these three questions will produce a list of your most obvious core customers. Identifying that group will give your management team a head start on the much more difficult task of developing the larger definition of core customer that your company will use in screening its customer base to see which defections warrant analysis. The discussion should also involve close scrutiny of some measurements and statistics that you ought to make sure you have available, among them the life-cycle profit pattern and the net present value of each customer segment, your share of customer wallet, and average customer retention by segment, age, and source.

Mass marketers such as banks and insurance companies often believe they must serve and satisfy all customers equally, and they therefore give equal attention to finding the root causes of all defections. Many companies give equal weight to first-class and third-class defectors in allocating resources to counteract defections, and some overzealous customer-recovery units spend money to save unprofitable customers or customers with negative value. Companies with high fixed costs, such as automakers, airlines, and telephone companies, fall easily into this trap. Every customer brings in revenue that helps offset fixed costs, they reason, so every customer is a good customer. But the companies that have achieved extraordinary levels of customer loyalty have discovered they must concentrate their efforts on that subset of customers to whom they can deliver consistently superior value. State Farm Insurance, for example, which serves more than 20% of North American households, knows it must focus intently on its own kind of auto-insurance customer: the better-than-average driver who values agent service. Sir Colin Marshall, chairman of British Airways, put it this way in a recent interview (HBR November-December 1995): “Even in a mass-market business, you don’t want to attract and retain everyone... The key is first to identify and attract those who will value your service and then to retain them as customers and win the largest possible share of their lifetime business.”

This is a good place to point out that all the techniques of root-cause defection analysis are important not just for customer retention but also for new-customer acquisition. After all, your new customers are some other company’s defectors. By interviewing them to find out why they left and came to you and by watching to see how much of their spending you earn and retain, you can learn a great deal about them and about how to improve your company’s customer-acquisition strategy. What percentage of newly acquired customers fits your definition of core customers? Are you effectively promoting your real strengths and attracting the kinds of customers your value proposition was designed to serve? How do your new customers compare with your competitors’ new customers and how do they compare to your defectors? One of the secrets of sustainable growth is to find and keep the right customers—core customers. If your advertising, sales incentives, or marketing promotions draw unprofitable or marginal customers, the sooner you know it—and fix it—the better.

Root-Cause Analysis

Getting to the root causes of human behavior takes a lot of time, effort, and experience. In a factory setting, where root-cause failure analysis has been perfected over decades, the process is known as the *five why’s* because you usually have to ask why something happened at least five times to get to the root of a failure. For example:

Why did the product get returned as defective?

The connector came loose.

Why did the connector come loose?

The plug was out of tolerance.

Why was the plug manufactured out of tolerance?

The intermediate stamping machine failed.

Why did the stamping machine fail?

Routine maintenance wasn't done on schedule.

Why?

There is an attendance problem in the maintenance department.

After five why's, you begin to see what needs to be fixed, though it may actually take a few more questions to figure out the best solution. Since applying this type of rigorous analysis to every single defect a plant experiences would be absurdly expensive, smart companies first perform a statistical frequency analysis, so they can concentrate their efforts on the 20% of categories that account for 80% of defects (applying Vilfredo Pareto's 80/20 rule).

Understanding weaknesses in customer value is much more difficult than understanding why a part was stamped out of tolerance in a plant. Objective fact is a big part of the five why's. The plug did not meet the precisely defined specifications for all such plugs. But the specifications for customer value are individual and tend to be subjective, so the only way to assess them is to interview customers and ex-customers and learn what they want and their views of the value they have received. The level of value a customer perceives can be defined as the time-weighted sum (more recent experiences are weighted more heavily) of all interactions with the company. So a good place to begin the search for failure is by reviewing the history of those interactions. (See the insert "Rooting Out the Causes of Defections: A Case Study.") Occasionally, a single event

is so powerful it leads to defection all by itself (“your clerk swore at me”), but that is the exception. In most cases, a series of events leads slowly to a decision to seek better value elsewhere. To assess the root cause of a defection, the interviewer must typically identify three or four disappointing events and weigh them appropriately.

Rooting Out the Causes of Defections: A Case Study

Everybank, with roughly 2 million customers, was a typical superregional commercial bank. With a typical defection rate of about 20%, Everybank was losing some 400,000 customers each year; and, aware of the dire economic consequences of defection, it found ways of learning from its lost customers. (Everybank is also fictitious—a composite picture of several such banks and representative experiences.)

Everybank had administered a satisfaction—or in this case, dissatisfaction—survey to customers who closed their accounts, but the superficial information the survey yielded was not much help in pinpointing what was wrong with the business system. For example, more than half of the respondents listed price or interest rate as the primary cause of defection. But when the bank called some of them, it heard stories like this:

How long had you been a customer at Everybank?

Twelve years.

What caused you to close your account and move it?

Commonbank was right around the corner and they paid a higher CD rate.

Have Commonbank's rates long been higher?

I don't know, I just noticed recently.

Sometimes it is helpful to map out the whole life cycle of a customer's interactions with the company. You can think of this life cycle as a corridor. (See the exhibit “The Customer Corridor.”) Imagine that customers enter at one end and that the arrows along the top of the passage represent doorways or interactions with the company. At a bank, the corridor might start with an account application. What determines customer value is the sum of relative benefits and drawbacks, advantages and disadvantages, that consumers encounter at each doorway. The model can also show the frequency of those interactions, and frequency combined with interview material can tell a company which interactions are the 20% driving 80% of the differences in loyalty and value.

What made you notice?

I was a little irritated at Everybank, and then I saw an ad in Thursday's paper.

Why were you irritated?

Because I was turned down for a credit card.

Had you ever been turned down before?

Yes, several times, but this time, the bank gave me this big come-on about being a preferred customer—and then turned me down with a form letter!

As it happened, the rates at Commonbank were almost identical to those at Everybank, except occasionally on Thursdays, because Commonbank changed rates on Thursdays and Everybank on Fridays. But of course price had little to do with the defection. The real root cause was the credit card division's failure to coordinate its marketing and qualification efforts. When interviewers pushed the questioning far enough, *most* defectors who named price on their surveys turned out not to be price defectors after all.

Everybank needed to find the real causes—or at least the 20% that produced 80% of defections—but even a good sample of the defectors is too many for in-depth, root-cause interviews that can take two hours each. The bank solved the problem with computers. Professional interviewers spoke to several hundred defectors, reviewed their interactions with the bank, created a series of questions that would permit any interviewer to uncover the real reason for a defection, then translated that series into a computer program that enabled relatively unskilled interviewers to get to the root causes of defections in an average of 20 minutes. For example:

Why did you close your personal account at our Pine Street branch last month?

Your prices are way out of line.

Do you mean our interest rates on loans or the fees we charge for checking services?

The fees on some of my automated teller transactions and your loan pricing. That's why I refinanced my mortgage with another bank.

Have you closed any other accounts with our bank over the past few years?

Yes, I used to do all my banking with you because your branch was located next door to my dry-cleaning business, but you closed that branch three years ago.

Did you switch your business accounts to another bank when your branch closed?

Not right away. But First National offered me a package product that combined everything into one statement and gave me a better value because they considered all my balances in determining my fees. But the real key was the convenient statement.

Would you have stayed with our bank if we could have offered a comparable package?

Yes, I think so. I like long-term relationships. Anyway, I like the manager at the Pine Street branch. He goes to my church. He really wanted my business—it's over \$100,000 in balances—but he told me he couldn't match First National's bundled account.

Thanks for your help. One last question. Does your current bank charge lower ATM fees?

To be honest, I'm not sure.

The computer system helped the bank question a large sample of defectors, identify core customers—in this case,

the 20% of customers who created 80% of profits—and dig deep enough to find solutions. Senior managers were impressed but then grew frustrated when defection rates did not come down fast or far enough. The problem was confusion about who needed to learn. Everybank's new methods produced reliable information, but branch managers had seen customer research before and doubted that these root-cause interviews could tell them much they didn't already know about customers they had worked with for years. When branch managers were asked to look at individual names and suggest root causes, they asserted confidently that most had left to get better rates or products, or because backroom processing had made errors in their accounts—all reasons conveniently beyond the control of a branch manager.

The interviews showed, to the contrary, that roughly half of all defections resulted from branch-level problems such as customer service and complaint resolution. Some skeptical branch managers insisted on listening to the interview tapes themselves. Others accepted the root causes identified by the study but refused to believe the defectors were profitable customers until they reviewed the records. Gradually, the evidence persuaded them to open their eyes.

Then other problems arose. Many critical changes affected several departments that needed to work together. But cooperation across units was not a company habit. Worse, the failure-analysis team was itself something of a problem. The junior executive in charge couldn't get the attention of other unit heads, who were his boss's peers. The bank found that failure analysis needed the leadership of an executive with the

power to assemble cross-departmental task forces, as the following example shows.

Removing the Sources of Failure

Among the most profitable defecting customers, 25% named incidental fees as a critical root cause. Large balances in multiple accounts delivered so much value to the bank, they believed, that \$35 for bouncing a check was unreasonable. Top management did the arithmetic, found that 0.2% fewer defections would more than offset lower fees, and reduced them. But a new failure-analysis team, led by a senior executive, discovered that the problem had several dimensions involving several units. One was that salespeople had steered clients into products inappropriate for high-balance customers. The right products—for example, a bundled checking/money-market/savings account—had no fees. A second was that the marketing department had failed to include balances from products like mortgages and credit cards in the pricing formula. A third was that budget constraints had led the data-processing department to postpone implementation of a computer program that would link all of a customer's accounts. The final resolution of the fee problem involved many constituencies—the entire branch sales force, training, marketing, data processing, and above all a failure-analysis team with the organizational clout to do effective root-cause detective work and implement solutions.

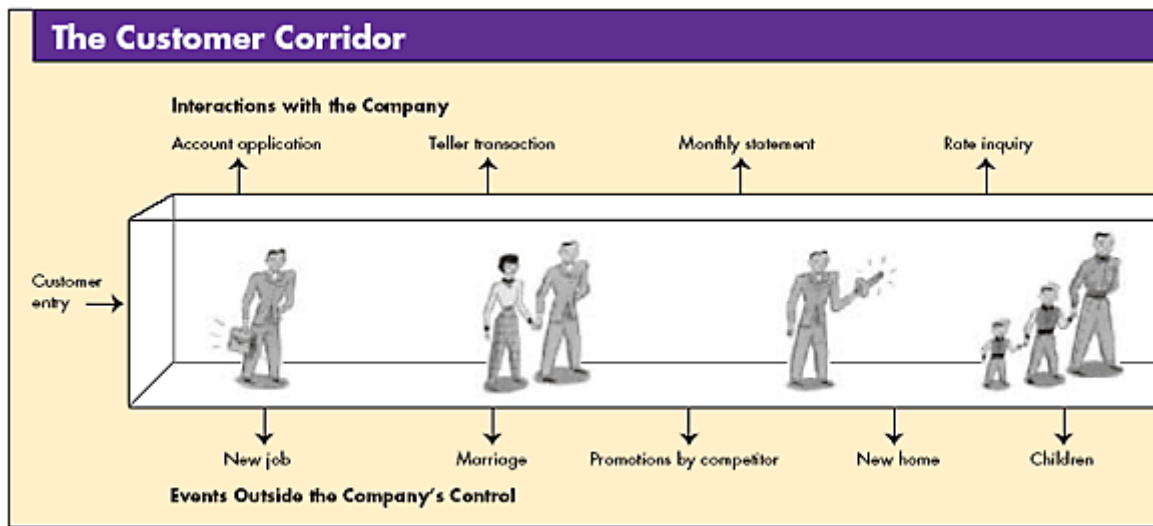
The bank also discovered that the efficiency of learning depended on incentives. Education's first rule is that the student must want to learn. To get branch managers to stay longer with the bank and do more business with their

best customers, Everybank revised its reward system to include multiyear bonuses based on each manager's success in penetrating and retaining top customer groups. The bank also found it could evaluate defection-correction teams by measuring how often root causes recurred. When people realized their bosses really cared about defections, they decided their root-cause analyses needed to be more precise. For example, credit-collection problems were high on the list of root causes, but no one knew what was wrong or how to fix it. Was it that collections officers called instead of the branch manager, whom customers knew as a friend? Were the calls too brusque? Did collections always know that a customer had \$200,000 in CDs in addition to a nonperforming loan? Or was it just that customers never talked to the same person twice and had to repeat their story again and again? Each explanation would require a different solution. The root-cause survey process needed to be more precise.

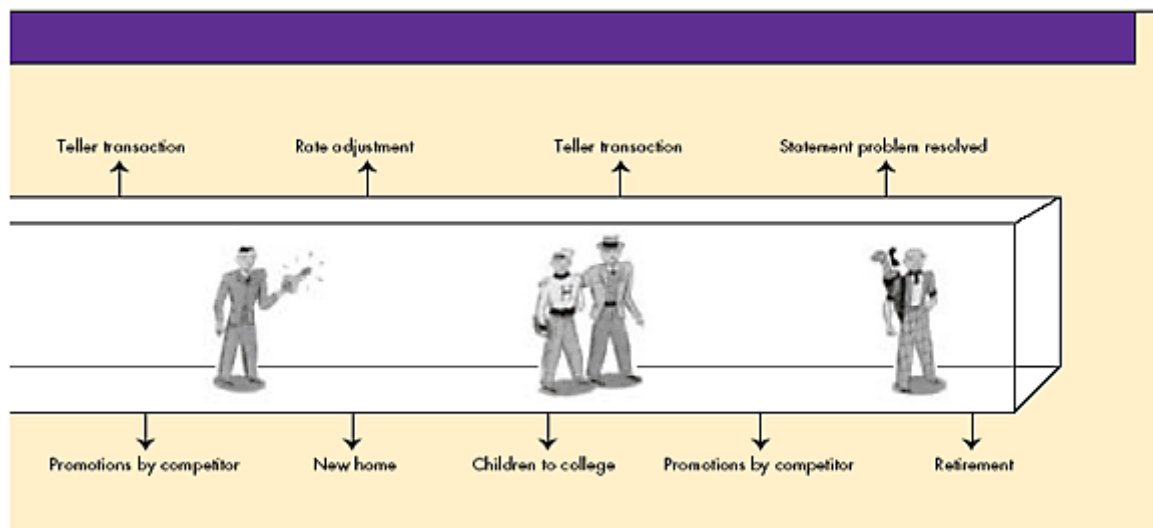
Everybank found it couldn't rely on interviews alone. Not even the most sophisticated survey technology will uncover every root cause, because some customers don't *know* why they defected. For example, branch managers knew that employee turnover affected customer turnover, but few defectors mentioned it. Statistical analysis showed that personnel turnover could explain almost half the differences in customer attrition from branch to branch. Customers couldn't put their fingers on it, but they clearly perceived that employees less familiar with their own jobs and with their customers delivered lower value.

Everybank also learned that it needed to look for customer categories with distinctive attrition levels. For example, customers whose initial purchase was a particular money-market account showed loyalty well above the average, so the bank redirected new-account promotions to feature that product. Customers who opened three or more different types of accounts simultaneously had the highest retention rate, so marketing created a new product that combined checking, savings, credit card, and an overdraft line—all with one account number. Conversely, the bank found that certain promotions—CD bonus rates, for example—brought in customers with lower retention rates, so it dropped them. And upon finding that certain mergers and acquisitions brought in customers with very high attrition rates, senior managers adjusted their acquisition strategy.

In case after case, Everybank identified failure and removed its source. The combination of root-cause analysis and systematic statistical study of customer segments improved the quality of the bank's customer base. In the first year, defections in the best customer group fell by a third. But among customers who failed to cover their own costs, defections actually increased—as managers had hoped they would.



The Customer Corridor



In many businesses, including banking, insurance, and other service industries, the customer corridor has a second set of doorways made up of the major changes in a customer's private life, which, along with competitors' efforts to lure the customer away, are represented by arrows below the corridor. Career moves, relocations, lifestyle changes, and almost any family watershed—a marriage, birth, divorce, or death—are often occasions for delivering additional value to the customer. In fact, if a company does not gear its products and services to such events, family upheavals will almost certainly produce defections. Banks that have analyzed defection frequencies find that changes of this kind increase the probability of defection by 100% to 300%. For obvious reasons, relocation is a prime culprit; but root-cause interviewers looking only at the arrows along the top of the corridor would miss that cause.

Once you have mapped out the customer corridor for your business, it is time to begin interviewing defectors in earnest—probing customer behavior, uncovering the root causes of each defection, and testing various solutions to see which, if any, would have saved the

relationship. One secret to this process is to have the right people take part. It can't be done with focus groups. Professional focus-group leaders from outside the company cannot have the deep knowledge of the business they need to ferret out root causes, and asking groups why they made individual purchase decisions produces nothing but groupthink. (If focus groups have a role, it may be to brainstorm solutions to specific root causes once they have been determined to have a high priority for core customers.) You can't contract the interviewing to a group of market research specialists, either, because they simply cannot know enough about your organization and its competitive situation, market and pricing strategies, cost position, and capabilities. Failure analysis demands a thorough understanding of the business system and its economics and a clear sense of what scale and unit of failure to scrutinize. In other words, failure analysis requires the guidance of senior managers. And if there is any uncertainty about precisely who the company's core customers are, or if the company needs to think about altering its value proposition or modifying its distribution channels, or if the defection data is incomplete, or if competitive conditions are undergoing rapid change, or if the organization is setting about failure analysis for the very first time—and there are probably very few businesses that meet none of those conditions—then senior managers must actually perform the failure analysis themselves.

The first step is to gather the senior management group (five or ten top executives) plus a sampling of respected frontline personnel—branch managers, say, or leading salespeople. Be sure to include people whose behavior will probably need to change. You must convince them that this diagnostic process has a top priority, and you must make it clear that they will not escape without making personal phone calls to defectors. Some will be very reluctant. Most people don't relish the idea of phoning strangers, let alone strangers who've been unhappy with the value they've received, and you will have to overcome that reluctance with leadership, peer pressure, and, if necessary, coercion. There is simply no substitute for having senior executives learn directly from defectors why the company's value proposition is inadequate.

There's no substitute for having executives hear for themselves what went wrong.

Before making the calls, the group must determine which defectors are worth calling. You need to look at market research and satisfaction surveys, consider the opinions of frontline personnel about why particular customers behaved as they did, and identify differences between your company and your competitors with regard to business processes, structure, financial incentives, quality measurement, and value proposition. If your current information system is not up to the

task of identifying key defectors, it is possible to assign telephone reps to call a large sample of apparent defectors and separate the wheat from the chaff by getting answers to half a dozen questions. You need to know something about their demographics—age, income, education, and so forth. You want to know how long they’ve been doing business with your company and to find out enough about their actual purchase history to determine whether or not they are core customers. And you need to make sure they have actually defected to a competitor, not simply stopped buying the product altogether. (The auto-insurance customer who sells the family car and switches to public transportation is not a defector but simply a former customer.) Phone reps are often a good investment because they not only collect basic data about each customer’s demographics and true purchase history, they also can set up appointments for company executives to call back for a full root-cause interview. Most ex-customers will be so delighted at the prospect of a senior executive listening to their problems and complaints that they will leap at the opportunity. Sometimes, of course, you will need to offer them an incentive. Go ahead and spend what it takes to talk with a true representative sample of your target defectors.

When you’ve done all this, assign each executive (yourself included) 10 to 25 defectors. When you’ve interviewed a quarter to a third of your defectors, you should reconvene to discuss what everyone is hearing, resolve any problems with the process, share best practices, and most important, use these early interviews to develop a preliminary list of corrective actions the company might take. Additional interviews can then focus on the most important questions and test hypotheses.

The final step is the joint development of an action plan based, of course, on the results of the defector interviews. The group will probably come up with some remedies that require little spending or preparation and can therefore be tested at once. Others may require further research or analysis because of the size of the necessary investment. The frontline managers included in the executive group will help to ensure that your interpretations of customer behavior are reasonable and that your proposed improvements can be carried out.

One word of warning: The realization that every company has some customers it’s better off losing poses a special hazard to companies engaged in defection analysis. The danger is that on the basis of inadequate information, the company will mistakenly identify potentially valuable customers as dispensable, ignore the lessons they have to teach, and make no effort to retain them. Such mistakes are easy to make because some first-class defectors are disguised as third-class. They were once outstanding customers and could be again, but by the time they’re ready to leave, they’ve already moved a substantial share of their wallet to a competitor. As partial

defectors, they look like unprofitable customers. But accepting the disguise at face value means accepting undesirable defections; it can tempt the company to under-invest in the kinds of improvements that make customers want to stay. These situations call for something resembling defection archeology—uncovering and analyzing several layers of historical and current data.

For example, one leading credit card company has built a computer system that lets its telephone reps instantly evaluate any customer who calls to cancel an account. The system is based on the potential profit from the customer's entire wallet, not merely on the company's present share, so a shift of spending to a competitor won't fool it. The phone rep can offer appropriate incentives to the best customers, and the company can watch to see whether the offers provide enough value to keep customers on board. Because of the inevitable tendency to dismiss all defectors as undesirable, knowing the true, sometimes hidden value of a defector turns out to be critically important in activating root-cause tracking systems.

In the case of a credit card company, information about a customer's entire wallet can be derived from credit-bureau reports. In banking, you can look at customers' mortgage applications to see where they keep their assets. In a few other industries, vendors make a business of collecting such data (the Nielsen ratings for television are one example). In most industries, however, the only way to determine share of wallet is to conduct a survey of your own and your competitors' customers. In other words, you have to ask.

Getting the Right People to Learn the Right Lessons

Unfortunately, useful learning is not closely related to the quantity of information available. If it were, we'd all be swimming in skills and expertise. Useful learning is instead a matter of getting the right information to the right people and giving them good reason to want to use it.

Market research with its customer questionnaires, satisfaction surveys, and focus groups was developed to give marketing departments the information they needed to set prices and design packaging, advertising, and promotions. It was not invented to help frontline employees provide better service or to give them better incentives or to solve the problems that cross departmental boundaries. Market research has the added drawback that those who learn most about customers are often the researchers, who usually are outside experts. They produce reports for managers (usually in marketing) who then interpret the findings for senior management. By the time information works its way back down the organization to frontline managers and employees in sales or service, it is too general to be at all useful.

The research we call root-cause analysis eliminates many of these weaknesses. When frontline managers and employees know the causes of customer dissatisfaction but cannot convince senior managers, the interviews that executives themselves conduct are nearly always persuasive. When frontline managers are mistaken about what is actually driving customers away, the immediacy, depth, and credibility of root-cause interviewing—they can often listen to taped interviews for themselves—overwhelms skepticism.

But although root-cause analysis enables people to learn, you still need some systematic way of getting them to want to learn. Therefore, the indispensable first step in unleashing the power of defection analysis is to make appropriate changes in measures, incentives, and career paths. In many organizations, the current incentives do little or nothing to make anyone care about fixing defections. Branch managers in a typical bank are paid bonuses on a variety of measures ranging from budgets to satisfaction surveys. Learning why customers defect takes time and energy, so unless it's clear to branch managers that their annual bonuses are tied to reducing attrition, supplying them with world-class failure-analysis technology won't improve their decision making.

Likewise, the marketing manager whose bonus is based on the volume of new deposit dollars generated through CD promotions doesn't really care if new depositors defect next year. And the credit-collections manager whose bonus is based on the balances collected from delinquent credit cards doesn't long to learn why customers defected from other bank products, such as savings and checking accounts. Often the most important barrier to learning from defections is that employees can't see how the learning relates to their own success.

Even in companies that care enough about retention to engineer effective incentives, it's sometimes necessary to remind employees how important it is to continue improving retention rates. Even though State Farm's agent-compensation structure was more heavily geared to retention than most competitors', managers at headquarters discovered that some of the company's agents had grown complacent. To shake them up a bit, the company calculated what would happen to an agent's income if he or she could achieve a one-percentage-point improvement in customer retention. The answer—a 20% increase in average annual earnings!—was just the tonic the company needed for its agents.

Lexus is another company that has cared passionately from the beginning about earning customer loyalty. The new carmaker chose dealers who had demonstrated a commitment to customer service and satisfaction. But like State Farm, Lexus has found it useful to let dealers know exactly how much their improved retention of customers is worth to them in dollars. The company has constructed a model that can be used to calculate how much more each dealership could earn by achieving higher levels of repurchase and service loyalty. These cash-flow calculations are important reminders, even for those who already believe in the importance of customer retention, because for some reason, raising annual retention rates just a few points doesn't impress people. Perhaps we should multiply all our numbers by 100 or 1000. Every baseball fan knows there's a world of difference between a .280 hitter and a .320 hitter, but the actual difference is only four percentage points. Business needs a similar way to dramatize the enormous potential of a four-percentage-point improvement in customer retention.

Making Failure Analysis Permanent

Once you have mastered the interviewing and analysis techniques, customer defections become such a rich source of information that you will want to make the system permanent. This is both harder and easier than it might seem. To begin with, you need to build a measurement system to monitor whether and how effectively the solutions you've arrived at are reducing defection rates. Share of wallet is one such measure, and to make it really useful you need to break it down further into the percentage of customers giving your business an increasing share of wallet and the percentage giving you a decreasing share. Another essential measure is the defection rate itself, calculated separately for separate groups of customers—your best core customers, the rest of your core customers, the rest of your customers, and, perhaps, the customers you wouldn't mind losing. You also need to monitor the frequency of various root causes to make certain that problems are actually being solved and that new problems don't arise undetected.

And you need to create an ongoing mechanism that keeps senior managers permanently plugged into frontline customer feedback. Lexus asks every member of its headquarters staff to interview four customers a month. MBNA, the credit card giant, asks every executive to listen in on telephone conversations in the customer-service area or the customer-recovery units. Some of those executives make the phone calls themselves. Every company benefits when executives can combine decision-making economics with lessons learned directly from customers and defectors. The alternative is to depend on research conducted by outsiders who will never really understand your business, your competition, or your customers, and who will never really care.

Executives at MBNA listen in on customer-service calls.

Deere & Company, which makes John Deere tractors and has a superb record of customer loyalty—nearly 98% annual customer retention in some product areas—uses retired employees to interview defectors and customers. USAA—the insurance and financial-services company based in San Antonio, Texas, that has come closer than any other U.S. company to eliminating customer defections altogether (it loses target customers at a rate of 1.5% per year, and most of that number are people who die)—treats customer defections very, very seriously and has pushed its analysis of them to a kind of pinnacle. The company recognizes that any event on the internal or external customer corridor that produces a spike in defection frequency highlights a dimension of customer value that needs improvement. USAA also tracks wallet share and retention rates separately by life-stage segment—for example, it knows when customers defect partially or entirely because their children have reached driving age and need auto insurance—so the company can spot problems and opportunities early and develop responses. In addition, focus groups of employees frequently review their customer interactions and draw up recommendations. Finally, to supplement its defector surveys, USAA has built an on-line system called Echo that enables telephone sales and service reps to input customer suggestions or complaints as they occur. Managers analyze all this data regularly to look for patterns, and they review problems and potential solutions at a monthly meeting with the CEO. The CEO then makes a formal quarterly report on customer retention to the board of directors. This careful, thorough, methodical approach to customer loyalty makes a striking contrast to the practice at most companies, where customer defection is either ignored, undervalued, or misunderstood.

The key to customer loyalty is the creation of value. The key to value creation is organizational learning. And the key to organizational learning is grasping the value of failure. As Vilfredo Pareto said more than 70 years ago, “Give me a fruitful error any time, full of seeds, bursting with its own corrections.” Customer defection is a unit of error containing nearly all the information a company needs to compete, profit, and grow.

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