

# Banking on Customer Loyalty

by Craig Churchill

**ABSTRACT:** Enhancing customer loyalty is a microfinance institution's most important business strategy. Every critical element involved in managing microfinance operations—from product pricing to staff incentives, from marketing to eligibility requirements, from client screening to the menu of available services—can (and should) be formulated to promote loyalty. While most MFIs recognize the importance of client retention, few have designed business strategies to maximize customer loyalty. Hopefully that will change. This article details the economic impact that customer loyalty has on a microfinance institution (and the negative effect of desertion).<sup>1</sup>

Most microcredit products were not originally designed to accommodate the specific and dynamic requirements of microentrepreneurs. They were created with rigid controls to compensate, or perhaps overcompensate, for the fact that the loans were unsecured. While group mechanisms, like solidarity groups and village banks, are the most obvious form of collateral substitute, other elements were also considered important, including frequent repayments, regular meetings, forced savings, small loans for short terms, and zero tolerance for delinquency. In the interests of delivering these loans efficiently, microfinance institutions adopted a one-size-fits-all mentality.

Some microfinance institutions used their loan products as a screening device. Almost anyone who applied for a loan received one, but a very small one. Those who repaid on time received another, slightly

larger loan, while anyone who had difficulty repaying was not permitted to receive subsequent loans. This approach, designed to reduce the credit risk, inadvertently created an operational culture in which staff were actually encouraged to exclude borrowers over time. This credit-driven approach also assumed that the customers who were not weeded out would continue to borrow again and again.

The resulting experience with these rigid credit products was largely successful. MFIs served markets with a seemingly insatiable demand. Clients were not particularly discriminating. Large volumes of novice borrowers were thrilled that an organization was willing to lend them money. If 20 percent of the customers were kicked out because they did not meet the strict on-time repayment requirements, and if 30 percent stopped borrowing because they were round pegs forced through square holes, there were more than enough prospective borrowers ready to take their places.

However, the landscape is changing—in some countries it is changing very quickly. MFIs are losing their monopolistic control over the market, and customers are becoming experienced purchasers of financial services. The microfinance industry is also learning that some of its original assumptions are not true, or are no longer valid:

- Some controls designed to exact timely repayment are excessive, which unnecessarily encourages customers to stop borrowing or go elsewhere.
- The market for microenterprise loans is not homogeneous; one size does not fit all.
- Many clients do not want to keep borrowing. They do not necessarily like being in debt.

.....  
*Craig Churchill is the Director of Research and Policy at Calmeadow, a Canadian NGO that specializes in microfinance.*

Changes in these assumptions, as well as the realities of increasing competition and a more discerning clientele, suggest the need for a different approach to microfinance. This article proposes that MFIs should respond by adopting a business strategy to enhance customer loyalty. It begins by defining loyalty and then attempts to demonstrate that customer loyalty is the primary driver of long-term financial performance. It illustrates the positive effect of customer loyalty (or the negative effect of desertion) on the organization's ability to manage growth, retain staff, and improve the lives of its customers. The article concludes by describing indicators to measure and monitor customer loyalty.

### What Is Loyalty?

Loyalty is the attachment a customer feels for a company's people, products, and services. Griffin (1995) defines a loyal customer as someone who

- Makes regular purchases.
- Purchases across product and service lines.
- Refers others.
- Demonstrates an immunity to the pull of the competition.

Loyalty can be broken down into four categories (see Figure 1) based on the customer's attachment or affinity to the products and services (or to the organization that provides them) and their purchase pattern (i.e., whether they take a repeat loan<sup>2</sup>):

1. **No Loyalty:** Some customers, for some products, never become loyal. They switch their affiliations depending on who offers the best deal. In competitive markets with products that are reasonably indistinguishable, certain marketing strategies can unwittingly create customers who lack loyalty. For example, if businesses try to achieve market share by providing a service at the lowest price, by issuing coupons, or by

**Figure 1: Four Types of Loyalty**

		<i>Likelihood of Accessing a Repeat Loan</i>	
		High	Low
<i>Relative Attachment</i>	High	Premium Loyalty	Latent Loyalty
	Low	Inertia Loyalty	No Loyalty

Adapted from Griffin (1995)

making special introductory offers, then customers may keep following the best deal and may even feel cheated if they do not receive a discount.

2. **Inertia Loyalty:** In less competitive microfinance markets, MFIs can be lulled into assuming that their clients are loyal because they have nowhere else to go. Consequently, clients may borrow again and again, but not because they have a particularly high attachment to the organization. If a new player arrives on the scene, these customers would be the first ones out the door.
3. **Latent Loyalty:** While customers may feel loyal to an organization, they may not want to borrow all the time. Perhaps they only borrow to stock up on inventory during the holiday season, or perhaps their business is generating enough revenue that they no longer need to borrow. While not highly profitable, these “latent loyals” represent a valuable market for new products as well as an indispensable source for referrals.
4. **Premium Loyalty:** Premium loyalty, characterized by a high affinity and repeat patronage, is the most desirable form of loyalty. Customers who exhibit premium loyalty are proud of their affiliation with an organization and they take pleasure in sharing their positive experience with others. The challenge is how to cultivate premium loyalty.

## Loyalty and Profitability

Loyalty has to be earned. If an organization is loyal to its customers, if it is committed to providing them with a valuable service, and if it improves that service as its customers' needs change, then customers are likely to repay the favor in the form of a mutually beneficial, long-term relationship. Is customer loyalty worth the effort? This section attempts to demonstrate that the road to profitability is paved with customer loyalty.

### Life Cycle Strategy

Many MFIs employ a life cycle strategy, which involves serving unprofitable clients in anticipation that they will become profitable customers over time. In this case, profitable means that the cost of providing a loan to a client is less than the revenue that loan generates. Following the life cycle strategy, the institution needs to retain clients at least until they produce enough revenue to cover the losses they accumulated during the previous loan cycles.

For the first few loans, the acquisition and screening expenses, on top of the regular transaction costs, are often higher than the revenue produced by low loan balances. Only after several loans do the unit costs come down (through more efficient servicing of repeat customers) and the revenues increase (through larger loans) to the point where that loan generates a net income. And still it may take several more loans before the accumulated income from that customer is sufficient to cover the losses from earlier loan cycles.

In a hypothetical example illustrated in Figure 2, the lender gradually raises the loan size from \$50 during the first cycle to \$750 for the tenth loan. Because of the administrative fee structure, the effective rate on this loan gradually declines. Through more efficient processing of repeat loans, the lender can lower the unit loan costs considerably after the first few loans, from \$175 for the first loan to \$50 after the fourth

loan. In this highly stylized example, it is only in the fifth cycle that a loan becomes profitable, and the MFI does not recoup its accumulated losses from the first four loans until the eighth loan.

**Figure 2: The Importance of Customer Loyalty**

Loan Cycle	Loan Amount(\$)	Effective Rate(%)	Revenue(\$)	Unit Cost(\$)	Net Income(\$)	Cumulative Income(\$)
1	50	35	17.50	175	(157.50)	(157.50)
2	75	35	26.25	100	(73.75)	(231.25)
3	125	34	42.50	80	(37.50)	(268.75)
4	200	34	68.00	75	(7.00)	(275.75)
5	300	32	96.00	50	46.00	(229.75)
6	375	32	120.00	50	70.00	(159.75)
7	500	30	150.00	50	100.00	(59.75)
8	500	30	150.00	50	100.00	40.25
9	600	28	168.00	50	118.00	158.25
10	750	28	210.00	50	160.00	318.25

If this client leaves before the eighth loan, the MFI will have lost money on this borrower. If this client defects in order to borrow from a competitor, and she uses her exemplary repayment record with MFI #1 to access better terms from MFI #2, then MFI #1 lost money on the client and effectively subsidized the competition by teaching that client how to borrow and supporting her while she developed a credit history.

**Portfolio Diversity?**

Of course, accounting systems track profitability from year to year, so they do not consider a client’s life cycle with an institution. An alternative way to measure client profitability is to consider an institution’s portfolio mixture at one point in time. Figure 3 helps to highlight this point. For illustrative purposes, assume that the cost of providing a loan is basically constant regardless of the loan size, and that the price of the

loan (interest rate) also remains constant. If these assumptions were true, then profitability would be purely a function of loan size.

In this example, the distribution of loans therefore represents the costs (i.e., approximately 12 percent of the administrative costs are involved in serving loans under \$200) and the distribution of the value of the loans represents the revenue (i.e., 2 percent of the institution's revenue comes from loans below \$200). By applying these assumptions to Figure 3, loans start becoming profitable somewhere around \$1000. While the simplifying assumptions do not work because many MFIs offer variable pricing and because the costs of originating a loan vary somewhat by loan size, the basic premise still holds that larger loans are subsidizing smaller loans to some degree.

There are (at least) two responses to this information. One response is to target heterogeneous clients so that larger borrowers can subsidize smaller loans. The downside of this approach, however, is that a lender will encounter high screening costs (and high risks) in delivering large loans to new customers. In trying to serve a heterogeneous market from the outset, the MFI may also be stretching beyond its core competencies.

The second (and preferred) response is to design and implement a customer loyalty strategy so that the MFI's portfolio is heavily weighted toward repeat clients. In a sense, this strategy achieves a heterogeneous portfolio organically. Loyal customers subsidize new clients because repeat borrowers are less expensive to serve and less risky, and they typically have higher loan balances. This is the preferred response because the MFI can focus on the market it knows best, and because a smaller loan to a repeat customer can be more profitable than a larger loan to a new client.

**Figure 3: Distribution of Costs and Revenue by Loan Size (Gheen et al, 1999)**

### **Improved Efficiency and Productivity**

New clients are expensive to find and serve. The rule of thumb in many businesses is that it costs five times more to gain a new customer than to retain an existing one (Reichheld and Sasser, 1990). In microfinance, based on an analysis of six MFIs in Latin America, Gheen et al. (1999) estimate the average cost of attracting new clients is about one-fifth of the total unit loan cost.

Besides the acquisition costs, MFIs invest a considerable amount of resources in preparing and educating new customers. Loan officers may have to complete the applications for the clients, and if they have not been keeping business records, the process of creating cash flow or income statements can be time-consuming. With group lending, and after clients have formed a group, the MFI spends time informing them about the roles and responsibilities of the group and testing group cohesion to make sure that members will stick together over the long term. It is not unusual for the whole process to take two or three months; for group lenders using a staggered disbursement schedule, it could take well over four months before an MFI starts earning any revenue on some clients.

Microfinance institutions can significantly reduce the costs of delivering a loan to repeat borrowers in good standing.<sup>3</sup> Loan applications may be shorter for repeat loans; loan officers may not need to conduct on-site business evaluations for each loan; the due diligence requirements may be less stringent; and clients with good repayment records may make payments less frequently (e.g., monthly instead of weekly), which reduces transaction costs. The list of efficiency innovations is long and growing.

Client loyalty not only improves efficiency, but it also enhances productivity. Since repeat borrowers with good repayment records take sig-

nificantly less time to manage than new clients, loan officers with large volumes of loyal customers can manage more clients. This compounding effect of improved efficiency and productivity is invaluable, particularly for MFIs serving the lower income markets, because they need to compensate for low loan balances.

### **Desertion and Loan Losses**

A loyal customer is also likely to be a low-risk borrower, assuming that an MFI tailors its services to the specific requirements of each client.<sup>4</sup> Since this customer has borrowed repeatedly, the institution should have amassed sufficient information to make wise credit decisions. If repeat clients represent a greater percentage of the portfolio than new clients, the MFI should extract a cost savings in the form of lower loan losses.

When the customer base consists of many new faces, the portfolio is invariably riskier than it appears on the surface. New clients tend to pay well for a while, but if a few of them start having repayment problems, delinquency can spiral out of control if the portfolio does not have a bulwark of tried and true customers to stabilize the situation. While portfolio volatility is a recognized risk in microfinance, particularly when large segments of the portfolio are unsecured, this risk should be substantially reduced if repeat customers represent the bulk of the portfolio.

If those repeat clients have a strong affinity to the MFI, portfolio quality is likely to be even better. High-affinity clients value the service that they are receiving. Since they want to continue to receive access to this service, loyal customers are more likely to maintain an unblemished credit record than a low-affinity client who will desert as soon as a better opportunity arises.

### **Word of Mouth Referrals**

A loyal customer is the best source for new customers. People are much more inclined to go to a movie, eat at a restaurant, or borrow from an MFI based on the recommendation of a friend rather than some form of mass advertising. Customers will have a higher attachment to the organization if it was recommended to them, and this creates a perpetuating cycle of referrals and retention.

Word-of-mouth marketing is obviously attractive because it is free, but it can also reduce the expenses associated with client acquisition and screening. Loan applicants who are referred by existing customers often know the rules of engagement, a fact that lowers acquisition costs. MFIs that use a group lending methodology, for example, often find that prospective clients arrive on their doorstep with their groups already formed because they heard about this requirement from other clients. The relationship between the referral and the referrer also provides invaluable information to a character lender. If a prospective client is recommended by a good customer who is willing to vouch for her character, that reflects more favorably on the applicant than if the referring client was a new borrower with chronic delinquency problems.

### **Compounding Profits**

The combination of these factors—higher loan balances, lower acquisition costs, greater efficiency and productivity, lower loan losses, word of mouth referrals—produce an increasing volume of profits during the customer's relationship with the MFI, as Figure 4 depicts. The relative value of each factor depends on institution-specific details, such as its cost structure and interest rate; but the result is that loyal customers generate increasing profits over time. Research in other industries has determined that companies can improve profits anywhere from 25 to 85 percent by reducing customer defections by 5 percent (Reichheld and Sasser, 1990).

## **Loyalty and Debt**

It is unreasonable to assume that all customers will want to borrow all the time. Credit-only programs have natural desertion rates that vary by region. Some customers will no longer need to borrow; others will only borrow when they absolutely have to. It is difficult to be a staunch advocate of customer loyalty for organizations that provide loans only because many people do not like being in debt.

For credit-only programs, the best way to enhance customer loyalty is by developing voluntary savings products. Microcredit alone does not provide the institution with a sufficient array of services to establish life-long relationships with its customers. While some regulatory environments present significant obstacles to mobilizing deposits, if an MFI recognizes the potential loyalty benefits of offering savings, it will find a way to deliver.

## **Desertion Causes Growth Problems**

Another way to understand the value of loyalty is to consider the alternative: desertion. When an MFI starts losing its best customers, it is bound to experience difficulties. The MFI will be running in place instead of growing, because new customers first have to replace the ones who left. Since the defectors probably had larger loan balances than their replacements, the MFI might see its portfolio decrease.

Desertion among group borrowers creates additional complications. Often the group is required to replace the departing client, but this can result in wide loan-size differences between new and old members. Since it is unrealistic to expect someone with a \$100 loan to accept joint liability for members with \$1000 loans, either the new client will borrow a large amount, creating a credit risk, or the old clients will accept smaller loans, which do not meet their needs. Alternatively, the group can con-

**Figure 4: Why Customers Are More Profitable over Time**

tinue without replacing the lost member, but attrition over the years can result in groups of one or two members, and this defeats the purpose of the group methodology.

Many microfinance institutions experience roller-coaster growth cycles of exponential expansion followed by consolidation. More often than not, this fits-and-starts growth pattern is evidence that the MFI has significant retention problems. This common experience of growth and then consolidation goes something like this. First, senior managers push for expansion, perhaps because the institution just received a grant or access to new loan capital. Loan officers, who already had some excess capacity, drum up a lot of new business. The organization gets flooded with inquiries, and to respond to all the new applications, loan officers take shortcuts in the screening process.

During this rush of new business, loan officers neglect their current clients. Existing borrowers stop receiving the levels of service they deserve, and they become disgruntled. If there are other service providers in the area, they may consider defecting; or they may conclude that if they are not treated well, they are not going to bother borrowing. If they become really irritated, they may even bad-mouth the MFI to prospective clients. Bad news travels far and fast, complicating the challenge of recruiting new borrowers. At the same time, the retention of the new clients is low because the screening shortcuts are creating portfolio quality problems. The burdens of delinquency management distract loan officers from providing quality service to their most valuable customers. Twelve months after a huge growth spike, the number of clients is back to square one, and the institution is facing significant loan losses.

### **Customer Loyalty Breeds Staff Retention**

The value of customer loyalty is further enhanced by the important influence it can have on staff retention. All other things being equal, an

MFI that serves loyal, satisfied clients will have a good chance of keeping its employees—most loan officers prefer interacting with happy customers.

In microfinance, staff retention is as important as customer retention. It is expensive to hire and train new loan officers to replace departing employees. If experienced staff members leave to work for other institutions, then the MFI is training the employees of its competitors. Green loan officers are not as productive as their seasoned peers, and they are more likely to experience portfolio quality problems. Over the years, loan officers hone their skills to identify credit risks and develop screening tricks that cannot be taught or built into a credit-scoring model. With a mature portfolio of repeat borrowers, senior loan officers tend to have higher productivity.

If an employee's job satisfaction is a function of customer satisfaction, then efforts to retain clients will likely have the additional benefit of retaining staff. This works the other way as well. The personal relationship between loan officers and their clients is a critical factor in promoting loyalty. Clients keep coming back because they like the loan officer, they trust her, and they receive a good service from her. If she leaves (especially if she goes to work for the competition), some of her clients may not come back. Consequently, there is a cyclical relationship with customer retention and staff retention reinforcing each other.

### **The Impact of Customer Loyalty**

Most microfinance institutions have a dual mission with social and commercial objectives. While this article has focused on the commercial benefits of customer loyalty, for many MFIs the social mission of helping low-income persons to work their way out of poverty is even more important than profitability. For MFIs to make a lasting and tangible impact on the lives of their customers, they need to serve them on an ongoing basis.

A single \$100 microenterprise loan will not make a dramatic difference in most people's lives. But if the microenterprise grows so that it can make use of increasingly larger loans, the business is likely to spin off impact benefits such as increased income and assets for the household, and perhaps even job opportunities for other low-income persons. Even if the business never grows, regular and sustained access to financial services can stabilize a household's income and reduce its vulnerability to risks.

A customer loyalty strategy that involves tailoring services to individual client's needs has the additional benefit of not causing damage (or at least causing less damage). When an MFI uses its loan product as a screening device, it may cause more harm than good, particularly with the most vulnerable clients. If a client receives a loan that is beyond her capacity to repay, she will face the moral dilemma of choosing between three undesirable outcomes: either she will have to reallocate resources from essential expenditures like food to repay the loan; or she will disappoint and perhaps be ostracized by her friends and neighbors (guarantors or members of a peer group or village bank); or she will be blacklisted by the MFI and not be able to access financial services again in the future. By responding to the unique needs of each client, a customer loyalty strategy will reduce the likelihood that round pegs are forced through square holes.

### **Measuring Loyalty**

To enhance loyalty, the first step is to measure it. With a set of baseline data, an MFI can gauge whether its efforts to improve loyalty are or are not successful. While loyalty defined as a feeling or an attachment may seem like an elusive and subjective characteristic, there are ways to monitor it.

## Customer Retention

The most common indicator of customer loyalty is the retention (or desertion) ratio. Tracking client retention serves two purposes. First, it provides a blunt indicator of customer satisfaction. Second, it is important in forecasting the overall financial health of the MFI. To develop accurate financial projections, an MFI needs information about client retention to predict the effect on average loan size (which determines revenue) and on the recruitment costs necessary to replace lost customers.

Calculating a retention rate for depositors is more difficult than it is for borrowers. For liquid savings accounts, it is necessary to consider both the changes in account balances as well as the number of transactions. An inactive account with a low balance is almost as bad as closed account. On the other hand, a closed account may not mean lost customers if they are transferring their balance to another savings instrument. For example, when a certificate of deposit comes due, rather than renew it the customer may deposit the funds in her current account instead.

## Primary Behavior: 3-D Loyalty

MFIs should also monitor the three dimensions of customer loyalty: length (longevity), breadth (range of services), and depth (share of purchases). Longevity is the number of years that clients have accessed the MFI's services. This can be expressed as an average or, more usefully, as a distribution. It is strongly recommended that MFIs monitor the percentage of clients (or portfolios) who have been with the organization for specific periods of time, such as (a) less than one year, (b) between one and two years, (c) two to five years, and (d) over five years. A healthy and mature organization should see a heavy weighting toward the latter categories.

For MFIs that offer a variety of voluntary financial services, another measure of client loyalty is the breadth of their relationship. A customer who has two different savings accounts, a housing loan and a business loan, and a life insurance policy—and her husband, mother, and daughter all have savings accounts—is a much more loyal customer than someone who has just an outstanding loan. To measure the breadth of relationship, MFIs need an information system that is organized around the customer, rather than the product, and if possible the opportunity to establish family linkages. Not only is the family linkage information useful to measure loyalty, it also helps loan officers to keep an eye on household overindebtedness.

Exclusivity is also an indicator of loyalty. In fact, the ultimate measure of loyalty is the customer's share of purchases. With deposits, for example, what percentage of a client's savings or assets is held by the organization? For loans, does the client have any other outstanding debts? Besides indicating the degree of loyalty, these details are also important for two other reasons. First, if a customer has outstanding loans from other sources, the MFI needs that information to gauge whether the client has the capacity to repay. Second, information about the client's use of financial services from other sources provides invaluable information for new product development that may allow an MFI to increase its share of purchases.

### **Secondary Behavior**

Referrals, endorsements, and spreading the word are examples of secondary behavior that indicate customer loyalty. Although it is difficult to quantify the rumor mill, there are two ways to measure this secondary behavior. The first is to monitor the number of referrals made by existing clients and how recent they are. Customers who regularly refer other clients could be categorized as highly loyal advocates. If they have not

referred any new clients recently, after a flurry of referrals early on, then perhaps an intervention is warranted, since it appears that their level of allegiance has waned.

While an active list of referrals is a strong indicator of a customer's loyalty, the opposite is not necessarily true: not all loyal customers are outgoing and know lots of other people who are potential customers. Another way to measure the secondary behavior is to use customer surveys to inquire whether they would recommend the organization to their friends and neighbors. The answer to this question is a good loyalty indicator, and the simple task of asking the question may stimulate another round of referrals.

### Conclusion

For a microfinance institution, customer loyalty is the primary driver of long-term financial success. If an MFI can retain a strong cadre of loyal repeat customers, it will be well on its way toward profitability. As such, every critical element involved in managing microfinance operations—from product pricing to staff incentives, from marketing to eligibility requirements, from client screening to the menu of available services—should be formulated to promote loyalty.

### References

- Brand, M., & Gershick, J. (2000). *Maximizing efficiency in microfinance: The path to enhanced outreach and sustainability*. Somerville, MA: ACCION International.
- Gheen, W. E., Jaramillo D., & Pazmino, N. (1999, July). "Measuring unit loan costs." *The MicroBanking Bulletin*, 3, pp.3-7.
- Griffin, J. (1995). *Customer loyalty: How to get it, how to keep it*. San Francisco: Jossey-Bass Press.
- Reicheld, F. F., & Sasser, W. E., Jr. (1990, September-October). "Zero defections: Quality comes to services." *Harvard Business Review*, pp.105-111.

## Notes

1. This article is extracted from a forthcoming MicroFinance Network Technical Guide by Craig Churchill and Sahra Halpern entitled “Building Customer Loyalty: Measuring and Maximizing Customer Satisfaction.” The full publication includes detailed examples of ways to improve loyalty and specific tools to measure satisfaction.

2. Loan products are used as examples throughout this article because they have a determinable term, so it is easier to demonstrate or measure loyalty—customers either return for a repeat loan or they do not.

3. See Brand and Gerschick (2000) for examples of improving efficiencies in delivering loans to repeat clients. In their research, however, Gheen et al. (1999) concluded that MFIs make few, if any, changes in the screening and processing phases for repeat clients, and therefore that they are not taking full advantage of the opportunities to reduce unit loan costs for repeat borrowers.

4. A microfinance institution that automatically increases the size of each subsequent loan without carefully monitoring the repayment capacity of its borrowers can find itself in the counterintuitive (and undesirable) situation of having worse portfolio quality from the clients that it should know the best.

