

NOVANTAS REVIEW

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RETAIL BANKING'S STEEPER CLIMB

As coping tactics run their course, retail banks must reposition for a challenging new market.

Risk and the Road Ahead:
What Bank Directors Need to Know

Slash or Transform
Retail Distribution?

Multi-channel M&A:
Where do Branches Fit?

Rescues Possible for
Zombie Branches?



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4 Practical Steps to Address the Crisis in Retail Banking

Retail bankers face the steep 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.

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

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To grow in a market that is only partially recovered, commercial bankers will need a set of focused initiatives that match strengths with select opportunities. As with other banking lines of business, much of the commercial opportunity for 2012 centers on gaining market share.

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Meeting 2012's Challenges Head On

Retail bankers face a profound challenge going into 2012, in that the revenue outlook simply is not sufficient to support the expanded branch systems that were built prior to the recession. This disconnect will become more fully evident on the bottom line this year as the forgiving trend of falling loan loss provisions winds down.

The traditional response in weak markets — tighten the belt and stay the course — will only be of partial use as the industry finds itself in new territory. Exhibit "A" is the profound consumer migration to online channels, which will force a re-think of retail distribution independent of the economy, new regulations, margins, et cetera.

As detailed in our cover story, "Practical Steps to Address the Crisis in Retail Banking," leading banks will respond to the challenge with crisp action plans, including immediate revenue and cost tactics and more visionary projects needed to transform the franchise. Even then, initiatives will only succeed if firmly grounded with markets and customers.

Steve Klinkerman

Steve Klinkerman
Editor-in-Chief

"Leading banks will respond to the challenge with crisp action plans, including immediate revenue and cost tactics and more visionary projects needed to transform the franchise."

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PRACTICAL STEPS

to Address the Crisis in Retail Banking

BY RICK SPITLER AND SHERIEF MELEIS

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.

“At the next level of performance improvement, banks need to experiment with new distribution approaches that embrace the new economics. For example, almost 25% of customers who open accounts in branches conduct the vast majority of their business online or at the ATM. ”

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

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

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

“Our research shows that top-selling branch managers, by contrast, 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.”

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

“Far fewer tellers will be needed to support manual branch transactions, for example, and major improvements in platform staff sales performance will be needed if banks are to sustain any kind of revenue momentum as they tighten network headcount.”

“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.”

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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The graphic features the word "SLASH" in white, bold, sans-serif capital letters, with a white diagonal slash through it, set against a red parallelogram background. To the right of this is the word "OR" in blue, sans-serif capital letters. Below "OR" is the word "Transform" in a large, blue, serif font, with the "T" being significantly larger than the other letters. To the right of "Transform" 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.

Slash or Transform Retail Distribution?

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.

“Convenience sells itself in many instances. With the right marketing and a bit of orientation, people often willingly adapt self-service technologies, as in the successful rollout of self-service booking and ticketing in the airline industry.”

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.

Convenience sells itself in many instances. With the right marketing and a bit of orientation, people often willingly adapt self-service technologies, as in the successful rollout of self-service booking and ticketing in the airline industry.

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.

“For institutions that intend to be long-term survivors and acquirers, the hard work of transformation simply cannot be avoided. The central question revolves around the future direction of profitable customers.”

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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Multi-channel M&A: **WHERE DO BRANCHES FIT?**

BY KEVIN TRAVIS

In-market acquirers typically rely on back office and branch combinations for savings to off-set takeover premiums. They also look for pricing power as they bulk up in local markets. In other cases, acquirers seek geographic market expansion.

These familiar merger concepts assume that branches are the core of franchise. But these former stars of the show are being relegated to more of a supportive role in retail banking. Novantas research suggests that up to a fourth of all supposed branch customers actually transact the majority of their

Familiar merger strategies are becoming obsolete as branch networks transition to a more supportive role in retail banking. As the retail banking revenue drought drags on, regional players face growing pressure for another round of merger-based consolidation. Based on a recent Novantas analysis of the U.S. branch system, roughly 16,000 outlets or 18% of the current total, will either need to be closed or reworked within the next three years in order to remain efficient. Traditional merger models will prove insufficient to meet this challenge. Beyond deal factors are critical issues of location, configuration, staffing and relationship building in alternative channels.

banking business through remote channels, including online, mobile, call centers and automated teller machines, and at least 20% are “thin network ready,” caring about branches but rarely using them.

This profound customer migration is accelerating, and has serious implications for merger strategy in 2012 and beyond. Banks will need to reconsider the entire branch decision chain — including what they are worth.

Traditional networks are in danger of becoming wasting

assets. It is not clear that acquirers and their investment bankers have factored this trend into valuation models.

Beyond deal factors are critical questions about repositioning branches for a very different future, including how location, configuration, staffing and relationship building through alternative channels. Acquirers will need a strong multi-channel vision for the merged entity, backed by appropriate developmental resources and an innovative sales and service culture.

From this multi-channel perspective, a regional merger could begin life with a serious competitive handicap if the predecessor companies had not already started transforming their networks. There still would be initial cost savings from capacity reduction, but the merged entity would be forced to spend heavily to catch up elsewhere, while facing an extended disadvantage in winning customers and building revenues.

There are three major steps that potential acquirers should take. The first is assessing the growing base of “virtual customers,” both in the current and target network. The second is identifying and aggressively addressing any competitive gaps in multi-channel capabilities. The third is incorporating these factors into decisions about the post-merger branch network.

CUSTOMER MIGRATION

Novantas research shows that in the realm of everyday banking transactions, the center of gravity is clearly shifting away from the physical branch. Consumers frequently roam between distribution channels to fulfill their banking needs.

Based on our national survey, for example, 70% of consumers first go online when researching banking products and services, up from 42% five years ago (Figure 1). The internet is now the favored channel for reviewing deposit balances among 68% of consumers, up from 40%. Consumers increasingly look beyond the branch for financial advice as well, with 35% of survey respondents saying they first turn to the online channel or to the call center.

When transferring funds, 60% of consumers primarily use the online channel, twice the rate of five years ago. Up from 19%, 26% now primarily use ATMs for depositing funds. Various flavors of online deposit also have gained popularity, with 15% of consumers now saying they prefer channels such as automated clearinghouse transactions, person-to-person payments, and remote deposit capture.

Consumers are also making greater use of mobile channels for basic banking services, such as account information and balance transfers, strengthening the tilt away from branch-delivered basics. More than a third of consumers now have smart phones.

These trends have significant implications for M&A, given that the physical branch has become an extremely thin tether for a large, growing and valuable portion of retail customers. As more relationships take on a virtual life, there is a growing risk of overpaying for physical capacity.

There is also the question of how to retain and grow virtual (i.e., non-branch) customer relationships under the disruptive conditions that accompany mergers. Bankers generally know about the relationship “stickiness” that comes with electronic services such as online banking and bill pay. What the industry is only beginning to think about, however, is the relationship “slipperiness” that builds when customers heavily embrace alternative delivery and begin to lose the branch frame of reference.

While switching costs and frictions don’t go away in the online space, they often are dramatically lowered. Also there are different provider choices (such as online banks and brokers) for virtual banking customers, and different decision factors about where to place accounts as well. This is a huge new aspect of merger strategy.

DEMAND ENGINEERING

While the branch will continue to play a powerful role in retail banking, the rules of the game have clearly changed. Along with a nearly \$40 billion gap in revenues created by regulatory and economic conditions, the U.S. branch system is experiencing annual declines in productivity for sales and transaction services.











Between 2003 and 2010, the average U.S. branch experienced a roughly one-third decline in the number of daily sales generated by each non-teller staff member, according to Novantas research. Meanwhile, branches overall are experiencing a 4% annual decline in teller transaction productivity. Over the next three to five years, a fourth to a third of full-time teller staff may become surplus to network requirements.

This problem cannot be cleanly solved by pulling the internal levers of branch cost reduction. Major customer-facing adaptations are needed as well. Specifically, banks must work to accelerate the pace of customer online migration so that technology-enabled channels become an ever-stronger substitute for physical branch transactions.

In the new era of “demand engineering,” there is a pressing need to consider trends in customer behavior and identify opportunities to change activity patterns, or “bend the cost curve” in the bank’s favor. The idea is to study specific categories of customer branch activity, including major types of customer transaction behaviors and the value associated with them, and then establish migratory paths that proactively guide customers into new arrangements.

Fig. 1: Customers Embrace Multi-channel Banking

Customers increasingly are turning to non-branch alternative channels for basic banking activities. High-value activities are migrating online as well.

Type of Activity	Primary Customer Emphasis	5-Yr Change
Research products: Online	70% 	↑ 28%
Check balance: Online	68% 	↑ 28%
Withdraw funds: ATM	65% 	↑ 13%
Transfer funds: Online	60% 	↑ 29%
Resolve issue: Phone	49% 	↑ 11%
Replace card: Phone	38% 	↑ 8%
Deposit funds: ATM	26% 	↑ 7%
Buy products: Online	22% 	↑ 9%
Get advice: Online	19% 	↑ 7%
Open account: Online	16% 	↑ 8%

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

In the best outcome, efficiency (and/or revenue) improves; customers are more satisfied; and job assignments are more valuable and rewarding for employees.

An example outside of banking is airline self-service, where customers routinely book their own flights, reserve seats, print their own boarding passes, and participate in baggage check-in. Not only have air passengers adapted to these changes relatively quickly, but most strongly prefer the new arrangements, which have given them more control over transactions and save time.

Another example is NIKE's "customize" program, which allows online shoppers to tweak the designs of shoes, garments and sports gear. Such "co-production" enables customers to produce tailored outcomes by interacting directly with the provider's systems, strengthening ties between customers and organizations.

So how does this apply to branch banking? Consider the burden of manual deposit-taking and check-cashing, which accounts for roughly 80% of the daily activity in a typical teller line. We believe that retail banks should strive to convert at least 50% of that manual activity to customer self-service 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 journey starts with a customer-based transaction segmentation, which helps the bank analyze key groups such as

check-only depositors and everyday small business cash depositors. This research provides key guidance in matching customers with new technologies for branch self-service.

Banks will need specific campaigns to deploy and promote self-service alternatives. Examples include: 1) promotion of bank-at-work programs and technology that permits remote deposit capture for small businesses; 2) revised policies that provide immediate balance credit on remote deposits, placing funds immediacy on par with in-branch transactions; and 3) significant promotion of online transaction alternatives, with emphasis on customers with high transaction intensity. Such customer-facing initiatives are critical in permitting banks to decisively lower the branch operating burden.

RE-MAPPING THE NETWORK

Ongoing trends in customer channel migration also have major implication for the shape of the physical network, not only today but in every year hereafter. As more sales and service transactions shift online, merger partners need to understand the implications for network configuration. Branches still have an important role to play, but there is a clear need for new strategies to maintain local market presence at much lower cost.

Sweeping measures, such as simply shutting the bottom 10% of branches, will prove too blunt, risking gutting 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 — all of which reduce the overhead for staffing and facilities.

To guide such efforts, acquirers will need a detailed understanding of the combined franchise, ranging from regional variations to micro-markets. In our experience, banks are greatly in need of improved network diagnostics to precisely identify the market potential and customer requirements in each cluster of local branches within the overall network.

By framing the analysis around future revenue potential, acquirers can develop appropriate treatments for various parts of the network. Some areas may need to be carefully protected, even augmented. Others are definitely in need of stringent cost reduction in light of insufficient customer demand and/or tenuous competitive stance.

The network analysis should be supplemented with a thorough exploration of staffing possibilities. Improved product

cross-training enables the branch to maintain full service with a leaner staff. Also there are substantial opportunities for flexible staffing arrangements that lower the FTE burden while providing quality part-time employment. Hours of operation also can be artfully trimmed.

MULTI-CHANNEL PERSPECTIVE

While all of these branch-related issues are important, the larger questions revolve around the multi-channel vision and strategy for the merged institution. What is the competitive proposition for the customer?

So-called “alternative channels” are becoming primary channels for a large and growing segment of the customer base. In turn, 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 banking, moving from account information to transaction capabilities to integrated functionality that supports customer decision-making and transactions at the point of sale.
- Streamlined experience cross-channel integration, so a customer could start an application on the iPad, a call center or chat agent, or in the branch.
- Use of smart phone location services to tailor service for high-potential customers arriving at branches.
- New infrastructure that enables customers to shape their branch experience before they arrive. An example is making an appointment for advice via mobile phone, or checking wait times in the teller line.

Some banks are considering managing non-branch-oriented customer groups independently from the branches, with separate reporting lines, budgets and dedicated resources.

It will be important for these teams to keep sight of potential revenue-enhancing offerings and the customers who might actually use them. Otherwise, scarce resources could be wasted on features and functionality that ultimately do not improve customer acquisition, retention or profitability.

An example of this balancing act is mobile banking, where there is a tendency to design offers to suit the tastes of the Generation Y crowd, the leaders in smart phone adoption. As underscored by Novantas research, this approach can go wrong by ignoring the preferences of other customers who potentially could make more extensive and financially meaningful use of mobile banking.

We identified a select group of “ultra-connected” mobile customers who defy the Generation Y stereotype. Having a more affluent profile and spanning the age brackets, these customers are adept at all forms of consumer communications

technology. They are also far more willing to undertake complex financial services transactions via remote channels.

The Gen Y segment may be quite happy to seek guidance from “the cloud,” based on ratings, user comments and feedback from friends. But in providing and promoting this arrangement, for example through a social network link, the bank could be turning off the ultra-connected, a group that is hungry for more expert advice and would be much more trusting of a personal advisor at the bank.

The upshot is that acquirers will need to do far more homework on customers as they consider alternative channel applications and innovations, particularly products that are expensive to build and complex to manage.

FUTURE CUSTOMER BASE

As banks consider their merger options for 2012, there is a clear need to look beyond traditional branch-centric plays based on cost reduction and market expansion. Acquirers could merely wind up with a tighter rendition of yesterday’s obsolete network configuration.

Successful acquirers will be those that correctly value both the network and the customer base within it. When performing due diligence, for example, it is critical to understand how many of the target bank’s customers are de-linked from the network. For example, what percent of customers visit the branch less than 12 times a year, or once a month? Which branches and markets have the largest concentrations of such customers? What about future waves of virtual customers?

Acquirers should also diagnose the current and planned capabilities of the target’s online and mobile platforms. How far from “market parity” are these systems? How much investment will be needed to not only integrate the two franchises, but also to be competitive from a call center, online and mobile perspective?

Lastly, potential acquirers should understand the true economics of the physical branch network, netting out the revenues and expenses assigned to virtual customers. What is the cost-to-serve for the “branch-centric” customer segment? What is the rate of customer attrition in this segment? Is there really significant “customer gravity” in all the branches, or are some deteriorating faster than others? Such customer-informed navigation will provide critical guidance in repositioning the combined franchise for multi-channel competition.

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NIGHT OF THE ZOMBIE BRANCHES

Rescues Possible?

BY DAVE KAYTES AND KEVIN TRAVIS WITH BRANDON LARSON

The U.S. banking industry is facing a burning issue that may well determine the future of many institutions over the next few years. The problem is a huge overhang of “zombie branches” that were crippled during the recession and may never return to financial viability under current ownership.

Like the living dead, these failing units have all the appearance of a normal branch, but no pulse. Based on a recent Novantas analysis of the entire U.S. branch system, nearly 16,000 outlets, or about 18% of total branches, may need to close over the next three years. This poses a major additional burden for an industry that is already mired in a sluggish post-recession economy and restrictive new regulations.

One saving grace has been the trend of improving credit quality, which has put earnings reports on steroids as banks slashed loan-loss provisions. But the peak benefits of this trend will soon be exhausted, fully exposing the industry’s dismal revenue dynamics and the cost challenge of maintaining impaired branch capacity.

The situation clearly foretells an accelerating pace of branch closures over the next few years. Yet the situation is not hopeless for banks that can think innovatively about the full range of options for dealing with zombie branches.

Nationally, Novantas estimates that about two-thirds of the impaired branches — roughly 11,000 in all — may be of value under different ownership. Major possibilities include in-market mergers; the spin-off of local networks as part of market exits; and the 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.

Realistically, it will take time to work through all of the options and deal possibilities, and that is why banks will

Night of the Zombie Branches: Rescues Possible?

need interim strategies to slash the overhead associated with zombie branches. The most immediate possibilities are adjusting staffing levels and hours of operation, based on a deep understanding of evolving customer transaction patterns and preferences for service.

DIFFERING IMPACT

Although the branch crisis is a nationwide problem, the impact is quite different among various markets and types of institutions. There is much more at work in the crisis than simple overcapacity. Often, for example, problems are traceable to local market network presence and the management strength of the parent company.

To diagnose the situation, we began by evaluating the current profitability of each of the nation's roughly 94,000 branches. Factors included local market share of loans and deposits; interest rate margins based on the performance of the parent company; likely occupancy and staffing expense based on standardized cost estimates; and additional likely operating expenses as indicated by other Novantas research.

Then to build context, we looked at the projected growth trend in each local market to see if there was hope on the horizon. Additionally, we evaluated how each branch fit within the local network operated by the parent company; overall market presence and local competitive stance; and the overall financial performance of the parent company (as an indicator of management strength).

Putting all of this together, we identified about 16,000 branches that are on a course for closure over the next three years, if they remain under current ownership (Fig 1). These units are unprofitable to such an extent that they could not be revived even if they were able to freeze costs while keeping pace with expected growth in their respective markets (de novo branches that have been operational for fewer than five years were exempt from closure).

Market perspective. In terms of numerical concentration of zombie branches, the hot spots are in major cities, including (in descending order) New York, Chicago, Philadelphia, Atlanta, Dallas and Washington, D.C. Novantas analysis indicates that about 75% of U.S.

banking markets will require a net reduction in branches (closures outpacing de novo expansion) over the next three years.

Underscoring the importance of local market presence, nearly a third of troubled branches are owned by good-performing parent companies, yet these units are handicapped by subscale network presence in their respective local markets. Many are owned by regional and super-regional banks, suggesting a particular need to rationalize networks on a market-by-market basis, instead of branch-by-branch.

In many other cases, branches simply are not living up to the potential of the markets in which they are situated. These units are more concentrated among under-performing parent companies, some of which are likely takeover targets.

Peer group perspective. In terms of proportion, the four largest U.S. mega-banks have the lowest exposure to zombie branches, roughly 3% of their combined networks, or about 600 units. Helped by their strong network planning functions, these banks have aggressively optimized their local branch systems. As a result, most of their branches are situated in local networks with at least threshold density levels, critical in providing customer convenience and building market visibility.

With a 10% concentration of troubled branches, by contrast, super-regional banks have a much more difficult case load of about 2,200 units. The proportionate burden is still greater among regional banks, which have a 21% concentration of troubled branches, or roughly 2,300 units.

Fig 1: Branches in Failing Financial Condition

Nearly 16,000 U.S. branches have lost financial viability and face closure over the next three years. However, about 11,000 could be valuable in mergers, market spinoffs and standalone sales.

Peer Group	# of Branches at Risk	% of Frequent Branch Users
National	602	3%
Super-regional	2,235	10%
Regional	2,286	21%
Super-community	5,046	26%
Community	5,249	32%
Unit & non-network	444	23%

Source: 2011 U.S. branch study by Novantas, LLC.

“Clearly, the U.S. banking industry is facing an epic challenge in dealing with troubled branches. A substantial number of branch closures ‘at total loss’ can be avoided, however, through transactions that transfer zombie units to better-managed banks and more solid local networks.”

Regional banks are the most likely to still run their networks as a series of regional domains with separate management teams. This often leads to a “sharing” arrangement for branch investments (if Tampa gets two, then Gainesville should have two), which can override important distinctions between local markets. Depending on network presence and market opportunity, continuing with this example, Tampa hypothetically may have needed six additional branches, accompanied by a net reduction of two outlets in Gainesville.

The situation is even more pressing among super community banks (from 10 to 75 branches), which rarely have a fully competitive network presence in the local markets they serve. Within this peer group, about 5,000 branches appear eligible for closure under current ownership, or 26% of the peer group total. Finally, community banks (up to 10 branches) are burdened with the highest concentration of troubled branches, about 5,250 units, or 32% of the peer group total.

AVOIDING CLOSURES “AT TOTAL LOSS”

Clearly, the U.S. banking industry is facing an epic challenge in dealing with troubled branches. A substantial number of branch closures “at total loss” can be avoided, however, through transactions that transfer zombie units to better-managed banks and more solid local networks.

To judge whether a network in any city was a strong candidate for branch consolidation (as opposed to outright closure), we looked at two factors, including:

1) Networks belonging to any bank that are subscale on their own, but which would be attractive to another leading market player as a consolidation target. Acquirers primarily would be looking to weed out duplicative branch capacity, but in some cases also would be able to beef up networks in select local markets.

2) Networks specifically belonging to underperforming banks which could be likely takeover targets in the future.

Based on these filters, we estimate that 11,000 of the total 16,000 troubled U.S. branches have an inherent value to someone other than their current owner, either to improve an existing network, or to reduce market over-branching.

As a result, we expect to see a series of specific market exits — entire companies sold; spin-offs of various local networks; sales of individual branches — where banks can

realize greater value from a sale of branch capacity than from an ongoing investment in it.

The most aggressive option is in-market consolidation, where a bank buys smaller and/or weaker competitors purely to grow customers and reduce distribution capacity within the current network footprint. There have been few such transactions in recent years. However, within the 75% of markets where we expect to see significant net branch consolidation nationally, at least 55% have regional or super-regional banks which could be candidates for merger-based consolidation.

The second option is to identify entire markets for exit, for example, large city markets where the bank’s network is terminally sub-scale, or small rural markets where the bank is unable to earn a hurdle rate for branch investment. Time is of the essence in making such decisions. Given the ongoing deterioration in troubled branches, the longer the bank waits to exit a market, the less value the local network will bring.

The third strategic option is to pursue closure of the “No Regrets” branches (units that may never meet the parent company’s hurdle rate) in all markets. These could include marginal branches in low opportunity markets and isolated branches in good markets. Closures could also extend to de novo units opened as part of the recent real estate boom in branching, which will never achieve breakeven based on current forecasts of deposit growth and customer profitability.

IMPROVING NETWORK ECONOMICS

These strategic options may require significant time to undertake and in some instances may prove extremely difficult from a political or cultural standpoint. Wholesale market exits, for example, have been historically rare in the U.S. banking industry. Even after decisions are made and deals are struck, it will take a period of months or years for the benefits of those actions to fully flow through to the bottom line.

This increases the urgency for banks to take immediate, tactical actions to improve the economics of the network now. Staffing levels and hours of operation are the most immediate levers for expense reduction and productivity gains, based on a deep understanding of evolving customer transaction patterns and preferences for service.

With in-branch transaction volumes falling by 4% annually across the industry, there are widespread opportunities

to further reduce teller staff. Trends in facilities utilization will improve as banks learn to treat hours of branch operation as a flexible resource (reducing hours in some locations, increasing elsewhere). The goal is to reduce expenses and boost sales by moving hours from low- to high-potential areas.

The mix of activities carried out in branches is evolving as well. Banks will need to carefully study the accelerating changes in customer behavioral patterns, including the rise of the “virtual-domiciled” customer, to accurately forecast the changing mix of branch utilization. Where appropriate, customers can be encouraged to make even faster shifts away from the branch, for example, by re-directing deposit transactions away from tellers to automated teller machines; mobile devices; and even to fully electronic formats.

By understanding and proactively managing these shifts, the bank can not only refine the plan for tactical staffing changes, but also lay groundwork to reconfigure the network. The goal is to identify which locations in the network primarily will be service and transaction hubs, and which ones will be sales and advice locations.

“Banks need to carefully study the accelerating changes in customer behavioral patterns, including the rise of the “virtual-domiciled” customer, to accurately forecast the changing mix of branch utilization.”

At every location in the network, a detailed outlook for future transactions (volume, type and complexity) can be used to determine whether the facility at that site should change, either in format, or in staffing and hours, or both. For some locations, downsizing the format and staffing can provide cost savings, particularly if the excess space is converted to revenue producing real estate assets, such as offices or retail space.

As banks begin to shrink the branch footprint at each location, finding suitable partners to “move in with” will matter. One set of partners includes linked financial services (tax preparation, accountants, insurance agents, registered investment advisors). These services would fit with branch locations that are focused on sales and advice. For transaction locations, where the emphasis is on access and convenience for everyday customer transactions and service, high-traffic retail and service industry co-tenants may make sense: dry cleaners, coffee shops, and pharmacies.

PARSING THE OPTIONS

Many of pressing questions have been asked about the future of the branch: do we need them; who is using them; can we close them? Almost all of the answers start with “it depends” — it depends on which segment you serve; it depends on which markets you serve; it depends on what you want to sell. But there is one answer that does not “depend” on anything: money-losing or marginally profitable branches, in low opportunity or over-branched markets, look ripe for action now.

The bad news is that the overhang of zombie branches is significant: about 16,000 units spread across the country. The good news is that perhaps two-thirds of them, or about 11,000, could prove valuable under different ownership.

In parsing the options, banks need to look beyond the question of individual branch profitability. A strong market context will be needed in crafting merger and spin-off transactions that will help to avert closures “at total loss.”

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Avoiding a Sales Productivity Crisis

Will branch staff cuts exacerbate the revenue crisis in retail banking? Much hinges on sales productivity. Leading banks are using four levers to meet the challenge.

BY DARRYL DEMOS

With its recent announcement of 30,000 job cuts, Bank of America Corp. fired the opening shot in an industry campaign for deep cost reduction in retail banking. Going into 2012, many other revenue-starved banks likely will slash branch staff as well, given the almost 40% profit decline in retail banking.

But aggressive contraction reintroduces an age-old problem, how to generate equal or greater branch sales volume with a smaller team. It gets down to staff sales productivity, which already was declining prior to the recession as branch customers began transacting an increasingly substantial amount of business online.

As measured by weekly sales per full-time staffer, average branch sales productivity has declined by a third since 2003, according to our research. Staff cuts could potentially lower expenses, but much of the benefit will be lost unless the remaining branch staff can sell at sustained higher levels.

So what will make the difference between authentic financial benefits to shareholders versus a sales productivity crisis that further undermines revenues at the worst possible moment?

There are four levers that banks can pull to reverse the current sales productivity trends: 1) superior flexibility in allocating resources and setting goals; 2) recasting branch managers as sales leaders instead of 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 multiple dimensions of flexibility in the formula for improving sales productivity. Looking at regional staff deployment, our research repeatedly shows dramatic skews in local market opportunity. Yet many banks cling to uniform branch staffing models, under-nourishing high potential locales and dissipating expensive sales talent elsewhere.

By segmenting various types of local markets (i.e. urban versus rural) within the branch network, banks can sharpen staff deployment. The idea is to redirect staff talent from areas where the sales outlook is less promising to markets where the bank can likely grow faster than the competition.

Inside the branch, flexibility is equally as important. There are huge untapped opportunities to cross-train people 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. This universal concept is not limited to staff. Many organizations are considering redeploying the assistant branch manager as an inside-the-branch “generalist” if the work load and work patterns fit.

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.

Many video-based pilot programs are coming closer to fruition, providing both sales and service expertise remotely. Video is a customer-friendly, low cost way to serve smaller locations and provide specialized expertise across the network.

Finally, there are better ways to accommodate daily customer traffic, both through flex-staffing to meet peak hours of branch activity, and through adjustments to branch hours of operation. For example, branch hours could shift to serve home-bound customers at the end of the workday.

Managers as Sales Leaders. Both in terms of skill and customer rapport, branch managers typically have high sales potential, yet most are 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 typically 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 in favor of 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 a decently performing mail campaign (roughly 18 sales per every 1,000 customers). There is great room for improvement in this area. Better information on customer traffic and potential is needed, 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, by contrast, 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 or Cooperation? 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 that is seldom seen in retail banking.

In retail banking, often individual channels (branches, contact center, online) function with a high degree of autonomy that borders on rivalry, with internal competition taking precedence over collaborative efforts to serve the customer more fully.

As more customers develop an expectation for “all channels all the time,” retail banks face a rising need for cross-channel coordination.

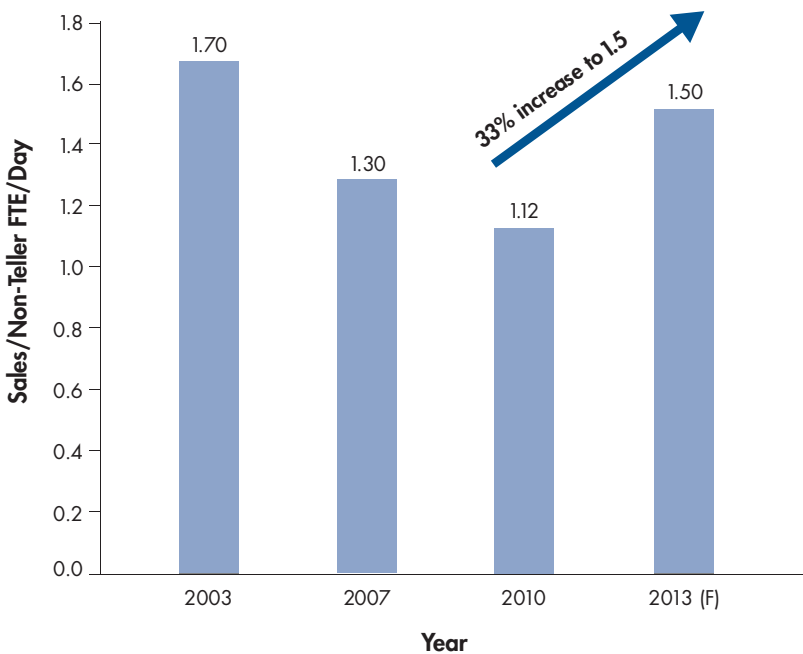
Prospecting and lead generation are often better conducted through the contact center, where dedicated sales personnel have the right skills and tools along with more experience and typically a better temperament and more perseverance in dealing with low acceptance ratios.

Meanwhile in the highly profitable small business segment, contact centers and relationship bankers are finding new ways to jointly deepen current relationships and find new ones.

Any major bank serious about improving sales productivity should be actively targeting and testing new coordinated multi-channel sales strategies, especially given changing patterns of customer channel usage.

As these initiatives illustrate, the core challenge in retail banking is not raw cost reduction — it is productivity improvement. The good news is that in order to return to pre-crisis sales productivity levels in the branch, the typical branch network only needs to lift performance by an average of two product sales per week per banker. Some banks are already making progress as they implement the various productivity levers.

Fig 1: Sales Productivity Trend



Source: Novantas 2011 Branch Productivity Benchmarking and Novantas analysis; Products include checking, savings, MMA, credit card, new CDs and loan/line for consumers and checking, savings and MMA for business.

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Overemphasis on Coaching: Killing Sales at Bank Branches?

Novantas research finds that branch managers who focus primarily on direct sales can outsell other banks by 30%.

BY DARRYL DEMOS

Common wisdom in retail banking states that branch managers should strive to be great sales coaches: observing other staffers, helping them refine their technique, and passing along personal and corporate knowledge about what works best in a variety of circumstances.

Recent Novantas research suggests otherwise. In a survey of more than 13,000 branches, we found a 30% performance advantage at banks where branch managers spend more time on direct selling than coaching — a powerful rebuttal of coaching being a priority role.

The bank with the highest percentage of managerial selling time was especially revealing. Managers devoted about 40% of their time to direct selling, the equivalent of two days per week. They spent only about 15% of their time on coaching, or about six work hours per week. As a result, this bank outsold the survey average by a whopping 50%.

By contrast, the banks with the lowest sales productivity allocated from 30% to 65% of managerial time to coaching, but only 5% to 10% to direct selling, almost the exact opposite of the top performer.

This is a profound finding and one that banks need to address quickly. As major banks consider a deeper round of cost cuts in a stagnant market, they risk exacerbating the revenue

challenge unless remaining branch staff can sell at sustained higher levels. Clearly, branch managers will need to lead the charge. On a practical level this conclusion should not be surprising, for three major reasons.

First, most branches are small places. The average number of full-time employees across the entire survey was 6.5 per branch, for example, and nearly 90% of bank branches had fewer than 10 full-timers. It is easy to see how the skills of a natural sales and service leader could be far more influential than the day-in and day-out routines of most coaching programs, especially with such small work teams.

Conversely, a heavy coaching schedule eats up absurd amounts of time. For example, if the bank develops a program where managers are supposed to spend 40% of their time coaching, and the average branch has six full-time employees (not counting the manager), that adds up to almost 2 hours and 45 minutes of coaching per person per week.

Second, coaching should not be employed to simply fill in dead spots in the work day. In our 10-bank survey, sales per branch per month averaged about 80 products. Over a 22-day work month, that is less than 4 products per day. If the manager spends 30% of the time coaching three employees, there is little time left for the manager to sell.

Third, if the bank tells managers that their most important job is to coach, then it is quite possible many managers, who were trained to strictly follow the rules, will interpret this to mean that selling is not their job at all, and shove the full responsibility to others. The issue, as we have shown above, is that there aren't that many "others," and there aren't many weekly sales opportunities on average.

Selling is a "contact sport," and in other industries, top-performing sales managers spend lots of time developing the biggest portions of business in their stores and trade areas. They play an active role in prospecting with priority clients, not only helping but often taking the lead to close deals. They do not confine themselves to the back bench role of passively providing advice to other representatives.

As bank branches spend less time on basic teller transactions, successful outlets will be heavily engaged in high-value sales and advice. New models for leadership will be required in these locations. As our findings indicate, banks cannot afford to cling to managerial concepts of the past. Leaders will need to seriously challenge the notion that "coaching is king."

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Pricing for Opportunity in Home Equity Lending

Advanced pricing skills will be critical as home equity lenders compete for selective growth opportunities going into next year.

BY GAURAV GUPTA

As retail bankers prepare for a challenging 2012, home equity lending will be a critical engine for revenue and asset growth in an overall tight market. But many lenders will forfeit opportunity if they confine themselves to traditional pricing practices.

Following the U.S. credit crisis, home equity lenders initially worked to fortify underwriting, realizing that they had not adequately protected themselves during the heady expansion years. This is certainly appropriate given the outlook for continued high unemployment, flat or falling housing prices and a towering consumer debt load.

Defensive measures only go so far, however, at a time when the pool of eligible customers is significantly reduced and banks are hungry for profitable assets. The larger question is how to generate profitable growth under more prudent lending standards.

The answer, in most cases, lies with improved pricing skills that go far beyond the basics of risk-adjusted pricing, the de facto industry standard. Risk basics fail to consider important variables such as customer relationship profitability and segment variations in customer demand.

For example, 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, judicious rate offers can attract many substantial new borrowers, materially

improving profits — by more than 20% in one recent case study — without disturbing underwriting standards.

Such opportunities typically are overlooked among most banks. Beyond risk, lenders largely confine their frame of reference to competitor actions, internal cost estimates and executive interpretations of recent results. This omits, for example, customer's sensitivity to price; the extent to which account holders actually will use their lines of credit; likely balance duration; shopping attitudes (price versus convenience); and the extent of consolidated business done with customers across all areas of the bank.

In many cases, lenders have yet to compile the source information needed to analyze such variations in customer demand and performance. We have seen instances where lenders either do not ask applicants to state the intended purpose of their home equity loans or record such information erratically. Even in cases where such information is available, it is not routinely analyzed and consistently incorporated into pricing decisions.

THREE-PART APPROACH

To address home equity pricing questions more systematically, leading institutions are adopting a three-part approach:

Product economics. Banks generally need a more precise workup on how various customer factors (i.e., expected funds usage and cost to serve) influence profitability.

And many could improve decision-making by using more robust metrics to assess value, such as economic profit, net present value, and risk-adjusted return on capital.

As to why expected usage matters, the potential for home equity lending profitability often is quite different between, for example, a borrower getting ready to add a room to the house; or someone who simply wants a backup line of credit to assure household liquidity; or parents who are looking to fund a child's education. Most pricing policies do not take such variations into account today.

Also, our research continues to show significant opportunities for improvement in cost calculations. More work needs to be done on funds transfer pricing methodologies, for example, to accurately calculate the cost of funding loans. Expenses for marketing, sales and supporting operations need to be accurately allocated as well.

Segmentation. Often today in home equity lending, customer segment dimensions are limited to risk basics, transaction characteristics and local geographies and housing markets. While these are important factors, they are not the complete answer in targeted marketing and pricing.

Additional perspectives, such as purpose of the loan, nature of relationship with the bank and overall household cash management needs, help to uncover pockets of opportunity

Fig. 1: Insights about behavioral differences can help make better targeting, pricing and portfolio management decisions



that are otherwise are not visible. With established customers, for example, the bank can augment basic risk scores with salient account and transaction information, which can help to clarify, and in many cases expand, the pool of qualified borrowers.

Elasticity of demand. Most banks routinely track competitor prices, which are then used as an input for subjective pricing decisions. For one thing, this approach fails to recognize that various groups of customers look in different places to get a sense of market prices. It also overlooks differences in consumer attitudes and responses to similar price signals. By contrast, advanced lenders carefully study and quantify how consumer demand varies in accordance with

changes in lending rates, and they use that knowledge to refine pricing strategies within customer segments.

Such in-depth preparation sets the stage for precision marketing and pricing strategies in home equity lending. Goals for various customer groups may vary markedly, everything from special offers to bring rate-sensitive customers off the sidelines to judicious adjustments that will improve margins in areas of stronger customer demand.

Together, consumer loan cross-sell and account consolidation represent one of the strongest opportunities in retail banking going into next year. Nationally, we estimate that there is a potential \$2 trillion opportunity for consumer credit consolidation, based on Novantas research indicating

that many consumers have scattered borrowing wallets but are attitudinally receptive to consolidating business with their primary bank.

Advanced pricing skills are critical in making the most of this opportunity, and indeed will provide the most immediate performance boost for well-prepared banks.

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Back to the Drawing Board for 2012

As banks gear up for 2012, the problem is not just overcapacity, but obsolete capacity. Deeper cost cuts must fit within a larger plan to rebuild the business, including assessments of future balance sheets. Decisions must be made regarding resource deployment, along with multi-year plans for implementation.

BY STEVE TURNER

With extended flat rates now a virtual certainty following the Fed's August 2011 announcement, all of banking's major profit levers are constricted going into next year. But it will take more than extreme cost reduction to meet the challenge.

Struggling with a weak economy and the regulatory effects of Dodd-Frank and Basel III, banks face a tremendous planning challenge, not just to slash overhead, but to reposition all of the major business lines for an uncertain future where few of the old rules apply.

For more than a year now, executives have been anticipating a rebound in interest rates. Swollen portfolios of cheap deposits could finally be invested in higher-yielding loans and investments, providing critical new streams of net interest income.

As that prospect is now gone, tough decisions can no longer be delayed. It is not just a problem of overcapacity, but of obsolete capacity. The checking business, for example, does not merely need to be economized following slashing of debit and overdraft

fees — it needs to be re-invented for a permanently changed market.

For executive management, one immediate priority is to comprehensively diagnose the unfolding revenue challenge. Some issues affect the entire organization; others have varying effects on individual lines of business.

It is a witches' brew of revenue challenges, including declines in debit and overdraft fees; tepid loan demand; slim margins; a dwindling trend of falling loan-loss provisions; and for the biggest banks, a bleak future for proprietary trading. Meanwhile there is a huge overhang of troubled residential loans.

Compounding the challenge are the new international banking regulations under Basel III. Along with higher capital requirements, Basel III changes the way that deposits are treated, making various categories of deposits less valuable than they once were, with a potential major impact on deposit strategy.

Each institution will need to consider how these economic trends and regulatory changes intersect with the major lines of business and

collectively impact corporate performance. One thing is for certain: successful strategies that were employed before the crisis will not generate superior results in 2012 and beyond.

PLANNING CHANGES FOR 2012

Finance and risk managers will need to help business line managers identify the major changes and quantify their likely impact. The goal is to come up with a side-by-side analysis that permits clear comparisons of the business lines, including profit and growth potential in this new world, which can be rolled up into a corporate outlook.

This quantification becomes the foundation for executive management decisions and strategic positioning, bringing urgency to the task of completing investigations in time to support the 2012 planning process. The leadership team and board of directors will be dependent upon this information to make informed decisions.

As underscored by Bank of America's announced elimination of 30,000 jobs, cost reduction is now a burning industry priority. Yet within viable business lines, deep cuts can pose a direct threat to competitiveness, customer relationships and future growth potential. This is particularly the case given the need to retool businesses in light of the changed market and regulatory environment. Elsewhere,

“Cost reduction is now a burning industry priority, as underscored by Bank of America’s announced elimination of 30,000 jobs. Yet within viable business lines, deep cuts can pose a direct threat to competitiveness, customer relationships and future growth potential.”

too little economizing may occur within business units that have lost financial viability in a weak economy with higher regulatory hurdles.

ASSESSING THE FUTURE

To sort through these issues, winning banks will comprehensively assess the future economics of each business line and consider cost reduction within that context.

Meanwhile, an equally intense effort is needed to nurture growth wherever it can be found. Over the next few years, for example, we believe that banks will play a much larger role in carrying residential mortgages on their balance sheets. Perhaps up to \$2 trillion of mortgages will move onto the balance sheet as banks claim balances that formerly went through securitization conduits, or to Fannie Mae and Freddie Mac.

What's still lacking at many banks, however, is a plan to win this business. A coordinated effort will be needed to harness the regional branch system. It is important to keep sight of such opportunities as the wildfires of cost reduction rage.

Another planning factor is risk measurement, which will be more complex going forward (e.g., with more mortgage and multi-family loans held on the balance sheet). Most plans have not adequately considered long-term strategic risk. That is, many measures of risk-adjusted returns are based on some form of one-year credit risk exposure, but do not consider the durability of estimates over the full economic cycle.

Advanced stress testing should factor into decisions on resource deployment. That is, does the return expected from a business justify the worst-case loss that potentially could be suffered?

For example, how does the

cumulative five- to seven-year expected return compare with the worst-case loss scenarios for each strategy? On this measure are there businesses that have superior risk/return relationships relative to others? If so, how should cost reductions be apportioned across these businesses?

In reviewing these factors, the main point is that a holding pattern won't work going into 2012, nor will a simple across-the-board expense reduction program. Because of regulatory and customer behavior changes, banks must undergo a complete rethinking and repositioning of their business models.

Instead of a collection of one-year business line plans, banks will need a multi-year vision to rebuild for a permanently changed market. Banks that ignore the long-term implications of this changed environment are at risk of making fundamentally wrong expense reduction and investment decisions for 2012.

“Advanced stress testing should factor into decisions on resource deployment. That is, does the return expected from a business justify the worst-case loss that could be suffered? For example, how does the cumulative five- to seven-year expected return compare with the worst-case loss scenarios for each strategy?”



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RISK

and the ROAD AHEAD:

WHAT BANK DIRECTORS
NEED TO KNOW

BY STEVE TURNER

To cope with market volatility and heightened regulatory pressure, bank boards must play a much more proactive role in risk management. For the past year, directors at U.S. banks and thrifts have been grappling with their new responsibilities in overseeing and controlling risk. The Dodd-Frank Act significantly increases the compliance requirements of banks and imposes operational and financial restrictions that materially change how banks will be permitted to compete. Dodd-Frank makes it clear that boards need to play a greater role in improving risk policies, controls and systems.

Bank boards will have a larger role — and likewise, greater liability — in risk management. This role must evolve to reflect the complexity in the current financial system and the changing demands required by regulators, investors and debt holders. The challenge for bank boards is immense and many are not up to the task. Traditional audit committee processes, although important, are not currently designed to consider the complexity of how risks evolve, interrelate and affect the institution. This problem is not limited to big banks. As demonstrated in the downturn, smaller banks — including community banks — are subject to the same events as larger banks, but have fewer resources upon which to draw.

The interconnections and interdependencies exposed in the financial crisis highlighted how difficult it will be to stop the spread of future problems and how vigilant directors must be at effectively discharging their responsibilities. The potential for a major market such as mortgages to implode and spread financial contagion across the global network of banking institutions is now well established. The likelihood of other cascading scenarios is high, making the board's risk management role a critical and very visible line of defense.

Board members of financial institutions must be able to answer the following questions to achieve effective risk management governance: What can be learned from the downturn regarding risk? What are the effects of the regulatory response on individual institutions? And, most importantly, what should the board's role in risk management be going forward?

LESSONS FROM THE REAL ESTATE COLLAPSE

Looking back, many financial professionals and market observers were well aware that a bubble was building in residential real estate. Prices were increasing rapidly, investors were actively buying and selling properties, and there was overbuilding in many markets. Individuals were taking on greater leverage and banks were complicitly allowing for little or no equity in the mortgages that they were underwriting.

Indeed, an overheated real estate market and a potential drop in the subprime market factored into many institutions' risk decisions and risk models. What was not appreciated was the cascade of problems from the subprime market seeping into other sectors. Aggressive banks in the subprime market were the first to suffer. The first wave of subprime defaults resulted in foreclosures on homes which were then brought to market as distressed properties. This resulted in a further drop in market values of residential real estate, which affected the next tier of mortgage borrowers, eventually compromising

Alt-A and even prime mortgage borrowers. The fallout from this sequence was a severe drop in construction, increased joblessness and mounting losses in credit card, personal loan and small business portfolios.

Rarely does the proximate event result in the largest losses. Like a tsunami, it's the secondary and tertiary ripple effects which cause the greatest harm. Hence, many banks with limited subprime exposures in 2007 suffered significant losses in their other mortgage, small business and consumer credit portfolios as a result of the contagion.

“The lack of preparation for the rapid decline of the subprime market illustrates one of the core issues within risk measurement. Risk has historically been addressed according to product silos. However, as is all too apparent, risk does not respect silo boundaries.”

The lack of preparation for the rapid decline of the subprime market illustrates one of the core issues within risk measurement. Risk has historically been addressed according to product silos. However, as is all too apparent, risk does not respect silo boundaries. When there is a shock to the economy, we relearn that the models that function well in stable markets often are fundamentally flawed in highly turbulent markets. There are two primary reasons for this weakness. First, most models do not effectively incorporate changes in the relationship of different economic and market factors caused by a shock. For example, in a stable economy, equity and bond prices tend to move rather independently, but in a stressed economy, their prices typically move in closer alignment. Second, most models do not capture the cascade effect from an initial risk event. When subprime mortgage portfolios collapsed, the losses cascaded into other portfolios to a much greater degree than these models projected.

NEW CAPITAL REQUIREMENTS

Globally, regulators have responded to the downturn by revamping the decades-old rules on risk and developing new compliance requirements to which the banks must adhere. The Bank for International Settlements in Basel, Switzerland — the global body formulating international rules for risk measurement and management — acted quickly by adding to its Basel II capital guidelines the next generation of global

risk guidelines, named Basel III. Basel III increases capital requirements by limiting what qualifies as Tier I capital and increases the minimum amount of capital that must be held. In addition, it adds a “capital conservation buffer” to be drawn from in periods of stress. Separately, a non-risk-based leverage requirement was established to ensure that banks always have sufficient capital against assets, even when those assets are perceived as low risk. These and other changes to capital and capital requirements, particularly for derivatives, are designed to counteract the worst effects of the recent and future downturns.

Basel III also establishes a set of new rules regarding liquidity, distinguishing it as a separate and independent financial resource from capital. That is, banks have two stockpiles of financial resources that they hold for periods of stress: capital and liquidity. The new liquidity rules require banks to hold a minimum of liquid assets that can be used to offset cash outflows experienced during stress periods.

Banks have new, very specific requirements defining the amount of liquid assets that must be held against specific types and levels of cash outflows. Those cover two things: First, for most banks, Basel III increases the amount of high quality, low-yielding assets on bank balance sheets. Second, by defining liquidity requirements by type of account, Basel III changed the economics of many businesses. Most retail deposits will not require significant levels of liquid assets to be held, while most corporate and financial institution deposits will have to almost entirely be offset with liquid assets.

In total, Basel III establishes the new norm for capital and liquidity requirements that banks must incorporate into the design of risk models and risk management processes. Importantly, U.S. regulators have been applying global standards for risk management to a broader group of banks than what is required by international standards. Basel II rules that are applicable to large, internationally-active banks are being applied in many ways to banks that don't fall into this category. However, the stated intention is still to apply risk management standards commensurate with the size and complexity of the institution being evaluated.

NEW US BANK REGULATIONS

Congress responded to the financial crisis by rapidly passing the most significant financial industry legislation since the Depression-era Glass-Steagall Act. Dodd-Frank has frequently been on board agendas and its aftermath will likely be driving those agendas for at least the next 18 months.

While Dodd-Frank covers a wide range of issues, there are two risk themes embedded in the act that boards should keep in mind as they enter 2012. First, regulators now have

the authority and resources needed to develop forward-looking perspectives on the risks of individual banks and the financial industry as a whole. The axis of power resides in the newly-formed Office of Financial Research (OFR). This office gathers and interprets detailed bank portfolio information to develop views of the risk levels and trends within the system. With an effectively unlimited budget to do its job, OFR is systematically gathering transaction-level data on credit risk within the system and will soon have unprecedented insight into the state of financial institutions.

Second, there is a strong emphasis on giving regulators the tools and the authority to take action, as evidenced by the newly-formed Financial Stability Oversight Council, whose purpose, according to Dodd-Frank, is to “identify risks to the financial stability of the United States...to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure...to respond to emerging threats to the stability of the United States financial system.” In other words, the regulators have been given authority to take preemptive action before the effects of risks are seen. These actions can be in response to evidence of building systemic risk that warrants actions affecting all institutions, whether or not those risks are outsized in any particular institution.

BANK BOARDS AND RISK MANAGEMENT

The implication of these themes is that regulators will have better information to evaluate and anticipate risks, and the authority to take action to mitigate those risks. Banks will need to retool their risk measurement and management capabilities to look forward and align with their regulators. Both bankers and regulators will be talking a new language of potential risks and actions to mitigate losses and exposures before they occur. Boards must learn this language and have available to them the critical information to ensure compliance.

The regulatory requirements are resulting in changes to board committee roles, responsibilities and composition. At the same time, there are near-term challenges the banks will be facing as higher capital and liquidity requirements drain the profitability of various business lines and significantly change their profit dynamics. These changes are likely to cause major alterations to the businesses that many banks pursue.

Within this context, the board has four primary roles in risk management: 1) Set risk appetite, 2) establish suitable limits, 3) monitor compliance and 4) ensure that internal processes are effective and consistent with the institution's risk requirements.

Set risk appetite. Among the board's most important

responsibilities is establishing the institution's risk tolerance. The board must set the risk policy, defining the level and type of risk that are suitable and consistent with the bank's strategy, capabilities and resources. It must balance the need to preserve capital, maintain liquidity and minimize losses with the exposure necessary to earn an appropriate level of return. The challenge for boards is to help management determine the right amount and composition of total risk.

The board must determine how the institution's strategy relates to the type and level of risk it takes on. A retail bank-focused strategy primarily results in credit risks associated with consumer and small business lending, real estate and other collateralized asset risks. The board's job is to determine the risk tolerance to defaults and to asset values. To do this, the board must understand how these risks relate to each other, and how much potential loss the bank faces under various economic scenarios.

The board should also determine what risks are inappropriate to the strategy. The retail bank strategy described above does not require a significant market risk exposure. If there is a significant market risk component, then management is either attempting to supplement core strategy returns or pursuing a separate strategy that results in significant market risk. The board must be able to discern the difference between these two reasons for market risk and determine the appropriateness of each.

Ultimately, the board must be able to develop an independent perspective on these risks in order to provide an effective counterpoint to management.

Establish suitable risk limits. Once a risk policy is established, risk limits must be set across the institution, by risk class, type and business line.

Certain types of risk are relatively easy to identify, size and establish meaningful limits. For example, credit and market risks are regularly measured and reported during normal business operations. Organizations are typically well versed in working with risk standards and limits in these areas. At the same time, all of these risks are embedded in transactions that were not explicitly created to take a credit or market position. Credit risk, for instance, can be found in loan portfolios, investment portfolios, vendor arrangements and insurance

contracts, among others. Banks must be able to identify the collective credit risk of these sources as well as consistently measure the risk from each. Market risk is embedded in investment portfolios, but also in loan portfolio valuations for securitizations or as collateral, and in embedded optionality (e.g. a bond that gives the issuer the option to call the bond early or convert it into equity), which affects the overall asset/liability position.

Measuring and setting limits for operational and liquidity risks is more complex and can cause severe damage to a bank. Two well-known forms of operational risk are model risk and rogue trader risk. Both of these are outgrowths of natural business activities of a bank and both require a combination of process evaluation and continual oversight. While a regulatory framework has been established for liquidity risk, the actual calibrations of the framework remain uncertain, and are still actively under debate.

In establishing risk limits, the board should frame issues in terms of the two primary warehouses of financial protection that financial institutions hold: capital and liquidity. The Bank for International Settlements makes the point on capital and liquidity by establishing separate regulatory requirements for these resources. Historically, capital was subject to regulation, but in recognition of the effects of liquidity on financial institutions in the recent downturn, new requirements have been established. This reinforces the point on interrelationships of markets, institutions and risks in today's global economy.

Monitor compliance. With these definitions and limits in place, management and the board must find ways to communicate in a clear and concise way. Management must report to the board the specific measures of compliance, along with supporting information that provides insight as to how risks are evolving and what types of risk events could occur in stressed environments. One of the most valuable initiatives management undertakes is formulating the reporting structures and information that permits the board to effectively monitor the risks and maintain effective control.

Ensure effective internal processes. Although process management is critical to an institution's success, it is often

“Banks will now have very specific requirements that define the amount of liquid assets that must be held against specific types and levels of cash outflows. This does two things: First, for most banks, it increases the amount of high quality and, hence, low-yielding assets on bank balance sheets. Second, by defining by type of account how much liquidity must be held, they have changed the economics of many businesses.”

“Banks are functioning in a highly complex and interconnected environment. As demonstrated in the recent downturn, problems that were assumed to be contained in one sector can cascade into other markets and portfolios, causing much greater damage than anticipated by most banks for even the most severe scenarios.”

overlooked by the board and relegated to lower levels in the organization. While there are a wide range of processes, few are as important to risk management as those related to compensation, compliance and clout.

The board should have a strong hand in setting the compensation principles of the institution and how those principles affect the size and types of risk being taken. As Dodd-Frank recognizes, people tend to do what you pay them to do. In the case of incentive compensation, if there is limited downside to aggressive risk-taking and significant upside, there is very little question what will happen.

This logic carries through to other roles within the institution and requires thoughtful balancing of risk concerns with the strategic objectives of the institution and the realities of doing business. Senior managers in credit businesses compensated on volume are going to behave differently than those compensated on risk-adjusted return. Most likely the former will be pushing to the edge of their credit limits while the latter will be working with the risk team to find ways to get greater return from their business while lowering the risk content.

Another area where alignment is often challenged is in systems and process support. Sarbanes-Oxley went a long way in raising visibility of this issue and in establishing compliance processes, but it does not obviate the need for active board involvement and oversight of how systems and process infrastructure affect risk.

Infrastructure oversight is particularly important in periods of rapid growth or significant cost cutting. Rapidly growing businesses are routinely given outsized influence in recognition of their success, which often results in less stringent compliance. Unfortunately, the most successful businesses are those that amass the greatest power and ultimately create the most significant risk to the institution. Conversely, cost cutting presents near-term earnings benefits but can create increased long-term risk exposure by removing or not implementing “costly” checks and balances. New capabilities that reduce long-term risks, but also have short-term costs, are difficult to fund in cost reduction periods.

The board has the ultimate responsibility for risk in the organization and ensuring that the processes in place are sufficient and effective under all conditions.

Banks are functioning in a highly complex and interconnected environment. As demonstrated in the recent downturn, problems that were assumed to be contained in one sector can cascade into other markets and portfolios, causing much greater damage than anticipated by most banks in even the most severe scenarios. Bank risk measurement and management processes fell far short of envisioning the breadth and depth of the downturn. Taken together, traditional banking risks combined with a highly-leveraged and intertwined economy make for complex business risks. To contend with this environment, banks must pair sound fundamental capabilities with the capacity and culture to convert their capabilities into strong strategic decisions.

For these reasons, the board’s role in risk management has been and continues to be critical to the long-term value of the institution. Bank boards should be intimately familiar with risk management issues affecting the institution, and ensure that they have the tools to anticipate and control the effects of both internal and external risk factors. Doing so requires a highly disciplined and effective framework. Few boards fully meet this standard, making future enhancements critical to their effectiveness. In short, bank boards have a very busy future in risk management, and can potentially have a very significant affect on the success — or failure — of their institutions.

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We work with clients to develop these customer-focused strategies, and provide strategy implementation and information services to help clients measure and maximize competitive positioning. Novantas counts among its clients most of the top-30 companies in the banking, brokerage, insurance, and credit card industries.

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Status quo strategies will exacerbate a growing industry disconnect with a permanently changed market. Winners will do the hard work of reinvention and restructuring.

Reconstructing the Retail Banking Business

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

Prioritizing for Growth in Commercial Banking

To grow in a market that is only partially recovered, commercial bankers will need a set of focused initiatives that match strengths with select opportunities. As with other banking lines of business, much of the commercial opportunity for 2012 centers on gaining market share.

Wealth Management Strategies for Boomer Retirement

While high liquidity premiums were entirely appropriate several years ago, they now are skewing bank funding incentives and lending competitiveness at many banks.

Efficiency, Growth and Risk: Striking a Critical Balance

Over the last three years finance and risk managers have been focused on short-term management of credit, regulatory, and liquidity issues that resulted from the global recession that peaked in 2008. In 2011, these issues have been largely resolved or, at least, resolution is well underway and the appropriate actions known.

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