How interactive marketing is changing in financial services

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# Purpose

This article explores the impact of the Internet and related information and communications technology (ICT)developments on how FS (FS) are distributed and how customers are managed, in particular how companies can differentiate between "good" and "bad" customers and manage them appropriately, but also how customers can be "bad" and escape the consequences. It also explores how changes in information asymmetry between suppliers and customers affects who gains or loses from the relationship between them. One of its findings is that those responsible for controlling damage done to companies by fraudulent or negative value customers (typically those managing underwriting or risk) and those responsible for recruiting, retaining and developing customers typically marketing, sales and customer service) do not work closely enough together. This can damage shareholder value and the customer experience. The data for the article is from the authors’ consulting and conference chairing experience. The article identifies the need for more research covering the processes, data, analysis, systems and strategies required to manage both good and bad customers and the practical problems of implementation. The main practical implication is that in designing products and the customer service experience, FS marketers need to take into account much more systematically the “dark side” of customer activity. This paper is one of the first to explore its issues in detail.

# Design methodology and approach

The data for the article is from the authors’ consulting and conference chairing experience. The article is in the form of a reflection on this, rather than a hypothesis-based research article.

# Findings

One of the article’s findings is that those responsible for controlling damage done to companies by fraudulent or negative value customers (typically those managing underwriting or risk) and those responsible for recruiting, retaining and developing customers typically marketing, sales and customer service) do not work closely enough together, and this can lead not only to damage to shareholder value but also damage to the customer experience.

# Originality/value

The article identifies the need for more research covering the processes, data, analysis, systems and strategies required to manage both good and bad customers and the practical problems of implementation.

# Practical implications

The main practical implication is that in designing products and the customer service experience, financial services marketers need to take into account much more systematically the “dark side” of customer activity.

# Key words

Financial services, channel management, competitive strategy, consumer behaviour, customer insight, ethics.

# Introduction

FS marketing has come some way in a few decades. In the developed world, agents who sold from door to door have largely disappeared, while agents in Main Street offices are much rarer. Suppliers and agents serve the mass market mainly through direct and digital marketing, which allow companies to use a deep, wide set of customer data that arises from their interactions with customers, from customers' use of different digital devices and from sources such as social media, to provide more value to customers and to market, sell and service more cost-effectively and profitably.

Human beings, whether customer-facing or back-office, are mainly reserved for higher value, more complex transactions and for customer service. There are still many bank branches, though their number is falling. Branches are increasingly mechanised and automated. In some countries, such as the UK and Australia, regulators have increased the speed of suppliers’ withdrawal from human-delivered services by cracking down on the unreliable, inconsistent and sometimes downright anti-customer behaviour of staff responding too avidly to sales incentives[[[1]](#endnote-1)], combined with often poor decision-making of customers (Chater et al 2010). This applies particularly to investment, life insurance and pensions.

The story for different types of FS varies, but the main trends are clear. How they affect different sectors of the industry depends on factors such as those listed below.

***The channel(s) used to make the sale and manage the relationship.***

The more humans are involved, the more they may be able to detect bad customers, but the more they introduce other problems (e.g. bad advice, mis-selling, fraud of their own). Direct and digital channels rule credit cards, banking and property and casualty insurance, whole-of-life insurance and health insurance (unless provided via employers in group or workplace schemes). More complex investment and risk products are generally provided via an advisor. For high value life or health insurance, medical examinations may be required, but medical assessment depends partly on questionnaire answers given by the insured person, introducing scope for fraud, particularly where questions relate to unverifiable past behaviour or the health of other members of the family.

## The frequency of transactions and of establishment and termination of relationships

A credit card or bank account customer might switch suppliers every few years and have several suppliers, transacting several times a day. Life insurance and pensions policies may be taken out only a few times in a life-time, with contributions usually being made monthly, but with ***the*** major transaction taking place once or very few times (e.g. death - when life insurance is paid, retirement - when a pension is taken, though in some countries customers can retire in stages and withdraw from pension funds in different ways, or switch funds between suppliers). Savings and investment products may involve one or a series of contributions, while mortgages may be taken out several times in a lifetime but involve monthly payments.

## The nature and gross value of transactions and their complexity.

Establishing and deciding when to draw a pension involves decisions about how much to contribute, for how long, when to start, when to retire and then in what form to take a pension. The sums are large and may be some customers’ largest asset (perhaps rivalled by their house). A mortgage decision can be of similar complexity.

## The breadth of range of expected net values of customers to suppliers.

This relates to the distribution between high or low positive or negative values. Value is defined by the difference between the sums paid by customers to suppliers and those paid out by suppliers to customers or to those liable to receive payments because of the customers’ actions (e.g. road traffic accident victims). There may be an estimated future value component, as most financial relationships last some time and many consist of a mix of positive and negative cash flows. In banking, this covers both debt and credit products. For insurance and debt products (e.g. credit cards or loans), the range of expected net values includes a small proportion of highly negative values, caused by fraud, genuine inability to pay or insurance claims. However, the proportion of negative values can be very great, for example, if a pattern of fraud is widespread and poorly managed, or if insurance is mis-sold and fines are levied by regulatory authorities.

For savings and investment products, the value to the supplier is usually positive, but failure of a bank or poor performance or even collapse in investment values can make the outcome for the customer far worse than expected. This applies to pension products, with an additional source of variability due to longevity. A customer who lives long past their expected death creates high negative value from the point of view of the supplier but not the customer – compensated for by customers dying before their expected death. Most normal variations in outcomes are handled by suppliers by assessing the risks of groups of customers and deciding whether or not to accept them. However, severe negative variations are caused by bad customer behaviour, which is where suppliers’ attention is focused, including trying to avoid accepting customers likely to be of high negative value, detecting when customers try to extract high value, or passing on that information to other suppliers to prevent customers re-offending.

# The need for greater awareness amongst marketers of dark-side customer behaviour

In 2015, one of the authors chaired a conference on insurance analytics. Part of the conference was split into two, one group focusing on the bright side – customer value, the other group on the dark side – fraud. The conference was impressed by a presentation from a former fraudster turned consultant, now advising insurance companies on preventing fraud. He made very clear the unending nature of the technological and managerial battle between fraudsters and FS companies.

At the conference, a common complaint of those responsible for handling the dark side of customers was that those responsible for managing the bright side did not take fully take into account the dark side, which the speaker had described so well, when designing customer management strategies, products, processes and systems. This was mainly because bright side managers were not aware of vulnerabilities they created by focusing on fast, simple service. This led to a reaction in the form of a tendency to treat all customers with problems (e.g. complaints, claims) as if they might be from the dark side, creating a dark side to the company’s own behaviour. This in turn made customers regard companies as “fair game” because customers experienced or had heard of examples of this dark side company behaviour.

Many conference attendees suggested that bright side managers should be more aware of dark side behaviour by both companies and customers and factor its prevention into their work. One reason for writing this article is to increase that awareness. In some respects, it builds upon the behavioural economics work of writers such as Ariely (2013), who have shown that most customers are likely to be mildly dishonest.

# Objectives of this article

This article explores:

* The importance that FS companies attach to assessing expected positive and negative value attaching to existing and prospective customers
* The problems that FS companies face in managing customers of negative value
* The impact of developments in information and communications technology on the above
* How the concept of information asymmetry applies to relationships between companies and customers.

# The basic CRM framework of managing customer value

The conceptual framework that most companies in FS work with to recruit, retain and develop their customers is one where a database of customers and prospects is segmented by various characteristics, including current and expected future value. This framework has been articulated fully in Stone & Foss (2002). The area of negative value has also been explored by Stone (Stone 1999a, 1999b, Stone et al 2000). A recent book has broadened the literature in this area (Nguyen et al, 2015). However, the impact of information and communications technology on this is relatively unexplored. That is the purpose of this article, which covers the following points

* Developments in ICT that affect relationships between FS companies and their customers
* The concept of information asymmetry as it applies to these relationships, and how information asymmetry can change under the impact of these developments
* The history of the FS industry in dealing with good and bad customers
* The increasing role of analytics in helping companies identify good and bad customers
* The emerging ecosystem of digital marketing in FS and its impact
* The role of third parties and affiliates
* Strategic learning for FS companies

# The impact of developments in information and communications technology (ICT)

ICT developments have made it easier for customers to choose suppliers and products more easily and quickly, to enter their own data and to make mistakes (which they will, often quite serious ones) (Stone 2012). These developments allow interactions and relationships between suppliers and customers to be established and consummated more quickly and conveniently (any time, any place) and analysed by suppliers more comprehensively and much faster. In turn, this allows suppliers to optimise their pricing, targeting, distribution channels and communications. It also facilitates identification of valuable customers for retention and development, but also of less valuable or loss-making customers, who might then be constrained as to what they can buy or how much they can use a product, or even have their product cancelled or relationship terminated.

Estimates of the seriousness of the problem and the impact of ICT on facilitating and preventing bad behaviour vary. Most of the “bad customer” cases dealt with by financial institutions are not classified formally as fraud, although financial institutions are the main victims of the large fraud cases which reach courts (KPMG, 2016). Certainly, where defences against “bad customers” are concerned, the focus is on the high volume of low level attempts by customers to get more value from suppliers, against the terms of their contract, as Ariely (2013) suggests. There are no public statistics for the amount of such behaviour encouraged or prevented by information technology and data analysis, though financial institutions would have to be remarkably stupid to invest as much as they do in fraud prevention if they did not believe it was a risk. Most large financial institutions do know the benefits of their vigilance, from the results of tests of deployment of particular methods to prevent abuse, but these statistics are private. The important statistic is of course the number of incidents prevented, not the number that get through” the defences. Put simply, it is is the loss prevented which is important, not the loss that actually results.

# The need for speed, better customer service and trust

The competitive battle between suppliers has focused partly on speed e.g. of approval of loans or insurance policies. This puts real pressure on them to marshal all their data to make quick decisions. Many companies now offer instant decisions on credit or insurance (“near-real-time”). This creates a requirement for analytics to be executed very quickly on the rapidly growing volume of data from an increasing number of sources (with social media being the latest addition).

Both types of customer (good and bad) expect better levels of service, not just in the initial interaction, but also to problem management. Suppliers want to avoid public criticism about failures in their processes and certainly do not want their attempts to prevent bad behaviour to compromise their main business, which is to serve good customers well. Hence the finding that banks that publicise to customers what they do to prevent fraud can improve customer relationships (Hoffman and Birnbrich, 2012). Suppliers also aim to avoid what is known as "double jeopardy", where the customer is initially treated badly and then the recovery process also goes wrong (Stone 2011). The desire to avoid double jeopardy can lead to bad customers getting very good treatment, but when it goes wrong, the opposite can be the result.

Behind some problems customers face in dealing with large suppliers is decline in trust. For both customer and supplier, trust is important. Most of the academic literature on trust in financial services focuses on the creation and maintenance of trust, and on changes in the level of trust (Devlin et al., 2016), but there has far been less focus on the relationship between the emergence of distrust and issues of fraud and negative value – one of the foci of this article.

The Edelman Trust Barometer (2013) shows the speed of the decline in trust of leaders (business or government). Only 18 % expect business leaders to tell the truth, while only 13% expect it from government officials. Interestingly, people trust institutions more than their leaders, with around 50% trusting businesses in general, implying that they trust a business’s workers to do what is right by them. Banks and FS are the least trusted sectors. This is caused by poor performance and by perception of unethical behaviour. Most respondents see the causes of financial scandals as corruption, corporate culture, or poor leadership. This can make customers feel that they have the right to misbehave in dealing with companies.

One important source on the size and impact of decline in trust is the Centre for Risk, Banking and Financial Services Trust Index. It is not surprising that the evidence from the Index, shows the serious impact of the events of the economic events of 2007-8 (Ennew et al., 2011). What is clear from much of the work on trust cited above is the enormous variation in levels of trust by consumers of different types of financial institution e.g. higher trust of brokers/advisors, lower trust of larger companies, and also the lack of clear correlation between levels of consumer trust and good behaviour on the part of financial instittions. In fact, there is evidence that lack of trust may result from consumers’ own lack of discipline or poor knowledge of financial matters (Estelami, 2015), particularly where it relates to estimation of risks laziness in information search.

# Other trends

It is becoming much easier for both suppliers and customers to identify the good, the bad and the ugly on "the other side" and on "their own side". Suppliers can identify customers likely to be of high or rising value and focus their marketing efforts on them. However, they can also spot delinquent or fraudulent customers more easily, or predict who may fall into this category. Customers can benchmark suppliers for the attractiveness of their propositions, products, terms and customer service more easily, using review or aggregator sites and social media (Robertshaw 2011 & 2012, Gamper 2012, Laffey & Gandy 2009). However, full comparison is not always easy, due to the variety of terms and conditions used by suppliers. Customers may be unsure whether they can trust what they see on screen, perhaps even actively distrusting it because of the role of advertising (in the case of comparison sites) or because of the unknown nature of those recommending. Or there may be a more fundamental problem associated with lack of trust in services provided on the web or in the usability of web interfaces, particularly as mobile handset technology and network service quality aspire to support increasing mobile access (Yang and Forney, 2013) The greater market transparency created by the web has led to acute pricing pressure, making it more necessary for companies to identify much more precisely and quickly those amongst their customers who are likely to lead to high claims, bad debt or excessive customer service costs.

The rise of more advanced measurement techniques allows suppliers to identify which members of their staff are treating customers well and which not so well, while social media analysis allows suppliers to find out more quickly what customers are experiencing (good or bad). Voice analytics allows the same in contact centres, helping suppliers identify where service can be improved, what needs customers articulate the most, and where they need help with more or clearer information, but also where a customer is likely to be fraudulent. However, relentless pressure from regulators (and commentators, analysts and customers) to "treat customers fairly" may mean that "bad" customers receive better treatment than they "deserve", resulting in greater supplier exposure.

Both sides can learn much more quickly. Suppliers can use advanced analytical techniques not only to identify individual "bad customers" and to identify who is likely to turn bad, but can also identify patterns of badness, which allows them to avoid accepting customers who look likely to be or turn bad. Similarly, bad customers can learn from other bad customers which companies are likely to accept their risks (or their toned-down version of risk) and which might treat them well when they turn bad financially e.g. go into unauthorised debt, make a false or expanded claim. This leads to adverse selection, in which bad customers target companies with weak defences. Also, customers who are seriously bad e.g. fraudsters, can contact each other more quickly to organise and execute fraud.

# FS is not an island

Many of the points in this article apply to the areas where the customer’s personal finances are not the main focus, but merely an indicator of goodness or badness in other areas e.g.

* Tax avoidance (anything from massive tax fraud to the avoidance of tax on small payments e.g. a small business run from home, rental income from a property)
* Money-laundering
* Proceeds of illegal sales (drugs, stolen items such as art and cars)
* Immigration law avoidance (by the customer or their agent)
* Funding for terrorism.

Behind these factors lies a slightly more sinister question - the Ariely (2013) question – how many customers are honest? Research on academic fraud (Stone & Starkey 2011) shows that at the start of their adult lives, around 40-50% of the population are exposed to institutions (namely universities) where appearances are deceptive and where students learn to manipulate the system to survive and do well. Informal evidence from those responsible for managing situations in which customers have a one-way bet suggest that between 25-50% of customers would lie if they saw the chance of making a gain without being caught[[[2]](#endnote-2)]. This is compounded by the general unwillingness of law enforcement officials to make lying to make a financial gain a criminal offence. This means that the cases taken to civil court are mostly large ones, where the wronged company has a chance of covering its costs and recouping some of its losses. However, the increasing use of information exchanges (hosting data about customers for sharing between suppliers) means that customer caught lying are likely not only to suffer financial loss, but also to be blacklisted.

One issue that has been raised concerning the academic treatment of the topics covered by this article is whether discussions of all aspects of financial services marketing has been biased towards banking and away from the area where many of the issues of fraud and bad customer behaviour or most critical, general insurance. Robson (2016) argues that the acedmic literature has been biased towards banking. This is in contrast to the issue of fraud itself, where journals such as Journal of Financial Crime cover much relevant ground. One of the few academic articles to properly research propensity to commit and attitudes to fraud in general insurance is that of Ishida et al (2015). This research highlights differences in attitudesto and tolerance of fraud between different age groups.

# The battle for information symmetry and asymmetry

The result of all the above is a battle to create information asymmetry or regain symmetry. Customers and suppliers try to create an information imbalance that gives them an advantage. Bad customers try to gain an advantage over companies and (sometimes) their fellow citizens. Companies try to gain an advantage over customers and over other companies that might unknowingly accept more bad customers. If companies do not co-operate, the risk is greater, as bad customers exploit companies that are poorer at detecting and/or managing their particular kind of risk, which suppliers might not have identified before accepting them as customers. Hence the importance of credit and insurance information exchange -a form of creating information symmetry between competitors.

Therefore, FS companies have become adept at sharing data and using public data (such as electoral roll-based socio-demographic economic profiling systems, to which credit data is often appended).

One of the best examples of shared databases in the UK is the Claims Underwriting Exchange (CUE), a central database of motor, home and personal injury/industrial illness incidents reported to insurance companies (they may or may not give rise to a claim). It is managed by a not-for-profit company, Insurance Database Services Ltd, using the services of the credit referencing company Experian, on behalf of its 99 members, who include all 60 major insurers, 30 other authorised members - mostly large self-insurers like local authorities, passenger carriers and transport companies, and 9 Associate members. It was established in 1994 to help keep down premiums for honest policyholders by preventing multiple claims fraud and the misrepresentation of claims histories. 32 million claims records are available to subscribers. Insurers also have access to the UK Government’s Driver and Vehicle Licensing Agency database.

A 2013 innovation in the UK is the No Claims Discount centralised database of records of individual’s ‘no claims discounts’, allowing insurance companies to validate a ‘no claims’ history declared by individuals during quotation, underwriting and claims processes, thereby minimising risk and providing a better service for customers. For good customers, it avoids the need to submit written proof of no claims history, reducing policy delays and improving customers’ application experience. It picks up the lies of bad customers. Plans exist to add customer identification, to validate who is applying, by creating a database of policy holders and applicants. These developments have helped redress what insurers saw as information asymmetry in customers’ favour. Once only customers knew that they were lying, but now insurers also do - immediately.

Such databases have implications in other domains. Credit risk is correlated with insurance risk - the leopard does not change his spots! One company that appended credit risk to its insurance file reduced its claims ratio by nearly 50% in both household and motor insurance.

Suppose customers believe they are a better risk than a particular supplier allows. This may be because they believe that they have more accurate information on their own level of risk, or because they believe that the supplier’s method of assessing risk does not apply properly to them (also a version of information asymmetry as it is the use of an incorrect methodology to interpret information). Such customers may try to give the additional information to the supplier or get the supplier to change the risk assessment model applied to them to the "right" model - in both cases trying to reduce information asymmetry. However, the supplier does not know whether these customers really are lower risk, or whether they are higher risk customers posing as lower risk customers (a common tactic - "honestly, would I really do something like that?"). The supplier should try to estimate whether the additional information or the suggestion of change in methodology is appropriate or a deliberate attempt to gain a further information advantage. However, in direct or digital markets with tight margins, the costs of human intervention in exceptions is high, so most suppliers prefer to stick to their own information and risk assessment methodologies.

# The expanding data set

The data set used by FS suppliers is expanding, with new items and sources of data appearing constantly and complexity and depth of data increasing. Social media data has proved valuable for managing value or risk. As digital interactions shift from computers to mobile telephones, the depth and complexity of data increases. Further, the mobile provides better information on networks of friends (and accomplices!). Meanwhile, marketing automation - a version of workflow management for marketing - improves a company's ability for insight to be integrated into marketing processes.

Most new sources can lead to information asymmetry and opportunities for "bad" companies and customers to exploit it to their advantage. Each new item or source of data is a challenge for suppliers, who must also assess whether it is an opportunity to gain competitive advantage, or one to be shared to the advantage of all suppliers.

# FS companies’ history of dealing with good and bad customers

The use of database and analytics in helping FS companies control the risk of bad customers and exchange more value with good customers has its roots in mail order and credit-referencing. Amongst the first players with big customer databases were charge card companies, with companies like American Express and Diners Club playing a similar role to that of mail order companies such as Sears and Readers Digest. Mail order suppliers sold significant amounts on credit.

A significant development was the credit card, usually but not always from bank offshoots. A complex value chain evolved, including card issuers (such as Barclaycard or any bank or other organisation that issues cards to customers) and acquirers e.g. Visa, Mastercard (who acquire the debt and present it to issuers). The end-customer database work is done by both, as the acquirers also maintain data on individual credit card holders. Both are exposed to bad debt, so a key use of the customer database is to identify likely fraudsters and prevent them getting cards, or to stop their cards (or of course stolen cards). The operational database of these companies (showing transaction patterns) is their first line of defence. They use sophisticated scoring algorithms to identify likely problematic customers

The liberalisation of banking sector in many countries is attracting new players who want to win customers from incumbents. One way to do this is to identify customers poorly served by incumbents, because they were being sold the wrong products or paying too much for them. However, new players do not want to attract “bad customers”, so they rely on data from third parties, often companies with roots in credit referencing, for data on “good prospects” - creditworthy individuals with reasonable incomes and net worth.

Today most banks have sophisticated customer databases and analytics, showing which customers are or will be profitable (often only 20-30% of customers at any one time, perhaps only 30-40% ever profitable), how customers respond to promotions, what happens to their enquiries, how long they keep products which have a fixed term and so on. The most advanced banks also have this at household level

# The role of analytics

The term “analytics” when applied to customer databases means processing customer data to find individuals or groups of customers who either definitely have particular attributes or may have particular attributes, based on their similarity in other respects to other customers. Analytics uses advanced software based on classic (e.g. regression, analysis of variance, cluster analysis) and modern (e.g. neural networks) statistical techniques, usually incorporating visualisation software to enable busy managers to get to grips with the complexities of their customer base (find out where the money is coming from/going to!), by giving them “customer insight”, which involves combining data, analytics, research and database marketing (especially testing) to produce a deeper understanding of customer than could be gained without converging these sources of evidence. A new category of managers – insight managers – has merged, along with new categories of software/services (e.g. specialised analytics agencies).

# Going digital

Digital data increases the volume of data on the customer database. Generally, customers who engage digitally buy more, particularly if they can buy digitally (Sorenson and Adkins, 2014). Some FS businesses are 100% digital, or nearly so. Most FS companies have seen a massive shift to digital interaction. It is not only better for customers, but lower cost. Many companies now only use telephone as a back-up.

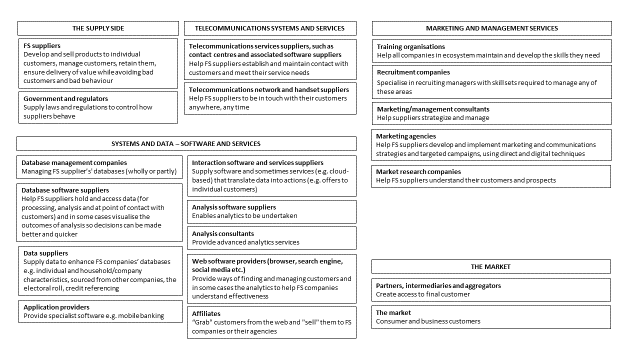
Today, banks and insurers have similar requirements of databases and analytics. They have very large customer databases (in the millions or even tens of millions of customers). Their aim is to help customers get better and more comprehensive value, while ensuring that their companies get good value from customers, by managing their customers cost-effectively, primarily through use of digital/low-cost channels. They also want to retain their customers by stopping them moving to competitors, particularly by anticipating their needs and ensuring that these needs are met before competitors can win the customer away. Finally, they need to identify the risk of fraud/bad debt and other “bad” behaviours, which in turn allows them to identify potential negative value prospects so that they are not recruited.

# The emergence of the digital FS ecosystem

We are seeing the emergence of a digital FS marketing ecosystem, but the evolution is complicated by the convergence of the marketing ecosystem with the ICT ecosystem, which is itself evolving rapidly. For example, in payment systems, digital marketing companies like Amazon are competing with digital payment companies like PayPal and Squared, conventional payment companies (like the members of the Mastercard and Visa consortia) and telecommunications companies with mobile payment options. Meanwhile digital marketing is taking over from conventional marketing, digital payment is taking over from cash, while web and cloud based IT are taking over from physical servers and installed software.

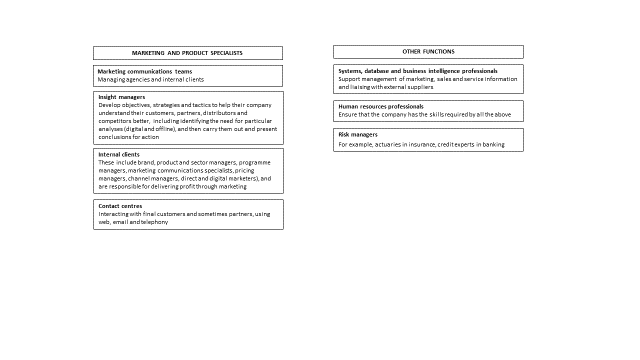
The evolution of the FS marketing ecosystem is allowing suppliers to understand and reach their target markets faster, more accurately and more cost-effectively, facilitating customer retention and development while paradoxically also making it much easier for new entrants to attack incumbents' customers and for bad customers to commit fraud. The main characteristics of this development are firstly, further moves away from face to face (in selling and service) to remote/direct marketing, first via call/contact centres, then Web/digital, secondly more acute competition, requiring companies to become much more skilled at marketing (e.g. in telecommunications, FS, travel. logistics, utilities), and finally the evolution of marketing technologies and processes (customer databases, analytics, contact centres, digital) to allow FS companies to use marketing more actively.

This new FS marketing ecosystem now includes (at least) all of the players in Figure 1:



**Figure 1 The digital marketing ecosystem**

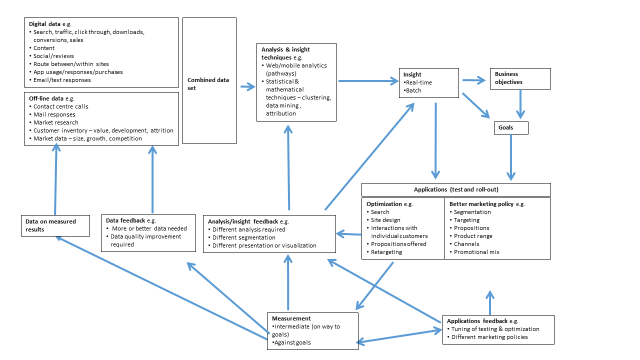
To match this "external" ecosystem, an "internal ecosystem" has developed inside large FS suppliers, merging (in principle at least) the capabilities of different departments, some of which that used to work quite separately. They include those shown in Figure 2.



**Figure 2: The internal ecosystem**

The ability of a supplier to manage the balance between good and bad customers depends increasingly on the contribution of other members of the ecosystem e.g. data suppliers, data hosters and business partners (Stone & Condron 2003). Data hosters are very important, as they may provide the means of sharing data between companies e.g. to identify mutual customers who may be bad for one but not yet bad for another. Unwillingness to share data can create problems.

Figure 3 summarises the data flows that the different parties work on.



**Figure 3: Data flows**

# The role of third parties

So far, we have discussed the relationship between customers and those suppliers who bear the risk (so rarely agents, who are commissioned for volume but do not bear the risk) as if they were the only ones at risk if severe information asymmetry (or some other factor) leads to exposure to the supplier's capital. In the crash of 2007 onwards, opaqueness of risk in customer investments was catastrophic, when assurances of credit-worthiness were taken at face value.

Some governments have implemented tough policies on who should get credit and at what rates e.g. for mortgages, minimum deposits (relative to income or equity), meaning that suppliers may no longer accept certain customers, but also increase the incentive of customers who do not qualify to "fake" qualification by exaggerating income or hiding liabilities. In insurance, the role of guardian of who should be insured is taken by reinsurers. They do not intervene in the detail, but do advise insurers on the systems and procedures that they should follow if they are to have their risks reinsured. For example, many risks are geographic. In order to reinsure an insurer against earthquake or flood risk, the reinsurer must be confident of the accuracy of the geographical data of the insurer (e.g. quality of build, location relative to earthquake or flood zones, to coastlines at risk from tsunamis) and may require access to it in order to process it to identify extreme risks.

# Partnerships

While more complex products (higher value life insurance, pensions) are often sold by financial advisors, other intermediaries (increasingly web-based) are now selling them. In property and casualty insurance, many policies are sold via the comparison sites or aggregators, though some companies believe that this leads to such commoditisation and price erosion that they have either withdrawn their brands wholly or partly from these channels, or have exited categories of insurance (such as motor insurance) where these channels dominate. Intermediaries in these channels have little interest in helping insurance companies manage bad and fraudulent companies. They are only interested in the volume that drives their profit.

Other channels, such as insurance brokers, retailers, general banks and mortgage banks do have an interest in helping insurance companies manage the bad customer better. However, there is still a tendency, particularly amongst retailers, to squeeze the insurance manufacturer on price and focus on the volume from which the channels derive their commission. However, as mentioned previously, some of the customer data owned by the channel partners could help the insurers avoid bad customers better and identify fraudulent claims more accurately. Also, as the insurance is often sold as part of a relationship with the customer and the partner wants to keep the relationship good (it may correlate with loyalty), the partner does have an interest in ensuring that it does not provide too many bad customers to the insurer. If co-operation can be established with some partners, so reducing the claims ratio on their "books" of customers, then partners who do not co-operate will be targeted by bad and fraudulent customers (the well-established principle of adverse selection), something that these partners may not want.

On the partner side, the team responsible for setting up and managing the relationship with the insurer may not have access to their own company's data sets, so may not be able to provide access to it for the insurer. In some cases, partners evoke data protection laws inappropriately, while in others they do not want to create extra work for their colleagues in the departments managing the data. Indeed, the latter may have no incentive to help them because they are required to focus on the company's own branded products. In some cases, the partner's approach to the relationship with the insurance supplier is so tactical that the partner does not even want to contemplate joint strategizing to build a viable book of profitable customers.

So, although the insurer may find these partner channels cost effective at generating volumes of business (because the insurers rely on the partners' good access to their large customer bases), the lower marketing cost is counterbalanced by a higher claims ratio. However, some partners have customer bases with lower propensities to claim or commit fraud. Whatever the situation, it is clear that the optimum outcome is full sharing of data at all stages, from customer recruitment to claims management (Stone & Mason 2000), as this is the only way to compete with direct insurers, whose big competitive advantage is their ability to develop insight from their integrated customer data (Stone et al 1997)

Additional issues relate to how to measure the quality of the relationship with partners and how to use these measures to manage the relationship. The team of supplier and partner can be successful or not, and this is determined as much by human relationships and trust as by hard technical factors and data.

# A new threat - fraudulent affiliates

Affiliate marketing is a form of performance-based marketing. In it, an affiliate is rewarded by a company for each visitor or customer brought by the affiliate's marketing. The parties involved in this form of marketing are as follows:

* The customer who buys or enquires
* The client company
* The network, that manages the arrangement, including providing a listing of the offers for affiliates to use and paying the affiliate
* The affiliate, who publishes the offer to customers

The central idea is that affiliates, by specialising in being very targeted and fast at identifying customers, where they are, which channel they appear in and what they want, can beat the client company at its own marketing game, so providing a more cost-effective channel. Affiliate programmes are widely used by companies, including (in insurance) those that refuse to use comparison sites - they are only seen as problematic when the leads they provide do less well in converting to sales than promised or than the commission paid implies, or when they commit fraud, as we shall see.

Affiliate management has become so complicated (and popular[[[3]](#endnote-3)]) that affiliate management agencies have emerged, as have super-affiliates and specialized third party vendors, who sell affiliate services. Affiliates use various marketing methods, including advertising (on and offline), search engine optimisation, pay per click, and publishing product and service reviews. Rogue affiliates have emerged, using techniques to inflate leads. Affiliates are paid directly when a sale can be validated on the insurer's management information system. These affiliates are often "one man bands" with their own blogs or websites. However, affiliates have been using real customer names and addresses to purchase policies, even though these customers are unaware that they “bought” a policy until a policy pack arrives in the post. The insurer cancels the policy when the customer calls. By this time, the fee may already have been paid to the affiliate. The policies are usually purchased on direct debit. The insurance company tries to take a payment that is refused by the bank and the policy is then cancelled. This process takes several weeks and the affiliate may have already received a fee. Stronger affiliate validation is needed to counter this, but this can mean that affiliates providing valid leads have to wait longer to receive their money.

# Barriers to improving the fight against fraud

As if the challenges described above were not enough, three further forces make things more difficult for suppliers (and sometimes for customers)

Firstly, advancing data protection legislation (for example, the EU’s new General Data Protection Regulation) creates increased transparency of suppliers’ data collection and storage processes and increased pressure on suppliers to dispose of data. This benefits customers because their data will be better and more confidentially managed, but may also benefit "bad" customers because it enhances their “right to be forgotten”, and may allow themselves to return to commit their previous bad behaviour because their records have been wiped.

Secondly human rights-related legislation or regulation is preventing suppliers discriminating between customers on the grounds of real "objective" differences in the level of risk e.g. on gender or exclusion grounds. For example, women generally live longer and drive more safely. Where life insurance is concerned, therefore, they would normally get better terms for on life insurance policies but worse terms for annuities. In some countries, recency of inward migration is associated with higher levels of fraud. Suppliers might want to discriminate in recruiting customers, or in dealing with customers after recruitment, but this might become illegal, even if it is highly probable as far as the supplier is concerned that a customer is likely to commit fraud. Disallowing discrimination threatens profit margin, and can make suppliers more anxious to develop what might seem to be customer-unfriendly policies in order to prevent fraud or other kinds of bad behaviour.

Finally, a rising level of cybercrime attacks (made easier by increased uses of digital devices in accessing finances and in paying) may create rising fraudulent leakage of value from the system, in some cases, making things very difficult for "good" customers, as well as for suppliers (e.g. identity theft).

# Some examples from insurance

Let us look at some examples of rising fraud from the worlds of insurance and credit.

## Geographical

There are particular patterns of risk associated with geography (e.g. flood from rivers and sea, risk from land use). Analysis of fraud shows a serious problem with claims expansion. For example, houses are demonstrably flooded, but some owners of flooded property have been filmed retrieving furniture from rubbish dumps and claiming that it was damaged by the flood.

## Cash for crash

A new breed of criminal has arrived, specialising in “crash for cash”. They find ways of forcing other cars to crash into them e.g. by pulling in front of them on freeways and braking sharply, by moving off at junctions and then braking sharply while the eyes of the driver of the car behind are focused on cars. They insure multiple cars at different addresses and often under different names, making it hard (but not impossible) to track them down. They also recruit other drivers. These are just a special case of a fraud network, who are increasingly identifiable by their mobile calling patterns and what they say on social media. It is this behaviour that has led to much closer co-operation between FS companies and law enforcement authorities.

## Usage/behaviour

Pay as/how/when you drive is now an option, with sensors fitted to cars. bBd driving is associated with certain lifestyles, hence the high accident rates among young drivers at weekends, particularly in the early hours of the morning. The evening rush hour is also bad, for different reasons (density of traffic, tired drivers keen to get home). Urban main roads in rush hours are the worst for accidents because of relatively high speeds and very dense traffic.

# Strategic learning

FS companies are learning how to strategize for all the above, but are still struggling with integrating classic data sets with the new digital data sets, which give them additional indications of goodness and badness. Those companies that manage to do this are identifying increasing number of ways to make more profit out of good customers by managing them better, and that makes them more robust in the face of risk from bad customers

# New research directions

The literature in this area is moving in two ways. Some researchers are focusing on "the real behaviour" of customers. We have already mentioned the behavioural studies of authors such as Chater (2010) and Ariely (2013). The dark side is now being explored by authors such as Farashah and Estelami (2014). The potential for social media to add value in retail bank relationships has also recently been researched (Murray et al 2014). However, to the authors’ knowledge, this article is the first to explore the interface between the three areas of behavioural finance, negative value/fraud and ICT. More research is needed to demonstrate where the leading edge is how it is developing.

# Further research required

The areas which require further investigation are these:

* How FS companies and security authorities can co-operate more closely to protect companies from fraud and ensure that honest customers get better treatment because resources are released from managing "bad" customers
* Organisational requirements for improving internal co-operation between those responsible for managing the dark side (underwriters, claims managers, credit assessors) and those managing the bright side (marketing and sales)
* Database and systems implications of the above
* How social media data can be used to track and predict fraud
* The business and legal requirements of data sharing to minimise fraud

# Conclusions

The increased competition for customers and the erosion of profit margins led to information asymmetry, particularly between insurance and credit companies and bad customers, in which the latter could become bad without suffering legal or other consequences in industries. This asymmetry is being redressed by shared databases, by use of many new sources of data, by much more rapid and accurate data analysis and forecasting (allowing FS companies to predict fraud much more easily), and by closer cooperation with law enforcement authorities. As the consequences of much higher levels of internal migration in the EU become clearer, governments will need to ensure that they do not handicap insurers and credit companies in their attempts to identify and deter bad customers. This is because there are clear benefits from this in terms of fighting crime. At the same time, they will need to ensure that the new capabilities of FS companies are not abused and that they observe the provisions of the various data protection laws.

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1. The bill for fines levied on banks for mis-selling Payment Protection Insurance on loans in the UK was estimated at £25 billion by July 2015. See http://www.theguardian.com/business/2015/jul/31/ppi-bill-rises-again-at-lloyds, accessed on 30th December 2015 [↑](#endnote-ref-1)
2. In informal discussions between one of the authors and the UK’s Department of Work and Pensions in 2004, it was suggested by a senior civil servant that around 50% of benefit claims where a case had to be proved (e.g. excluding benefits as of right such as old age pensions) were wholly or partly (i.e. through claim expansion) fraudulent. Research carried out by a leading insurer indicated that around a quarter of claimants had ever exaggerated an insurance claim, and the proportion prepared to admit this in a survey was only slightly less. [↑](#endnote-ref-2)
3. For more on this, and in particular to see sites recommending becoming an insurance affiliate, simply Google "insurance affiliate programme" or similar and you will end up on a site like this: <http://www.affiliatetips.com/insurance-affiliate-program.html>. For more on this and the general issue of application fraud, see https://www.abi.org.uk/News/News-releases/2014/09/Motor-insurance-application-fraud-backfiring-on-motorists [↑](#endnote-ref-3)