NOVANTAS STRATEGY & MANAGEMENT

Preserving old-style branches will be of limited value in a permanently changed market. For renewal, winning banks will look to the future of multi-channel retail distribution.

Rebuilding Retail Distribution

BY DAVE KAYTES

Reposition for the future? It sounds like wishful thinking at a time when banks are facing a massive revenue shortfall within their retail branch networks. Yet this is the only real choice, given the constrained outlook and accelerating changes in customer behavior.

For two main reasons, there will be no return to "normal" conditions as they might have been defined perhaps five years ago in branch banking. First, there is way too much capacity relative to the foreseeable revenue potential. Second, online banking has altered customer behavior, changing the role that surviving branches must play.

To thrive in the new environment, branches must take the lead in building deep, multi-product customer relationships. That is the key to winning share in a tight market. A concerted effort will be needed to precisely identify and nurture the local branch clusters that are best positioned for multi-line service.

Meanwhile, instead of raw cost and headcount reduction, winning banks will focus on productivity improvement. Through improved product-cross training, flex staffing and the greater the use of specialists (including small business), banks can lower overhead while actually improving customer responsiveness – even revenue generation.

A third priority is accelerating the pace of customer technology adaptation, so that electronic alternatives become fuller *substitutes* for on-site transactions. Given the substantial investments in ATM networks and remote deposit capture, for example, banks should ask why 58% of consumers still primarily use the branch to make deposits, a significant influence on staffing requirements.

Finally, online banking will require far more executive attention and developmental resources going forward. As shown by recent Novantas research, online banking is gaining ground as the primary customer destination for many types of basic consumer banking transactions. It also is making inroads in high-value activities such as financial advice, account acquisition and credit origination. Not a place to be caught flat-footed.

The bottom line is that banks have already entered a new competitive era where branches will play a more defined role and the emphasis increasingly will be on retail distribution strategy, including the full array of

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physical and electronic channels. The recession hastened a transition that already was underway.

This year, retail banks understandably will be preoccupied with cost reduction, given the estimated 10% to 20% revenue shortfall stemming from restrictive new regulations, slack demand and flat margins. But to prepare for stronger growth in 2012 and 2013, a concurrent effort is needed to reposition the franchise as well.

TRANSACTION FACTORY

While there have been major ebbs and flows in branch banking before, the general strategy based on standardization and mass-market outreach has mostly stayed in place for several decades. But this time around it's not just a question of weathering an economic downturn – the model itself is broken.

Certainly, the origins of modern branch strategy are logical and compelling. As regional banks consolidated and ever-larger networks were formed, huge efficiency gains were realized as branch formats and back office systems were standardized. On the marketing side, the new mega-banks had resources for efficient, multi-regional promotions, which were generally successful in driving product demand.

In retrospect, this paradigm of marketing-generated product demand, matched with efficient and standardized branch fulfillment, probably peaked in the 2003-2007 era, undoubtedly fueled by an overheated economy. But why can't banks restore a sane version of this model in some future era when the economy normalizes?

Much of the answer revolves around the fact that the branch no longer can function as a transaction factory. Customer online migration is one reason. For certain types of basic transactions, Novantas research shows a doubling of customer online migration in just five years, with more electronic adoption surely on the way. In turn, we estimate that branch transaction volume is dropping by roughly 5% annually – far faster than the pace at which branches have been able to reduce staff and other overhead.

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Compounding the challenge, tightened regulations have drained significant fee revenues from the checking business, a principal branch activity. The business case for providing teller-based transaction services in the branch is weakening by the day.

Then there is the question of what a "normal" consumer banking market will look like going forward. There are strong lingering issues with employment, housing, personal debt retirement, governmental budgets and taxes, and the health of local economies. Even long term, we don't see a return to extravagant consumer borrowing, and meanwhile both the fee and margin sides of the deposit business are becalmed.

Together, these factors have sent a veritable bulldozer through retail branch banking. On the one hand, many branches aren't sufficiently positioned for multi-line service supported by a consultative sales culture, limiting the revenue potential. On the other hand, they are over-weighted in floor space and manual transaction-handling activities, limiting the efficiency potential. These squeezed outlets are prominent among the estimated 40% of U.S. branches that are financially underwater today.

This is not primarily an efficiency challenge. It is a strategy challenge.

REVENUE NUCLEUS

In re-casting the branch network, the question revolves around customers and markets, and the high-value role that branches can play in revenue generation. While the prior emphasis was on high-volume product sales, the new priority is anchoring and expanding customer relationships. It's all about building customer lifetime value, and finding the product combinations of highest mutual value to the customer and the institution.

The good news is that there is continuing customer support for this approach. Novantas consumer research, for example, shows that people still have a powerful branch orientation for high-value banking activities, despite some erosion in recent years. Seventy-six percent of consumers view the branch as the primary place to open new accounts, and 65% look there first when they buy banking products. Meanwhile, 59% of consumers give first consideration to the branch when seeking financial advice, and 36% still turn first to branches to resolve issues. Even among the heaviest users of alternative channels, there is a strong appetite for branch-delivered products and services.

Attitudinally, moreover, consumers are receptive to much higher levels of account consolidation than what typically is seen today. Roughly half of the survey respondents agreed that "I would feel comfortable consolidating all my finances with one financial institution," with a similar level of affirmation that "I prefer to have most of my cash and investments with one financial institution so I can monitor easily."

In a well-positioned multi-line branch supported by an authentic sales culture, the goal is to deepen the relationship with each individual, household and small business. Under this scenario, rather than a source of transaction volume, customer traffic provides entrée to present the best products and services to prospective buyers. There is a rich menu of offerings, including loans, lines of credit, investments, payments, financial advice, brokerage services and insurance.

To justify the level of staff talent needed to support a relationship strategy, banks will need to concentrate on well-positioned local networks – branch clusters with competitive presence in high-density, high-traffic markets. Based on a market-by-market analysis of the major regional banks, we estimate that from the standpoint of positioning, the potential for using multi-line strategy ranges from half to three-fourths of the overall branch network, depending on the institution.

A locally dense, multi-product distribution network will feature more outlets of the type being steadily introduced by HSBC Bank USA along the East Coast. In Potomac, Maryland, for example, a spacious new HSBC facility offers a full range of financial services to both consumers and businesses, including mortgages, loans and wealth management (including private banking). Personnel in such multi-line branches primarily will be responsible for consultative sales, rather than teller functions.

The value of effective cross-sell extends well beyond numerical count and product margins. In-depth customers tend to stay with the bank longer and make higher use of their products. They give the bank a higher priority in the repayment of debt. In many cases, price sensitivity falls as the focus turns to rewards, recognition and service. Also, cross-sell is more cost-effective, compared with a product-by-product effort.

This is a case where the total value truly exceeds the sum of the parts. There is a definite "relationship premium" that is realized in effective cross-sell, In turn, this is one of the primary tools that successful banks will use in combating the ongoing revenue drought and shoring up the economics of the branch network.

INNOVATION IN PRODUCTIVITY

If multi-line branches will need more staff talent, how does that square with the pressing need to reduce operating expenses? For progressive banks, the four-part answer includes innovations with front-line staff; specialists; technology substitution and "thin" networks.

Staffing. There still is a tendency in branch banking to split up various product assignments among staff members, contributing to higher FTE requirements. One way to efficiently provide a range of product expertise is to follow the example in supermarket branches, where the staff often receives extensive product cross-training. There also are extensive possibilities with flex-staffing, which provides ongoing part-time employment to people who can assist with counter transactions at peak traffic times within the branch.

Specialists. As seen in small business banking, there will be a greater need for floating specialists who can serve a cluster of branch locations, possibly by appointment. There also will be opportunities to drive referrals to regional teams of specialists, such as with investments and insurance, possibly operating through the call center.

Technology substitution. In the near term, banks should be asking how they can encourage customers to make greater use of branch alternatives already in place. According to Novantas survey results, for example, 26% of consumers primarily use automated teller machines for depositing funds, up from 19% five years ago.

What will it take to shift the majority of

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depositing activity away from the branch? Banks that answer this question will gain a clear advantage in the quest to reduce the transaction burden in the branch. Part of the answer lies with online deposit transactions, given that 15% of consumers say they prefer channels such as automated clearinghouse transactions, person-to-person payments, and remote deposit capture.

Longer term, banks will be looking for breakthroughs in customer self-service. As evidence of customer receptivity, 74% of survey respondents said they use some form of electronic check-in for flights, including online, the self-service kiosk and the mobile phone. Respondents also reported high satisfaction with the experience. Replicating this self-service orientation in branch banking is critical, given that in any kind of branch there will be less justification for manual processing.

Thin networks. By marrying a thin network of attractive branches with a strong network of ATMs and a robust online and mobile offering, it may be possible to establish a new network paradigm that offers unprecedented efficiency and also strongly appeals to customers. Think Apple Store: a few select high-touch centers, complemented by a dense network of ATMs with extensive mobile services.

ONLINE MIGRATION

In the realm of everyday banking transactions, it is clear that the center of gravity is shifting away from the physical branch. From this perspective, retail banking is no longer tightly synonymous with branch banking. Consumers now freely roam between multiple channels to meet their banking needs, as underscored by our research:

- Thirty-eight percent of retail banking customers report a strong overall orientation to the online banking channel.
- Seventy percent of consumers first go online when researching banking products and services, up from 42% five years ago, and the consumer preference to use the online channel to check deposit balances jumped to 68% from 40%.
- Sixty percent of consumers primarily use the online channel when transferring funds, nearly double from five years ago.

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Online banking is facing a two-fold challenge. First, further progress in technology innovation and customer adaptation is needed, so that significant numbers of individuals, households and small businesses use the online channel as a true substitute for basic transaction services formerly delivered through the physical branch. The Internet becomes the safety net. Otherwise, how will banks permanently consolidate low-traffic local branch networks without losing myriad customer relationships altogether?

Second, the online offering must be strengthened to compete for high-value transactions, such as opening new deposit accounts and accessing retail bank credit, and the customer relevance and revenues they represent. When people go out into the local community, the selection of competing branches, while perhaps not restrictive, is usually limited. When they go online, by contrast, the banking options are virtually unlimited. Also, online retailers are finding more ways to insinuate financing options into their web site offerings, both bank and non-bank.

The point is that excellent functionality ultimately will be table stakes in capturing fair share of the retail banking revenue stream that is migrating online. Build it and they may not come. There is a whole set of strategy and marketing questions that will require much fuller management attention, centered on strengthening the online proposition for high-value retail banking services.

LOOKING AHEAD

Looking out over the next five years, it is clear that sweeping changes are in store for retail bank distribution. The customer online migration will continue to accelerate, including a much more prominent use of mobile banking applications for everyday transactions. Meanwhile, the branch role increasingly will center on high-value products and services, supported by a skilled, flexible staff and an authentic sales culture. It is time to say goodbye to former strategies centered on all-purpose branches.

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Ultimately, this is a journey that banks and customers will take together. Robust distribution strategy will critically depend on a nuanced understanding of varying perceptions and possibilities among major customer groups – such patterns will exert a pivotal influence on priorities.

Along with continued advances in customer segment *knowledge*, leading banks will take the next step of establishing a customer segment *dialogue* – grounding new propositions in customer preferences and then continuously adapting, depending on how customers respond and further refine their preferences.

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