


 The title features the word "SLASH" in white, bold, sans-serif font, crossed out by a white diagonal slash, set against a red parallelogram background. To the right of this graphic is the word "OR" in a blue, sans-serif font. Below "OR" is the word "Transform" in a large, blue, cursive script font. At the bottom right of the title is the phrase "Retail Distribution?" in a red, sans-serif font.

SLASH OR Transform Retail Distribution?

BY KEVIN TRAVIS

Banks that under-invest in a multi-channel future do so at considerable risk. New strategies are needed to balance branch cost reduction with distribution innovation. Retail banks are facing a critical balancing act. On the one hand, revenue-starved players are scrambling to preserve and economize their expensive branch networks; on the other hand, competitors need to stay relevant with customers.

The branch cost cops are trouncing the distribution futurists when it comes to setting management priorities. This tendency is quite understandable at a time when retail banks are being slammed with an estimated \$40 billion revenue shortfall, driven by changed regulation and a changed economy.

Banks must now transition into a multi-channel future or risk being left behind. Novantas research shows that roughly a third of U.S. retail customers have already drifted away from the branch for their day-to-day banking activities (Fig 1). The numbers of these “virtual-domiciled” customers will

continue to grow as the banking center of gravity shifts to alternative channels such as online banking, automated teller machines, call centers and mobile devices.

A leaner version of the traditional branch network will not keep pace with this trend. 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 stages of activity that regional banks should pursue, each with a significant cost and revenue component:

- Most immediately, there is a pressing 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., those without any real growth prospects or eroded by transaction trends) should be closed, and others will need much leaner staffing.
- The intermediate stage focuses on customer channel migration: enhancing, accelerating and more strongly capitalizing on the trend. A major goal is promoting customer self-service to further offload large chunks of branch transaction volume, permitting greater staffing efficiencies. Strategies will be needed to acquire more virtual-domiciled customers and serve them with a wider range of non-branch services.
- Long term, new distribution models will come into view. Networks will be increasingly efficient in adapting 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 as time goes by. Banks in this situation ultimately will feel the greatest pressure to sell.

COMPETITIVE GAP

Certainly there is some notable multi-channel innovation among major U.S. regional banks, including online financial management tools; mobile phone and tablet applications; and time-savers such as remote deposit capture for consumers. Overall, however, the are being squeezed at both ends of the spectrum.

Capitalizing on the enormous resources at their disposal, the top four or five mega-banks have been honing their multi-channel strategies for years. One institution has successfully re-routed

40% of all deposit activity — a 50% improvement over the big-bank average for ATM substitution and more than double usage progress seen at some banks. Community banks, meanwhile, are well-versed in using outsourced expertise, and many have dived right into more advanced online and mobile applications provided by the scale-based vendors of banking solutions.

By contrast, many regional banks have stayed focused on their extensive physical branch networks, deploying alternative channels as a loose assemblage of network supplements, often independently managed. Falling behind in coordinated customer outreach and product and service innovation, these under-funded channels represent a mountain of work that in many cases should have started several years ago.

The distribution challenge extends even further. Although

Fig. 1: Customers Drift from Branches

A large and growing percentage of customers have a banking “center of gravity” in alternative distribution channels, using branches infrequently.

Bank	% Infrequent Branch Users	% Frequent Branch Users
"A"	43%	57%
"B"	41%	59%
"C"	40%	60%
"D"	37%	60%
"E"	37%	63%
"F"	35%	65%
"G"	32%	68%
"H"	32%	69%
"I"	30%	70%
"J"	30%	70%
"K"	28%	72%
"L"	27%	73%
"M"	27%	73%
"N"	21%	79%
"O"	18%	82%

Source: U.S. National Consumer Survey by Novantas, LLC.

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banks are rightfully concerned about cost reduction in their physical networks, even that domain is in need of transformation. One of the major questions is how to achieve the right level of local market presence with breakthrough efficiency.

Future networks will need to operate with perhaps a third less staff than what is typically seen today, using a variety of small-format outlets to provide local coverage at much lower cost. Dense urban markets will be configured much differently from what is seen in scattered suburbs, with the rural market outreach requiring greater refinement.

These transitions cannot be achieved through blunt-force cost control. Slashing (for example, the bottom 10% of underperforming branches) may only produce a tighter version of a network that continues to face obsolescence on multiple fronts, including shifts in customer demand and technology requirements.

The counter-argument, of course, is that a future market rebound certainly would ease a lot of this pain. The instinctive thought is that banks will ultimately be rewarded if they can just hang on until revenues return.

However, revenues are unlikely to return to anything approaching pre-crisis levels, certainly not in the near to intermediate term. For institutions that intend to be long-term survivors and acquirers, the hard work of transformation simply cannot be avoided.

Fortunately, the same trends that are creating the distribution challenge are also part of the solution for innovative banks. Rather than resisting the changes, banks can harness cost pressure, customer demand shifts and emerging technology to build a new model for the future — a transformed distribution and sales network that efficiently delivers service to customers where they are and when they want it, and at profit levels that meet hurdle requirements. This is the argument for a cohesive, multi-channel distribution strategy.

PRAGMATIC STEPS

In these strained times, practicality and pragmatism should take priority. Instead of trying to develop wholly new ways of organizing, banks should focus on what they can do using what they know now, and build the agenda from there.

First, banks know that some significant portion of the customer base is already largely detached from the branch. Our research indicates that in the U.S. as a whole, this is about

a third of the bankable population, with a general range of 25% to 40% among major institutions.

This virtual-domiciled segment should be carved out for special attention, much in the manner that banks already do with small businesses and mass affluent households. This 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.

Second, banks need to get up to speed on customer behavioral analysis, based on multi-channel transaction patterns. To stay abreast of free-ranging 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 studying transaction patterns to anticipate emerging customer needs and risk factors. But in retail banking, longitudinal data about customer behavior (at the branch and ATM, on the phone, online and on mobile devices) has routinely been ignored — or never even reviewed 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.

Third, with an accurate sense of customer value in each channel, the bank can pursue targeted channel migration campaigns. In many instances, it will be worthwhile to offer product and pricing incentives to encourage the use of alternative channels as a true substitute for branch-based services.

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In other cases, channel-defined arrangements can be steadily introduced into the account origination process, which offers its own possibilities for traction given the large annual account turnover seen in the banking industry.

After all other avenues are exhausted, fees can be introduced for unprofitable customers who want to continue to use expensive branch services. It goes without saying that this must be handled with great delicacy and almost never as the opening move. Overall, we estimate that up to a fourth of the retail customer base is attitudinally receptive to the use

of alternative channels as complete substitutes. Multi-channel strategists will make it a central mission to move this group into alternative channels and eliminate the corresponding costs of their former branch service.

Lastly, in conjunction with channel migration, the bank can begin to forecast and revise branch plans, from operational issues such as staffing and hours to strategic decisions about how many branches to build, close or radically transform. Once a clear set of customer channel behaviors is segmented and identified, those behaviors can be trended, forecast, and used to understand the network of today, in 2012, and beyond.

ONLINE SUPPLEMENT OR SUBSTITUTE?

Retail banking had a fairly stable run from the early '90s until 2007. Now, through a combination of economic change, customer demand shifts and regulatory pressure, the industry faces the most challenging set of problems in recent memory.

The central question revolves around the future direction of profitable customers. Novantas research indicates that most customers acquired after 2005 are actively using online banking, with mobile banking showing modest but steady enlistment as well.

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Previously this activity was seen as a supplement to the branch experience. But now more high-value transactions are entering into the alternative channel transaction mix — checking and savings account originations; applications for credit cards and installment loans; requests for financial advice as a prelude to investment decisions. High-value customers are part of this trend as well, including a segment of “ultra-connected” customers who are older but sophisticated in their use of all available banking channels.

The multi-channel revenue play remains murky at this moment but deserves serious attention. Banks have provided extensive channel alternatives for customers without figuring out how to sell effectively in that space.

The multi-channel cost play is becoming more definite. Our research, corroborated by other industry studies, shows

a pronounced tilt in the everyday banking patterns of retail customers, with transactions steadily being shifted out of the branch. Now there are substantial opportunities to monetize this trend by firmly cementing customers in alternative channels and eliminating corresponding branch overhead, most notably with staffing requirements.

These trends have a bearing on the physical network, not just overall capacity but future configuration. Branch networks represent 60% of the retail cost base and are in need of streamlining. Yet they also need to be repositioned for emerging multi-channel competition, with a lighter physical presence that is more firmly integrated with remote alternatives. The investment implication can be hard to swallow, but is undeniable.

Finding a way through the fog, using profitable customers as the guide, is the most likely way out. Figure out who matters, what they want and what they will pay for, and deliver it. Any legacy of the past that does not align with this imperative should be questioned. While there will be losers in the process, there will also be winners. The decisions that banks make today will help determine which group they are in tomorrow.

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