The main reasons banks will lose clients to competitors in 2021

Financial institutions (FIs) are rightfully concerned about PAR, productivity, growth and various other factors that impact their long-term viability. An additional metric is routinely ignored despite being of critical importance: client desertion. In all other business segments, whether service providers, retail sales or manufacturing, it is hard to think of a business that does not actively seek to retain clients and secure repeat business. It is a mystery why client desertion is so rarely discussed at FIs. There is no industry-standard means to even measure it. Without active measurement of client desertion, it is impossible to understand and control.

Client desertion is complex and its impact is often indirect. FIs implicitly assume that it is *exogenous*, i.e. that it is beyond their control. This paper will challenge that view by exploring the causes of desertion, its impact, and means to control it.

Why do clients leave an FI?

From the perspective of the FI there are two categories of desertion: voluntary and involuntary. **Voluntary desertion** refers to clients who would like to obtain another loan but the **bank chooses** to not extend one. This might be because the client defaulted on the previous loan; their business has deteriorated or undergone some sort of change that renders them ineligible for a loan; the FI has changed focus away from this target client group; or the bank is low on liquidity and choses not to lend to this client. There are other reasons, but the key point is that the bank does not wish to lend to this client, for whatever reason. This is not the problematic client desertion that threatens an FI.

Involuntary desertion occurs when the bank would like to extend a loan to a client (i.e. the client qualifies for another loan), but the **client chooses** to not take a loan. There are two broad categories:

- **Competitors:** the client can obtain a similar loan elsewhere at a cheaper price; or a superior loan product that better meets their needs; or can obtain better service quality from a competitor. The key point is that the client wishes to obtain another loan but chooses to do so at another FI.
- **No need for a loan:** the client may simply no longer need a loan from any FI. This could be due to their business doing sufficiently well to be able to grow organically, or so badly that a loan would only worsen the situation. Perhaps the client wishes to rest, suffers an illness or finds paid employment and no longer wishes to operate the business. The client stops borrowing from the FI, but there is little that the FI can do about it other than wish the client well and perhaps offer them alternative services (insurance/savings etc).

The focus of this paper will be **involuntary** desertion to **competitors**. This is the only segment of desertion that should be of concern to an FI: clients who want another loan, qualify for another loan, but choose to go elsewhere to obtain another loan.

		Type of desertion	
		Voluntary	**Involuntary**
Desertin g client wants a	**Yes** (but form competitor)	Bank does not wish to lend to client. Neither problematic nor included in desertion metric.	Bank would like to lend to client but client choses to borrow elsewhere. This is problematic desertion.
	No	Irrelevant, client does not want a loan, not included in desertion metric	

The impact of client desertion

The impact spreads in waves, with initial ripples causing secondary and tertiary problems. It is precisely because these secondary and tertiary problems cannot be immediately linked to the underlying cause that they are often ignored or tolerated as inevitable.

The first impact is that portfolio growth slows, stops, or begins to shrink. There are only two ways to reverse this: increase **loan sizes** to remaining clients or attempt to **replace** deserting clients. Most FIs attempt both. Increasing loan sizes is not necessarily problematic if this does not increase **risk**, cause **over-indebtedness**, or contradict the underlying **mission** of the FI. So-called *mission-drift* is often associated with FIs that initially target poor clients, but gradually increase loan sizes until they serve a different, richer segment. Increasing average loan sizes may improve productivity (fewer clients for any given portfolio size). The danger of this strategy is that the bank relies on it indefinitely and while it may not be problematic initially, it eventually becomes problematic, by which point it is hard to reverse.

The more obvious solution is to replace departing clients. This incurs multiple problems, both direct/immediate, and delayed/subversive problems that are hard to monitor. This is the most complex area of client desertion.

New clients are more expensive to serve than existing clients. There are **client acquisition costs** involved in the due diligence, house visits, credit bureau checks etc. This places additional pressure on loan officers – it is more work for them and reduces their productivity. A loan officer might be able to process five repeat loans in the time it takes to process one new loan. This will increase pressure on the staff while reducing any performance-related pay (incentive plans etc). One immediate result of client desertion is thus **loan officer desertion**, which inflicts a direct cost on the FI (replacing loan officers is time consuming and expensive), and also tends to result in increased PAR amongst the clients of departing loan officers.

Loans to new clients tend to not only be more time-consuming, but are for smaller loan amounts, i.e. **reducing the interest income** per client. New clients are generally riskier than existing clients. In almost every FI on earth the **PAR** by loan cycle follows a downward trend, and this is common sense – the relationship is new and the bank has less information about the client. This combination is dangerous: higher client acquisition costs, reduced gross income and higher PAR. The elevated PAR of new clients incurs not only direct provisioning/write-off costs, but additional staff time spent on loan collection, legal costs etc. New clients are rarely profitable for a bank.

Increased operating expenses due to client desertion and reduced gross income will deteriorate the **net profitability** of the bank. Not only will this irritate the shareholders and worry commercial lenders, but it will limit the FIs ability to pay salaries. Client desertion is already likely to have reduced any performance-related pay to loan officers, but the secondary effect of reduced profitability of the FI will further limit the FIs ability to pay competitive salaries and risks further **loan officer desertion**. Loan officer desertion is both a primary and secondary effect of client desertion.

Reduced profitability also means there is less funding available for additional services, to maintain pleasant offices, to invest in infrastructure. FIs often compensate for reduced profitability by cutting "non-essential" staff, which might not jeopardize day-to-day operations but reduces service quality. They may reduce marketing expenses, stall growth plans or reduce training costs – all such measures will have unquantifiable secondary impacts on the broader **service quality** of the FI. And reduced service quality will result in one guaranteed outcome: **further client desertion**.

The ultimate danger of client desertion is that it creates an invisible vicious circle: desertion leads to more desertion. There are many reasons why profitability may decline, why staff may become disillusioned, or why operating costs might increase. It is hard to demonstrate that these are a direct consequence of client desertion while other factors also contribute, and the impact of desertion may be a secondary or tertiary effect. Thus the problem may be allowed to fester, to permeate, to become accepted as an unavoidable outcome that the FI simply has to live with. It may be compared to a disease: invisible from the outside but slowly spreading around the body, and yet with no immediate symptom that can be uniquely linked to the underlying disease.

How to control desertion?

Fortunately, there are some simple steps an FI can take to tackle this insidious problem.

1. If desertion is not **measured** it cannot be controlled. Be careful to only measure involuntary desertion to competitors. A deserting client must possess three characteristics: the client **wishes** to obtain another loan, **qualifies** for such a loan at the FI, but choses to go to a **different** FI. If any of these criteria are not met, ignore the client in a desertion metric.
2. **Analyse** desertion statistics. Do they vary between branches? Are certain loan products more likely to result in desertion? Is desertion more common amongst clients in certain business segments? Is desertion more common in regions also served by a specific competitor? Analysing desertion can reveal other underlying problems that are the root causes of desertion. If desertion is linked to a specific loan product, product-misspecification is the problem to tackle. If it is only in one branch, might the branch manager be problematic? If desertion is high amongst specific business segments, might a more suitable loan product be required?
3. **Perform exit interviews:** ask deserting clients a single question: why are you leaving? There are not that many possible answers – health, business problems, no need for a loan, cheaper or better loan elsewhere etc. Capture and analyse the responses. It takes one minute per client to obtain this information, and the feedback is some of the most useful market research imaginable for the FI. But this information must circulate throughout the entire organisation, from the most junior loan officer to all branch managers, the senior management team and the board. What better statistic can address the core question of "why are we failing?" than the desertion reasons of successful clients voluntarily leaving the institution to a competitor?
4. Consider including client desertion as a **target** for branch managers and incorporating into an **incentive plan**. Incentive plans typically incentivize loan quality and portfolio size, but why not also client desertion?

Summary

Client desertion is monitored by most industries worldwide, and yet FIs, particularly in developing countries, largely ignore this metric to their peril. It is so fundamental to the well-being of any institution, it is not hard to measure, and it can provide insights of incredible value to the FI. The negative implications of high client desertion circulate throughout the entire institution, often in dangerous vicious circles, and damaging not only net profit but the reputation and core mission of the FI. Obsessive monitoring of PAR and portfolio growth is pointless if client desertion is not also considered – eliminate the reasons for client desertion and PAR will improve and growth will resume, on a lower cost base resulting in higher profitability. It is not a mere statistic, it is a vital key performance indicator (KPI).

Client desertion is often accompanied by loan officer desertion. When both clients and staff voluntarily abandon an institution, surely this is cause for alarm? But the corollary of this is positively reinforcing: banks that monitor client desertion closely and address the root cause will benefit from all possible angles: reduced dependency on new, riskier clients; larger loan sizes due to the maturity of clients rather than mission-drift; reduced operating costs and higher productivity; reduced PAR; lower staff turnover; greater profit; superior reputation in the market; better relationship with commercial lenders; and a greater chance of accomplishing the mission statement.

Consider the final, grossly simplified example of different loan cycles of an FI.

	Cycle			Note
	1	**2**	**3+**	*High acquisition cost for new clients, low loan renewal cost*
Operating costs	-$50	-$10	-$10	
PAR/provisions/write-off	-$20	-$10	-$5	*PAR declines with maturity*
Gross Income	$30	$40	$50	*Larger loan sizes*
Total	**-$40**	**$20**	**$35**	*Higher profit at later cycles*
Accumulative	**-$40**	**-$20**	**$15**	

New clients are loss-making for the bank due to the higher acquisition costs, increased risk and lower gross income. By the second cycle the client generates a net profit of $20 due to the reduced costs of a loan renewal, reduced risk and slightly higher gross income from a larger loan. By the third cycle this increases further, to $35, as PAR declines slightly and income increases slightly. However, the key take-away is the final line – the accumulative profit to the bank. Although clients in their second cycle generate a net profit for the bank, this is not enough to compensate for the loss of the new clients. The total profit of clients in the first two cycles is still negative ($20). It is only when the even more profitable clients in the third cycle and beyond are included that the bank generates a net profit. Obviously the higher the proportion of clients in cycles 3+ (and thus the lower the proportion of clients in the first two cycles) the more profitable will be the bank. Indeed, for FIs that actively manage client retention, perhaps the single most important statistic to monitor is the (weighted) average loan cycle – in which cycle is the typical client? Maximising this single statistic is perhaps one of the wisest strategies a bank can pursue.