

Reconstructing the Retail Banking Business

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Retail Banks must transform their cost structures to deal with new revenue realities. Major institutions that do not address this issue head-on will be at a severe disadvantage in the constrained market that lies ahead, and increase their likelihood of being consolidated rather than consolidating others.

Retail banking is in crisis. After years of profitable growth, U.S. retail banking has seen the revenue engine sputter badly, and total industry profits are down more than 50% from the pre-crisis peak. It is now clear that revenues will not return to former levels, presenting a new “normal” to which retail banks must now adapt. A top priority for the industry now must be transformative cost reduction and productivity improvement.

Underscoring the enormity of the challenge, many retail banks will need to slash overhead by up to 15%, with much of the effort centered on the branch network. Major institutions that do not address this issue head-on will be at a severe disadvantage in the constrained market that lies ahead. As the likelihood of further merger-driven consolidation increases, leaders in productivity and cost control will see new opportunities for acquisitions, with many others relegated to take-over targets.

Going into next year, the revenue headwinds include

a \$25 billion shortfall in fee income stemming from new regulations; a \$50 billion margin shortfall as flat rates persist; and a constrained post-recession lending environment. Meanwhile, retail banks have not been able to right-size operating expenses fast enough. And in parallel the role of the physical branch is changing as more customers migrate online, creating a need for thoughtful restructuring to preserve strengths while dramatically lowering overhead.

While a rising rate environment and strengthening net interest margins could ease many of these pressures, hopes are fading for an early upturn. Instead, bankers are increasingly preparing for a sustained low-rate environment, trying to ensure profitability even if the economy suffers the risk of Japan’s “lost decade.”

The traditional playbook of cost reduction will not address this problem. Retail banks have already wrung out substantial industry overhead through merger-driven consolidation,



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aggressive outsourcing and technology standardization. Now a fundamental re-think of the business model is needed.

Preserving customer relationships and revenue momentum will be essential as banks work through transitions. As banks learned during some of the dramatic mergers of the late 1990s, heavy-handed cost takeouts (e.g. massive branch closures) can stampede valuable customers and employees alike, offsetting the benefits of consolidation.

Thus the mandate is for revenue-friendly cost reduction that transforms the business model in ways that are better for customers and cheaper for the bank.

RETAIL COST AGENDA

Two types of efforts are needed, one centering on customer interactions and the other on transforming distribution.

Customer interaction. While classic re-engineering approaches are based on a dispassionate analysis of processes, the frame of reference now needs to be expanded to more fully consider proactive possibilities that change customer behavior. With such “demand engineering,” there are

possibilities to profoundly change the way customers interact with their banks.

In particular, the account-opening process, routine deposit transactions, problem resolution, and loan underwriting are ripe for radical streamlining, with electronically-enabled self-service replacing manual transactions. This transformation will have both a demand-side and a supply-side component, with customers adopting new transaction arrangements and banks developing new routines to support them.

Transforming distribution. In U.S. retail banking, more than two-thirds of annual expenses go for branch facilities and staffing. This marks the prime intersection for restructuring and reinvention.

Novantas research suggests that we are at an inflection point in terms of customer transaction preferences. Routine transactions are steadily migrating out of the branch to online channels, at a roughly 4% to 5% annual pace that could accelerate. In turn, branches are left to handle high-value activities such as consultative sales. This introduces a transitional balancing act, with banks needing to preserve the

branch revenue stream while capturing major cost-saves as customers adopt other distribution channels.

Both in customer interaction and distribution transformation, there are opportunities for tangible performance improvement starting next year. Projects should be undertaken, however, within the context of a multi-year planning agenda centered on transformative change.

In many cases, retail banks have not yet fully quantified the financial performance challenge that they face. It is more of a crisis than some executives realize. Revenue initiatives, though needed, will not address the problem alone. Nor will simple belt-tightening, much of which already has been done. Instead, this is a time to rebuild the retail banking business.

CUSTOMER INTERACTION

One of the great opportunities in retail banking is guiding customers into new processes for everyday transactions such as opening accounts; check-cashing and depositing; resolving problems; and making consumer loans. The goal is to process such transactions more quickly and at lower cost, ideally with improved customer satisfaction.

The key is to identify opportunities to re-engineer demand, i.e. shift customer behaviors. One powerful and concrete example centers on deposit transactions, which typically consume up to half of the teller workload. Some of the largest U.S. banks have made remarkable progress in shifting almost half of routine deposit transactions away from the teller window. Alternative transaction conduits include next-generation ATMs, which take advantage of digital imaging technology and are easier to use for more complex transactions; and remote deposit capture, which allows customers to use desktop scanners and personal computers to make deposits via the Internet.

Such transitions are essential in the quest to cut the volume of everyday manual branch transactions, which currently account for roughly 80% of the daily activity in a typical teller line. Retail banks should endeavor to cut that figure in half over the next three to five years, keeping in mind that this can't be a dictated outcome — customers must see an advantage in electronic alternatives, learn the particulars of how to fulfill various transactions, and incorporate new arrangements into their banking routines.

The process of “re-engineering demand” starts with a careful study of customer transaction patterns across channels, which helps the bank to identify major groups such as check-only depositors and everyday small business cash depositors. This behavioral analysis provides critical guidance as banks consider how to match various customers with alternatives for electronic self-service, both within the branch and remotely.

Banks can then use product design, pricing, staff incentives, communication, and other levers to help shift demand and cement new customer behavior patterns. Examples include:

- Increased promotion of bank-at-work programs and technology that permits remote deposits for small businesses.
- Revised policies that provide expedited balance credit on ATM and remote deposits, placing funds immediacy on par with in-branch transactions.
- Significant promotion of online transaction alternatives, emphasizing on customers with high transaction intensity.

Feasibility is underscored by recent Novantas research, which suggests that many “branch-attached” customers feel quite comfortable with new air travel arrangements that allow them to book their own flights and print boarding passes online, and use dedicated terminals to check baggage at the airport. Other industries have found ways to incentivize behavior modification as well.

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In conjunction with these customer-facing changes, banks are also re-evaluating internal operational processes. As an example, we have seen many banks moving from dual control (which introduces redundant counting and verification steps) to sole control. Obviously this has implications for risk, but differences can typically be offset by staffing-related savings. Meanwhile, teller assist units that serve as mini-cash vaults can help to facilitate sole control and reduce cash handling.

Other examples include the elimination of unnecessary/redundant logs, forms and review procedures. And the process of customer identification, perhaps one of the most time-consuming aspects of transaction-handling, is ripe for improvement through process and technology changes.

TRANSFORMING DISTRIBUTION

All of the above will help reduce the claims on distribution (by customers and staff), but financial benefits are not actually realized until the bank is able to correspondingly reduce major expense categories, such as for facilities and staffing.



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The good news is that these changes can be made in the context of accelerating changes in customer preferences and behaviors. Retail banking is no longer tightly synonymous with branch banking. Novantas research suggests that routine, simple transactions (other than deposits) are steadily leaving the branches.

For example, 70% of consumers first go online when researching banking products and services, up from 42% five years ago. Meanwhile, the consumer preference to use the online channel to check deposit balances has jumped to 68% from 40%. And 60% of consumers primarily use the online channel when transferring funds, nearly double from five years ago. As a result of all of these factors, branch transactions are declining at a rate of 4% to 5% per year.

On the other hand, consumers still choose their bank based on ubiquity of nearby branches, and they still have a powerful branch orientation for high-value banking activities. Seventy-six percent of consumers view the branch as the primary place to open new accounts, for example, and 65% look there first when they buy banking products. Even among the heaviest users of alternative channels, there is a strong appetite for branch-delivered products and services.

This juxtaposition of consumer trends — online migration of routine transactions combined with ongoing branch strengths in attracting new banking customers and handling complex transactions — suggests that the current distribution system is wholly ill-suited for the new reality. Our vision of the future is for smaller, more thinly staffed branches that are still ubiquitous, combined with more advanced ATM, phone/mobile, and online capabilities for routine transactions.

Specifically, we see the following opportunities to transform retail distribution:

Radical restructuring of branch staffing. With branch transactions coming down at a rate of 4% to 5% per year, it won't be long before retail branch networks are 20% or more over-staffed. Novantas sees many opportunities to close this gap, including re-structuring of roles (e.g. more universal bankers); lowering minimum staffing requirements; replacing manual transactions with in-branch self-service; and more precisely allocating staff resources based on local demand.

Where staffing levels reach irreducible minimums at particular branches, banks are considering enlisting staff to help out with customer inquiries routed through the call center, permitting immediate reductions in call center resources.

Lastly, while banks have long talked about deploying sales staff in better alignment with local market potential, we see this strategy now taking hold across many organizations. Rigorous allocation of sales resources is becoming the norm. To further leverage branch sales capacity, some banks are moving to centralized systems for making phone-based appointments.

Network rationalization. The expense overhead of the physical branch network is out of line with the foreseeable revenue opportunity, although we have established that local network density remains as important as ever. Banks will need new strategies to maintain local market presence at lower costs.

Sweeping measures, such as shutting the bottom 10% of branches, will prove too blunt, given the risk of over-reducing local market presence. A better approach is to steadily introduce more efficient physical touch-points into the overall network mix, including small footprint branches, storefront-style ATM installations, and in-store branches and ATMs.

Online foothold to online foundation. Novantas research suggests that at a typical retail bank, people who are primarily oriented to direct channels (e.g. online banking) represent as much as 20% of the customer base, and they contribute a comparable proportion of branch franchise value. So-called “alternative channels” are no longer alternative, they are primary for a large and growing segment of the customer base.

In recognition of this trend, progressive banks are beginning to upgrade online/mobile functionality and blend channel features to serve the cyber crowd more fully and keep people firmly engaged with the overall bank. Examples include:

- Continued investment in mobile and online banking, moving from account information, to transaction capabilities, to integrated functionality that supports customer decision-making and transactions at the point of sale.
- Cross-channel integration, for example, so a customer could start an application on the iPad, work together with a call center or chat agent (working real-time on the same application), and then finalize a transaction in the branch (if desired).
- Using location services on smart phones to identify customers when they arrive at branches, and provide higher levels of service to higher value customers.
- Enabling customers to shape their branch experience before they arrive. One example is making a real-time appointment for advice via mobile phone, and then checking wait times in the teller line or drive-through before getting off the highway.

Some banks are going so far as to consider managing non-branch-oriented customer groups independently from the branches, with separate organizational reporting lines, budgets

and dedicated resources. Considering that for a typical bank, this customer segment can be the equivalent of one-fifth of the retail customer base, it justifies both significant management attention and significant investment to build capabilities.

PERFORMANCE EQUATION

To be sure, there are important revenue opportunities in retail banking for next year. Banks can and will re-price their checking and fee-based services in response to lagging deposit rates in a rising rate environment. And there is a continued strong opportunity to win market share by serving customers more fully, particularly in the cross-sale of consumer credit, which is still relatively unconsolidated.

But the fact is that these revenue opportunities will not offset extreme headwinds from the economy and new regulation. Costs must come down sharply — by as much as 15%, according to our analysis. Strategies to fundamentally re-engineer customer interactions and transform distribution will be at the center of this effort.

Fortunately, this crisis is coming at a time when many consumers seem ready to transform the way they interact with the bank, easing transitions away from manually-intensive service. The opportunity is there for banks to reduce costs materially while enhancing the customer experience and maintaining revenue momentum.

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