

# PRACTICAL STEPS

*to Address the Crisis in Retail Banking*

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Following basic measures to cope with the revenue drought, retail bankers face the steeper challenge of transforming their franchises to compete in a changed market. Cost control will remain a top priority, but extreme branch closures are not the answer for an industry that still needs to retain customers and prepare for future growth.

Facing a continued revenue drought in 2012, retail bankers are feeling the heat for massive cost reduction. Across the U.S., about 16,000 branches are underwater, and an equal or greater number are barely getting by; one third of the branch system is in trouble.

In lieu of draconian action, how will the retail franchise be fixed? It is a complicated question that may involve repositioning many lines of business that are dependent on the branch. In the beginning, players focused on immediate coping tactics such as obvious branch closings, fee re-pricing and staff reductions. There is no silver bullet, as even profound

cost cuts cannot provide a complete answer. Branch banking executives will inescapably face the challenge of transforming their banks to compete in a changed market.

In fact, it is practically impossible to predict exactly what the new industry configuration will eventually look like, given the shifting sands of external factors. However, executives still can take a series of practical steps to address the crisis, beginning with a crisp set of revenue and cost tactics and extending to strategies for transformational change in coming years. Such focus is essential if organizations are to avoid paralysis during the protracted market slump.

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On the revenue side, the first thing to do is to capture as much of the relationship wallet as possible – long an objective of retail bankers. Specifically, the most valuable and immediate opportunity is to expand the credit side of the retail customer relationship, which monolines historically have scooped away from all but the largest banks. It is time for banks to finally master the art of selling loans to deposit customers, in particular, revolving and installment credit and to a lesser extent, home equity.

The other revenue priority is to re-think fees at a much more fundamental level. Banks have reacted in haste following the setbacks with debit interchange and checking overdraft fee revenues, mostly by trying to lift various charges for current services. Across the industry, there appears to be mostly knee-jerk reactions, with little explicit rationale that customers could count on. Having done the first round, it is time to step back and think more innovatively about overall fee strategy, both for current and new services, that reflects the brand position and customer promise of the bank.

Competition in a tight market is sure to limit the amount of new revenue a bank will be able to generate to cover the cost of the branch network. While banks cannot avoid the inevitable cutbacks, branch network expense must be reduced in a way that minimizes the impact on long term growth. The options include additional closing of the “no regrets” branches and reducing staffing and overhead within branches in which such tactics have not been fully deployed.

From the Novantas viewpoint, the more progressive opportunity is the proactive management of demand — incenting more retail banking customers to perform their own service delivery. Along with promotion, education and training, this entails deploying online banking-like capabilities in each of the bank’s points of contact, particularly in the branches and call centers. Failing these, it may be time for banks to consider market spinoffs and targeted branch sales.

The objectives of these tactics are to increase the revenues from the current customer base and to lower the cost of providing local market presence. The ultimate target is improving the efficiency ratio of the business by as much as 20%–30%. These tactics will provide a major step in that direction but may not close the performance gap.

At the next level of performance improvement, banks need to experiment with new distribution approaches to

embrace the new economics. For example, almost 25% of customers who open accounts in branches subsequently conduct the majority of their business online or at the ATM. These customers often fall off the marketing radar screen because they do not appear in the branch lobbies.

Novantas has found that a modified “direct-to-consumer” approach is needed to realize the value of these network-originated but undeveloped relationships. In such an approach, channels such as phone and online should no longer be considered “alternate.” Meanwhile, banks need to get started on new network formats (small footprint outlets, enhanced ATM networks, etc.) that will provide local market presence at much lower cost. Such evolutions in distribution will reshape the way branch banking will be done.

#### **NEAR TERM REVENUE PLAYS**

A top priority for 2012 is rebuilding retail lending and fee revenue streams. In lending, winning banks will distinguish themselves by gaining market share, principally through targeted cross-sell to the deposit customer base. Winners will also optimize their lending activities through precision pricing. In fee-based activities, banks should lay the groundwork for innovative new services that can unlock future revenue streams, and fee strategies that will encourage the customer migration to online self-service.

**Credit.** Product cross-sell is an old concept that has taken on new urgency. In selling retail credit to deposit customers, home equity loans and lines of credit still offer superior returns relative to most other options. However, campaigns will need to be tailored to select customer groups, given the great variations seen in household debt capacity and local housing market conditions. Most of the opportunity resides with affluent households situated in more stable local markets.

Enhanced capabilities are needed to unlock these possibilities. In particular, banks need to leverage the treasure trove of information they have on their DDA households, which can be used to predict credit performance, product usage and price elasticity of demand. Novantas has found that banks must upgrade both the analytical marketing and pricing of these products to close the performance gap. In so doing, substantial near-term revenue improvements are possible. Leaders in this area will be able to gain strong competitive advantages.

Revolving credit can be a daunting challenge as the best practices have already been highly developed by monolines. In general, banks should not try to replicate monolines; rather they need to modify their approaches to recognize the fundamental advantages they have over national players, namely their deposit relationships with their customers and their local presence.

**Product Innovation.** There is an opportunity for innovation by reconceptualizing the deposit product as a “cash management” offering that incorporates components of revolving credit. By blending revolving credit with deposits and payments, banks can provide profitable new arrangements to help meet customers’ short term revolving needs.

**Pricing.** In marketing and pricing, banks will enhance consumer lending initiatives to align with borrowers’ profiles; intended purposes for using credit; and accompanying price elasticity of demand. In a growth-starved environment, the tendency is to price aggressively across the board for the sake of volume growth. Along with eroding risk-adjusted returns, this overlooks many opportunities for segment-based pricing initiatives that can realize similar levels of growth at higher spreads.

In home equity lending, there is a large group of credit-worthy customers who don’t have time for price-shopping and just want convenient access to a rainy-day line of credit. In other cases, segment-focused rate offers can attract many substantial new borrowers, materially improving profit — by more than 20% in one case study — without disturbing underwriting standards.

**Fee Strategy.** Turning to retail fee revenues, much of the industry’s response to the collapse of checking overdraft and debit interchange revenue has been a scattershot re-pricing of various exception fees and monthly services, mostly based on the premise of “inelastic demand,” or customer tolerance out of a desire for continuity. It is time for a more systematic approach that refines current practices and also sets the stage for new innovations and strategies that will support emerging goals in a changed market.



For various customer groups, a central question on fees is what kind of “currency” would they like to proffer — express or implied — in exchange for checking and payment services. Some customers, for example, will accept a minimal monthly fee that includes incremental charges above a monthly transaction threshold. Others prefer “free” services that are conditioned on checking balances or the total banking relationship. Still others prefer “free” services that are conditioned on the substitute usage of ATM and online channels for transactions.

With exception fees, our research shows continuing customer demand for some form of checking overdraft coverage. There are opportunities for proactive arrangements including

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standby credit; transfers from other accounts upon notification and approval; protection that limits potential charges in exchange for a monthly fee (i.e. insurance) that provide value for customers and revenues for the bank in a positive context.

We also see possibilities to extend “concierge” propositions into fee-based payments services. This includes, for example, expedited services for important transactions, or various kinds of informational services that help with special situations and/or overall household cash management.

Providing such offerings will entail a development cycle that includes customer and competitive research, product innovation and testing, staff orientation and field marketing. Particularly among regional banks, we have not seen the level of developmental effort that is needed in these changing circumstances. Building new fee revenue streams must be one of the highest priorities over the next few years.

#### **NETWORK RENEWAL AND COST RATIONALIZATION**

Despite potential new revenues, branch networks are vastly overgrown relative to the foreseeable revenue opportunity. The role of the branch is also changing as customers move more of their everyday banking activities to alternative channels such as ATMs, online banking, call centers and mobile devices. This introduces a dual challenge: reducing costs decisively while also repositioning networks for future competition in an increasingly multi-channel market.

Nationally, Novantas research indicates that about 16,000 branches, or about 18% of the U.S. total, are in failing financial condition. First and foremost, banks should be exploring ways to minimize closures “at total loss.”

The good news is that about two-thirds of the impaired branches — roughly 11,000 in all — could be of value if placed under stronger management and situated in stronger local networks. Major possibilities include in-market mergers; local network spinoffs as part of market exits; and selective sale of individual branches to other players in local markets.

All of the options depend on a clear understanding of local market opportunity and the role of network presence in winning customer patronage. Even as the customer online migration continues, area branch networks still perform best when they provide adequate density of coverage. This “density factor” is the key to branch consolidation and divestment

options that create value by helping acquirers to optimize customer share of market. It also is a guidepost in making decisions about individual branch closures.

Finally, within almost all networks there are clear candidates for “No Regrets” closures of branches that may never meet the parent company’s hurdle rate. These could include marginal branches in low opportunity markets and isolated branches in good markets. Possible closures could also extend to de novo units opened as part of the recent real estate boom in branching, which according to current forecasts of deposit growth and customer profitability, will never achieve breakeven.

Where some banks will go wrong, however, is in sweeping network cuts that only consider individual branch profits. Our national research continues to show material performance benefits for branches that operate within solid local networks, which offer more convenience for customers and carry more brand impact. This local market perspective will be needed to make sound decisions about necessary branch cuts.

A key question is how to maintain adequate density of local market coverage at much lower cost. Many customers still select their bank on the basis of local network presence and branch adjacency to home and work. Yet there is a need for a migratory path in branch location and design, that enables outlets to capitalize on the sales opportunity in dense markets and also make greater use of technology substitutes, lessening the need for manual transaction services. In many markets, there are customers with high-value needs, but simply not in sufficient quantity to justify an elaborate physical branch presence.

A complication is the accelerating customer migration away from the branch and into direct channels. Novantas research shows that roughly 25% of U.S. retail customers have already drifted away from local branches for day-to-day banking.

A leaner version of the traditional branch network will not keep pace with the growing ranks of “virtual domiciled” customers. Instead, future industry leaders will need a transformed distribution and sales network, one that is much more firmly guided by the multi-channel usage patterns of major customer groups. A growing portion of the retail customer base and revenue stream will hinge on success in this area.

To balance multi-channel development with branch cost control, there are three waves of activity that regional banks should pursue, each with a significant cost and revenue component:

- Most immediately, there is a strong need to develop cross-sell strategies for virtual-domiciled customers. This growing customer portfolio is not formally “owned” by any part of the organization today, and revenue is being left on the table. On the cost side, hopeless branches (i.e., lacking growth prospects or eroded by transaction trends) should be closed. Others will need much leaner staffing.
- The intermediate stage enhances, accelerates and capitalizes on the current customer migration trend. A major goal is promoting customer self-service to offload greater chunks of branch transaction volume, permitting further staffing efficiencies. Strategies will be needed to acquire more virtual-domiciled customers and serve them more fully.
- Longer term, new distribution models will come into view. Networks will be more efficiently adapted to local markets; branch formats will be modernized and tightened. Cross-channel sales and service will become a much firmer reality.

In contrast with this progression, some banks are clinging to troubled branches and local networks while actually curtailing investment in online and mobile banking, awaiting some distant revival of interest rate margins and loan demand. This type of hunkering down, in our view, simply locks in a competitive handicap that will only grow with time. Banks in this situation ultimately will feel the greatest pressure to sell.

### TRANSFORMING SERVICE & SALES

Ultimately, retail branch banking is defined by service and sales transactions. But currently there is an imbalance in the staffing and technology configuration needed to assure service and sales productivity in future markets.

Fewer tellers will be needed to support manual branch transactions, and major improvements in platform staff sales performance will be needed if banks are to sustain revenue momentum as they tighten network headcount. Meanwhile,

technological facilitation of customer interactions must be further strengthened and promoted to encourage fuller customer usage of direct channels as “true and complete substitutes” for former branch activities.

**Staffing.** One implication is a need for radical restructuring of branch staffing. With branch transactions declining at a rate of 4% to 5% per year, it won’t be long before networks are 20%+ over-staffed. Novantas sees many opportunities to close this gap, including re-structuring of roles (e.g. more universal bankers); lowering minimum staffing requirements (through changes in administrative and security policies); replacing manual transactions with in-branch self-service; and more precisely allocating staff resources, i.e. part time staff, based on local demand.

However, as every banker knows, it is not always easy to reduce staff in small branches. Where staffing levels reach irreducible minimums at particular branches, banks are considering adding non-branch responsibilities to branch staff, e.g. helping out with customer inquiries routed through the call center (which can permit immediate reductions in call center resources).

Lastly, banks are now realizing the long-talked-about alignment of sales staff with local market potential. Rigorous allocation of sales resources and market based goal setting are becoming the norm. To further leverage branch sales capacity, some banks are adopting centralized systems for making phone-based appointments.

**Sales Productivity.** Aggressive staff contraction reintroduces an age-old problem: creating equal or greater branch sales volume with a smaller team. Staff sales productivity already was declining prior to the recession as customers began transacting an increasingly substantial amount of business online. In fact, as measured by weekly sales per full-time staffer, average branch sales productivity has declined by a third since 2003, according to our research.

While staff cuts may lower expenses, much of the benefit will be lost unless the remaining branch staff can sell at sustained higher levels. There are four mechanisms for banks to reverse the current sales productivity trends, including: 1) superior flexibility in resource allocation and goal setting; 2) recasting branch managers as sales leaders instead of

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backfield coaches; 3) improving service-to-sales conversion programs; and 4) eliminating internal channel competition in favor of collaboration between the branch, contact center and online channels.

**Flexibility.** There are several dimensions of flexibility in the formula for improving sales productivity. In regional staff deployment, our research repeatedly shows dramatic skews in local market opportunity. By segmenting various types of markets (i.e. urban vs. rural) within the branch network, banks can re-direct staff talent from less promising areas to markets where the bank can grow faster than the competition.

Inside the branch, flexibility is equally as important. There are huge untapped opportunities to cross-train staff so that they can flow among multiple assignments during the workday. The “universal staffing” concept is already in use at supermarket branches and in select traditional networks, but is currently under-utilized nationally.

Banks should consider using cross-trained, universal staffing at most locations having six or fewer full-time equivalent staff positions. There are also opportunities to provide more advisory and product expertise “just in time,” for example through the use of roving specialists, appointment-based service from central teams, and greater use of video technology.

**Managers as Sales Leaders.** Both in terms of skill and customer rapport, branch managers typically have high sales potential, yet many are often severely distracted from that role. There is a widespread perception that managers should largely function as coaches for sales staff, but our research shows that branch sales productivity is sharply higher when managers are directly involved in selling themselves.

In a recent multi-bank study, we found that among top-performing branch sales teams, managers spent an average of twice as much time on individual and direct selling than the bank with average branch sales productivity.

**Service to Sales.** One of the great ongoing challenges in branch sales is converting customer traffic for service into completed sales. Some banks do a far better job than others in preparing and equipping branch staff for peak sales performance.

On average, banks convert walk-in customers only at the rate of a decently performing mail campaign (roughly 18 sales per every 1,000 customers). There is much room for improvement in this area. Better information on customer

traffic and potential is needed, for example, as well as creative programs for handling lobby traffic.

The service-to-sales challenge is further compounded by skewed performance incentives that often emphasize administrative goals. Our research shows that top-selling branch managers have well-defined sales goals, including units and revenues, more strongly linked with overall branch targets for revenue and profit generation. Managers also respond well to specific cross-sell targets.

**Channel Coordination.** Our research indicates that online and contact center channels likely will continue to grow rapidly relative to branch sales, yet most customers still prefer an “in-the-branch” sales experience. This calls for a coordinated

channel proposition seldom seen in retail banking. Often individual channels (branches, contact center, online) function with a high degree of autonomy that borders on rivalry, with internal competition actually taking precedence over collaborative efforts to serve the customer more fully. As more customers come to expect “all channels all the time,” retail banks face a rising need for cross-channel coordination.

Prospecting and lead generation, are often better conducted through the contact center, where dedicated sales personnel have the right skills and tools; more experience; and typically a better temperament and more perseverance in dealing with low acceptance ratios. Meanwhile in the small business segment, contact centers and relationship bankers are finding new ways to jointly deepen current relationships and find new ones.

**Multi-Channel Strategy.** Any major bank that is serious about improving sales productivity will be actively targeting and testing new coordinated multi-channel sales strategies, especially given changing patterns of customer channel usage. It will also study customer behaviors, attitudes and profiles, particularly as they pertain to the growing base of virtual-domiciled customers.

Overall, we estimate that a quarter of the retail customer base is attitudinally receptive to the use of alternative channels as substitutes to the branch. Multi-channel strategists will make it a central mission to move this group into alternative channels and eliminate the corresponding costs their former branch service.

The question is whether this will simply be a talking point or a basis for sustained action. One of the largest U.S. banks

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has seized the initiative to guide an estimated 40% of check deposit activity away from the branch to the ATM, more than doubling this type of channel substitution seen elsewhere.

Customer self-service seems to be gaining new momentum in other service industries, for example in checkout lines in drug stores and grocery stores. The proposition is much more complicated in banking but it is not without possibilities.

As we have repeatedly stated, a new frontier in retail distribution is demand engineering, a proactive exercise that uses the customer standpoint to guide strategies for channel substitution and self-service transactions. The idea is to provide appealing technology bridges that provide recognized benefits to customers while lowering the cost to serve, supported by orientation, marketing and pricing arrangements that will more firmly cement customers in new transaction behaviors. The goal is to develop a suite of segment-targeted channel migration campaigns.

### **ORGANIZATIONAL ENABLERS**

Finally, banks are particularly in need of stronger customer guidance and market guidance as they broach the challenges of 2012 and beyond.

The virtual-domiciled customer segment, for example, should be carved out for special attention, much in the manner that banks already do with small businesses and mass affluent households. This change will provide a focus for marketing and sales, products and pricing, and infrastructure investment — without the disruptive effect of a wholesale reorganization of the bank.

Banks also need to get up to speed on customer behavioral analysis, based on multi-channel transaction patterns. To stay abreast of free-roaming customers and make accurate decisions, retail banks will need a detailed, trend-line understanding of how individuals and major customer groups are using various channels, linked with cost-to-serve and channel profitability metrics at the customer level.

Credit card companies have made a science out of anticipating emerging customer needs from transaction patterns and risk factors. But in retail banking, longitudinal data about customer transaction and payment behavior (at the branch, at the ATM, on the phone, online and on mobile devices) has routinely been ignored — or never even compiled at the customer level. Few banks can reconstruct customer behavioral histories longer than 12 months, for example, and many can only look back 90 days.

There is also a strong need for customer-informed pricing expertise in retail credit. Precision pricing, based on price elasticity of customer demand, will be critical in optimizing margins and balance formation in a climate of slack demand.

In network and staffing-related decisions, banks will need a stronger grasp of local market dynamics, including factors such as the shape and scope of customer demand and competitive presence. This is fundamental context in making decisions about mergers, spinoffs, targeted branch sales and branch closures. Context will be needed in exploring staffing possibilities and requirements, both sales and service.

While retail banks face a challenging 2012 overall, there still are systematic ways to address the major issues confronting the industry. Particularly for executive management, it is a time for clarity about specific options and priorities, and the organizational abilities that will be needed to follow through.

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