Come Out a Winner in Retail Banking

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Today’s retail banking industry is in crisis. The symptoms can be ticked off like so many ingredients in a bad recipe: a lack of market growth, shrinking revenue pools, uncertain long-term liquidity, huge loan losses, tightening regulation, and sluggish value creation. What’s more, interest rates have dropped to their lowest level in generations. Where the profit decline will stop—and how long rates will stay low—is anyone’s guess.

These factors and others add up to a stark fact: the economic fundamentals of the banking business are changing. Not only are deposit margins being squeezed by low rates, but the ability of banks to recover is being compromised by hypercompetition for funding and pressure from regulators on fees. As a result, the search for profitability is tilting permanently toward the asset side of the balance sheet—where more difficulties await.

Indeed, although margins on the lending side are widening, bad debts are worsening as the results of poor credit decisions made over the past five to ten years come home to roost. The availability of credit has dropped, and underwriting and risk management have become more critical than ever. On a positive note, established brands will fare better than monolines or newer, attacker-type companies. But both attackers and incumbents will have to dramatically improve their sales and service processes.

The global trends in retail banking have crystallized. The industry’s focus is now on the following:

◊ Generating superior returns on assets
◊ Acquiring sufficient funding
◊ Enhancing risk management
◊ Understanding customers and regaining their trust
◊ Coping with increased demands regarding product transparency and overall service levels
◊ Achieving multichannel excellence with fully integrated banking channels
◊ Moving toward higher levels of industrialization (which is mandatory for rapid innovation and deployment)

These trends threaten the viability of many banks. But the trends are also creating opportunities for institutions that astutely adapt their strategies and implement change quickly, efficiently, and effectively. Such banks will come out of the crisis as winners in their markets. A first step in this process involves recognizing that the roles of core products and distribution channels are shifting significantly.

The Shifting Roles of Products and Channels

Traditionally, core retail-banking products played specific roles and served specific purposes. Today, these roles are changing. The same can be said for the roles of different channels. Let’s first take a closer look at product evolution.

◊ Savings Accounts. For many years, savings accounts provided wide margins from long-standing customers and opportunities to manage margins with new customers. Funding was mainly an afterthought.
Now, with profit margins from all customers being squeezed, savings accounts have become primarily a funding vehicle for the asset side of the balance sheet.

- **Checking Accounts.** In the past, checking accounts enjoyed standalone profitability, provided a source of new customers, and represented an anchor product for cross-sales. The key metric was volume. Today, checking accounts have become a secondary funding source for assets and a vehicle for maintaining long-term relationships with high-value customers. The key metric is customer quality. Retail banks that are unable to garner sufficient liabilities through savings and checking accounts will be constrained.

- **Unsecured Credit.** Traditionally, cards and loans were cross-sold to deposit and mortgage customers—at increasingly thin (and even negative) margins—to solidify relationships. They were vehicles for lucrative fee income and payment protection premiums. Today, they are a source of wider margins in the core product itself, funded by the liability side of the balance sheet. As banks attempt to rectify the loose credit standards of the recent past—and the havoc those standards have wrought—they are placing greater emphasis on managing underwriting risk.

- **Mortgages.** Mortgages used to be a source of margin from long-standing customers and a means of acquiring new customers in a competitive market. Losses were minimal as housing prices escalated. Today, mortgages are a game of microsegments for new customers—constrained by funding and compromised by risk but with wider margins across the book.

- **SME Banking.** In the recent past, SME banking was a transactional and lending-based business with very low loan losses, low funding costs, and many options for highly profitable growth in specialized lending. The key metric was book size. Today, SME banking remains attractive as a relationship-based, full-service business. Deposit gathering is highly competitive, but specialist lending offers high returns in exchange for high risk. The key metric is book quality and loss mitigation.

When it comes to the shifting roles of channels, the evolution is somewhat more subtle than in the products arena. It is more a question of emphasis. But one thing remains certain: a holistic multichannel strategy will continue to be paramount if banks hope to successfully navigate the current environment.

- **Bank Branches.** In the past, branches were focused on acquiring primary banking relationships, executing complex transactions, and generating sales through service. Today, they are increasingly focused on generating quality assets, managing credit risk, and retaining high-value customers. Emulating other industries that have successfully engineered low-cost variants, leading-edge banks are successfully deploying low-cost branches.

- **Direct Channels.** The online channel (as well as call centers, to some extent) was once the preferred channel for “commoditized” sales and simple transactions. It was also the channel of choice for certain segments. Now the online channel delivers a more tailored approach to driving sales and retaining high-quality customers, while also providing a simple, intuitive way to execute transactions at low cost. Institutions that succeed with direct channels make the effort to truly understand their customers and to react quickly to their preferences. They address the need for convenience and simplicity that so many customers seek. And, while banking via the mobile handset is still in its infancy, early adopters are already shifting to banks that are especially capable at offering mobile services.

As for other channels, intermediaries used to dominate mortgage sales, with agencies and joint ventures providing secondary sources. ATMs and IDMs mopped up simple cash and statement services. Today, intermediaries are being prioritized and radically repriced. There is less focus on agencies, and ATMs and IDMs are being used to manage costs and customize messages.

It is also worth noting that some institutions seem to have forgotten the link between physical presence and market share. We have found that a competitive share of physical presence (approximately three branches in a small city, for example) leads to a 10 to 14 percent market share across all products—in contrast to 3 to 7 percent in areas where the physical presence is sparser. Clearly, physical presence drives market share—with key sales-fulfillment and service roles being played by call centers and the online
channel. Moreover, despite the growing use of direct channels, branches will continue to be the most important channel for selling primary and secondary products through 2012. Branch-acquired customers will drive growing volumes of call center and online sales.

Ultimately, the current financial crisis is reinforcing the evergreen truths of retail banking. Understanding customers and gaining their trust—as well as scale, cost efficiency, risk management, and cutting-edge product capabilities—are more important than ever. We are also seeing a shift from the price-intensive, demand-driven climate of recent times back to the branch-based, relationship-intensive, supply-driven markets of 20 to 30 years ago.

True, there are some signs that the global financial crisis is beginning to abate. But retail banks must continue to prepare for any eventuality. They must also take action to position themselves for the postcrisis era and the next growth phase in the industry.

**Taking Action for the Postcrisis Era**

In BCG’s Collateral Damage series of White Papers, we have argued that companies in virtually all industries must take some fundamental steps not only to survive the crisis but also to emerge well positioned for the postcrisis era.1 Among other measures, companies must protect their financial fundamentals, safeguard their existing businesses, and manage for the long term. Let’s briefly review this general advice before addressing the opportunities for retail banks in particular.

◊ **Protect the financial fundamentals.** Ensuring adequate cash flow, access to capital, and liquidity is of paramount importance in weathering the current storm. A lack of liquidity creates obvious short-term problems, but sufficient liquidity is also vital to making smart investments. Companies must protect their cash with vigilance, rigorously manage credit risk, revisit and optimize their financial structure, and significantly improve risk management.

◊ **Safeguard existing businesses.** After securing their financial foundation, companies must take steps to safeguard the viability of their existing businesses. Ever since the recessionary environment began to present tall challenges, the most successful companies have not been afraid to act decisively. Among the actions they have taken is to revisit their cost structure and organizational efficiency, manage top-line revenue aggressively, adapt their product portfolios and pricing parameters, and explore the possible divestiture of noncore businesses.

◊ **Manage for the long term.** To be sure, the best companies do not just survive a severe recession or depression. They prepare themselves to thrive during the subsequent growth phase. Companies should consider three key actions to exploit the current downturn: investing for the long term, pursuing transformative and opportunistic mergers and acquisitions, and redefining their business models.

In our view, in addition to taking these broad measures, retail banks should set timelines for specific complementary steps aimed at leveraging the crisis to their advantage. Let’s look at which initiatives can be effectively tackled in the short, medium, and long term.

**Short-Term Opportunities.** Within the first six months of starting to reshape themselves for the postcrisis era, banks should consider the following initiatives.

◊ **Adopt principles-based cost reduction.** Many major retail banks have been carrying out cost-cutting programs since the crisis began. And cutting deeper can be devilishly difficult. But in our experience, at

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least one-third of total FTE costs typically stems from noncustomer-facing employees—and one-third of those costs can be cut with no negative impact on revenues or on the customer experience, all within a six-month period. The end result is trimming “a third of a third,” or about 9 to 10 percent of total FTE costs. In some cases, up to 20 percent of total FTE costs can be cut—with no “creep back” in subsequent months or years. The key is a four-phase process that involves establishing specific principles through which head count reductions can be identified and carried out without compromising the bank’s future. Hence, the method’s name: *principles-based cost reduction.*

**Bolster near-term risk management.** Banks should complete a business-by-business, line-by-line review and revaluation of their balance sheet. And they should concentrate on improving asset quality, managing costs, charging for risk, and growing the top line in their credit businesses (possibly by charging above the market rate). Finally, they should review all processes to improve efficiency and effectiveness.

**Create a performance-oriented culture.** Banks that emerge from the crisis with an established high-performance culture will be in the best position. A mandatory step is to clearly articulate the bank’s vision, values, and target behaviors. Also important is taking the steps necessary to boost motivation, align incentives accordingly, and retain key talent. A high-performance culture also aims to improve retention of the highest-value clients.

**Medium-Term Opportunities.** Between 6 and 24 months after starting to reshape themselves, banks should tackle the following initiatives.

**Strengthen individual business units.** This effort begins with reviewing product portfolios and pricing strategies in each business unit. Banks should also take steps to improve sales force effectiveness by means of scorecards, KPIs, and training and coaching. They should revisit their marketing and branding concepts and analyze their assumptions regarding customer segmentation, as well as review their CRM effectiveness and their cross-selling success (or lack thereof).

**Further tighten risk management.** Banks must extend and intensify the short-term steps taken to beef up risk management. But the object should not be merely to reduce risk. Banks should also focus on improving the quality of their assets. Achieving efficient distribution and sustainable volumes at acceptable risk levels is critical. And while risk-based pricing has been a popular concept for some time, far too few banks implement it systematically. What’s more, banks must establish a culture of true accountability and transparency, not only at the top but far down into the organization. Processes and reporting on key risk areas must become more efficient and effective so that corrective action can be taken while it can still make a difference. Finally, banks must leverage their technology and quantitative tools to lower both costs and risk.

**Reemphasize value over volume.** Leading banks are beginning to reorient their processes, targets, and incentives to focus on value over volume. In doing so, they must anchor their segmentation efforts in the needs and attitudes of their customers. They must develop processes to deepen customer ties, such as aggressive “onboarding” campaigns during the critical first year of the relationship, and adopt early tenure-management programs. Banks need to elevate the importance of customer service, behavior analysis, attrition risk modeling, and proactive customer retention. Introducing or enhancing such initiatives will help them maximize value and reduce their obsession with volume.

**Transform technology.** A major part of improving the performance of a bank’s information technology is ensuring that business strategy and IT strategy are aligned. Banks must prioritize their IT investments, establish internal service levels that are agreed upon by all parties, and carefully manage vendors and insourcers. To be sure, the downturn has created opportunities to build deeper, better aligned, and lower-cost relationships with a select few strategic vendors and insourcers.

**Optimize operations.** On the operations side, banks should align their call centers with their customer segments both to provide a truly differentiated service and to manage their high-value customers most
effectively. They must optimize costs by means of first-contact resolution, skills-based routing, and periodic and accurate root-cause analyses of failure demand. The deployment of more self-service and online options can lead to a reduction in unnecessary contact with customers, but it is not a panacea. Noncontact operations must be standardized and automated, and, where appropriate, outsourced or offshored. A lean, simple, and service-oriented operating model is an enduring source of competitive advantage.

**Long-Term Opportunities.** Two to five years into their postcrisis initiatives, as the economy recovers, banks must review their portfolio of business units and customer segments to capitalize on emerging opportunities that play to their specific strengths. They need to be extremely vigilant about controlling insidious cost increases in noncore areas. Divestments, acquisitions, and portfolio transformations must all be approached with a realistic view of the institution's resources and capabilities. This requires a clear and distinct strategy on how to create advantage for the bank’s sales and service propositions—one that is based on a deep understanding of customers’ preferences in a multichannel environment.

**Coming Out a Winner**

The downturn has tested the mettle of most retail banks around the world. Yet some institutions have weathered the crisis far better than others. Banco Santander, Standard Chartered, and Wells Fargo are among those banks that have taken concrete steps to emerge from the crisis well positioned. Still, many other banks that have not fared as well possess the capabilities and resources to right themselves—provided they take action now. And bold action it must be. Although financial downturns come and go, the current crisis is arguably the worst in the past 100 years, perhaps second only to the Great Depression of the 1930s. Indeed, the present downturn might be called the Great Recession. The road back to prosperity for the vast majority of financial institutions will be a long and arduous one.

Ultimately, retail banks must realize that the game has fundamentally changed—for good. Those that do not recognize the changing roles of products and channels, and that do not adjust their strategies accordingly given their particular resources and markets, will end up losers in the postcrisis environment. Those that face the reality that they must take decisive—and probably unprecedented—steps, both to survive and to once again thrive, will come out as winners. Which type of bank is yours?
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