

## Key Trends in Retail Banking

Growing a retail banking business is becoming increasingly challenging. The yield curve is flattening, reducing banks' net interest margin. Competition is intensifying, as new, non-traditional players enter the retail banking space. And consumer preferences for financial products, payment methods and distribution channels continue to evolve, providing revenue opportunities, but also introducing new operational challenges.

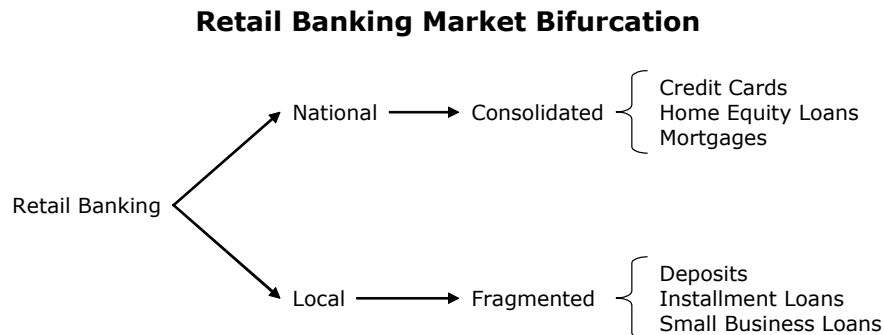
The changing dynamics of the retail banking business have significant implications for financial institutions. In order to successfully compete in this environment, banks must provide a distinctive customer experience and offer innovative product solutions in order to differentiate their value proposition in the marketplace.

This article identifies five key trends that are shaping the future of retail banking, and discusses the strategic implications that retail banks need to address now.

1. Bifurcation of the retail banking business
2. Lack of differentiation in retail financial services
3. Proliferation and growth of electronic payments
4. Continued growth of de novo branching
5. Increasing demand for ATM access

### ***Trend #1: Bifurcation of the Retail Banking Business***

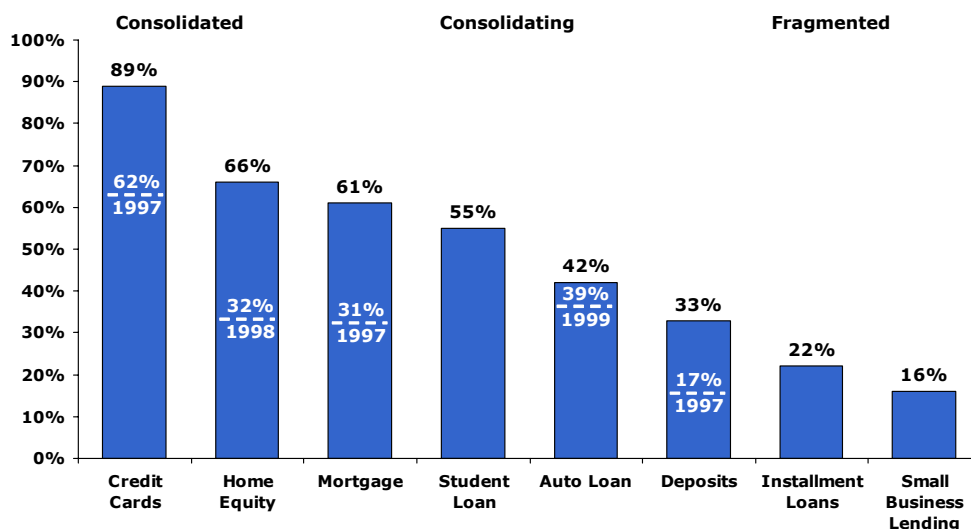
Historically, local banks provided deposit and lending services to customers within the bank's geographic footprint. Today, however, the market is bifurcating: deposit services and small business loans continue to be provided locally, while consumer lending businesses (e.g., credit cards, home equity loans, and mortgages) are becoming increasingly consolidated, with fewer national providers garnering an increasing share of the market.



In many consumer lending businesses, the top ten players now represent 60-90% of the market. For example, over the last seven years, the credit card industry has become highly consolidated, with the top ten players representing 89% of the market in 2004—up from 62% in 1997. Similar trends are occurring in the home equity loan and mortgage lending businesses. The top ten players'

share of home equity loans has reached 66%—up from 32% in 1998, and the top ten players’ share of mortgages is now 61%—up from 31% in 1997. In contrast, the market for deposits and small business loans remains local—and therefore fragmented—for now.

### Top Ten Players’ Market Share, 2004



Source: FDIC, Bankstocks.com

### Implications for Financial Institutions

Whether the retail banking business will remain bifurcated in terms of local versus national services, or whether what are currently local, fragmented markets will become consolidated, is still to be determined. Retail banks have already ceded the credit card and other consumer lending businesses to national providers—but it is not too late to protect their share of the core deposit and small business lending markets.

- FI**s need to act now! The deposit market is attractive, with returns on equity averaging 40-50%, and it is already attracting attention from large-scale lenders looking to lower their cost of funds by acquiring lower-cost deposits (e.g., Capital One, ING Direct).

Banks need to act now to protect their business from competitive threats made possible by ongoing technology advancements (e.g., remote deposit capture, Internet-based financial services), which will likely undermine the advantages of 'local banking' going forward.

- FI**s need to develop a stronger value proposition. Retail banks need to think about their business in terms of the customer experience. As many brick-and-mortar businesses have discovered, the advantage they have over remote or Internet retailers is a physical experience. Think Barnes & Noble versus Amazon.com: one sells books to customers looking for the lowest cost option, and facilitates selection using sophisticated algorithms; the other sells books to customers looking for a leisurely, tactile browsing experience, and facilitates selection with face-to-face interactions, coffee, and cushy chairs. Both companies are thriving.

In the world of financial services, Commerce Bank (NJ) has focused on enhancing the customer experience, introducing seven-day banking and extended hours, Penny Arcade coin counting machines, and restrooms—and seen dramatic results. Over the last five years, assets, loans and deposits have increased at an annual rate of 39%, 27% and 39%, respectively.

- **FIs need to capitalize on their local presence.** Consumers continue to rely on branches for new account openings—a fact that financial institutions can use their advantage. FIs need to maximize sales opportunities by exceeding new clients' expectations during the account opening/fulfillment process and cross-selling additional products and services early in the customer's relationship.

FIs also have another physical asset: their ATM network. ATMs have become a primary customer touch point, and FIs should complement their branch-based sales initiatives by leveraging this self-service channel—as well as their telephone and online banking channels—to increase customer awareness of their products and services and generate additional sales.

## **Trend #2: Lack of Differentiation in Retail Financial Services**

Many financial institutions are struggling to differentiate their value propositions in the retail banking market.

- Free checking is now offered by all or most financial institutions.
- Most institutions no longer charge for online banking or online bill payment.
- Extended branch hours are increasingly common in many markets, as banks seek to increase customer convenience.

Free checking and other services have increased value and convenience for customers, but they have not led to higher levels of customer commitment. As reported in J.D. Powers and Associates' *2006 Retail Banking Satisfaction Study*<sup>SM</sup>, only 28% of customers are highly committed to their bank. Simply introducing a product or dropping a fee won't produce sustainable differentiation; when the point of differentiation is easily imitated, consumers' 'loyalty' incentive is diminished.

Two exceptions are USAA Federal Savings Bank and Commerce Bancorp, both of which have successfully differentiated themselves in the market place. Both were high performers in the Retail Banking Satisfaction Study—73% of USAA's customers and 41% of Commerce Bank's are 'highly committed' to their bank. USAA has built a brand that focuses on providing exceptional customer service to U.S. military personnel and their families, while Commerce Bank has established its reputation as 'America's Most Convenient Bank'—and invested in a compelling customer experience to support that claim. Both are examples of organizations whose entire business system—their products, services, marketing message, and culture—is consistent, focused, and customer-driven.

### **Implications for Financial Institutions**

At the Best Practices conference in February, Doug Freeman, CEO of NetBank, emphasized that banks need to 'be different' to ensure long-term success and

build a base of committed customers. 'Being different' in retail financial services means creating a sustainable, unique position; being different is not necessarily based on a single product, a fee or lack thereof, but on a cohesive strategy focused on increasing customer value, designed to help the FI stand out in the market.

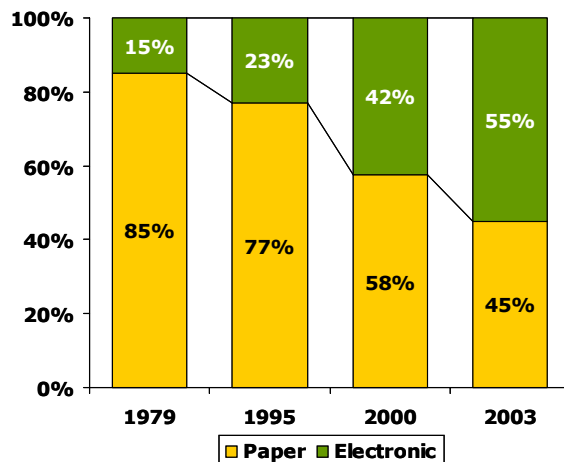
- **FIs need to engineer for value.** Banks need to determine what their customers really value and focus future investments in those areas. Which products, services and features can have the greatest impact on loyalty and create 'customers for life'? While the 'basics', such as maintaining a high level of ATM uptime or offering a competitive interest rate, are still important, doing them better than other institutions will not have the same impact on long-term customer loyalty as delivering greater value relative to the competition.
- **FIs need to develop and institutionalize a service culture.** Customer service is the most important lever of differentiation available to retail banks today. Banks need to develop a customer service strategy for their retail business, starting with a vision of how the bank will deliver great customer service and how all employees in the organization can support the vision. By providing a superior experience, banks can significantly impact customer retention and generate additional sales opportunities.
- **FIs may want to reward customer loyalty directly.** Consumers are increasingly interested in earning rewards, as the success of credit card loyalty programs has demonstrated. Financial institutions should capitalize upon this trend by implementing rewards programs for their deposit and loan customers. If properly designed, these programs can provide a strong incentive for clients to consolidate their account relationships and increase usage of bank products and services such as debit cards and online bill payment. These programs can also attract new customers and help differentiate the bank from other institutions, as Citibank is doing with its 'Thank You' program and National City is hoping to do with its new 'points from National City' program.

### ***Trend #3: Proliferation and Growth of Electronic Payments***

In the last 25 years, the range of payment methods available in the market has exploded. In addition to cash, checks, and credit cards, consumers can now use one of an expanding array of electronic payment options that includes debit cards, prepaid cards, online bill payment, automatic bill payment, and P2P services.

Consumers' adoption and use of these payments has increased significantly over time, often at the expense of more established payment methods, dramatically altering the payments landscape. According to the Federal Reserve, electronic payments accounted for only 15% of all non-cash payments in 1979. In the last 25 years, electronic payment methods' share of wallet has increased, from 15% in 1979 to 23% in 1995 to 42% in 2000—most recently reaching 55% in 2003.

## Non-Cash Payments Mix, 1979–2003



### Electronic Payments:

#### Annualized Change in Percentage Points

1979–1995	+0.5
1995–2000	+3.8
2000–2003	+4.3

Source: Federal Reserve

Consumers' shift to electronic payments is being driven by increased use of debit and electronic bill payment. In stores, consumers are increasingly choosing PIN and signature debit—and 33% of consumers report that debit is their 'most frequently used' payment method at the point of sale. Even in the bill payment space—where checks have long held a dominant position—online bill payment and automatic payments are rapidly gaining ground.

### Implications for Financial Institutions

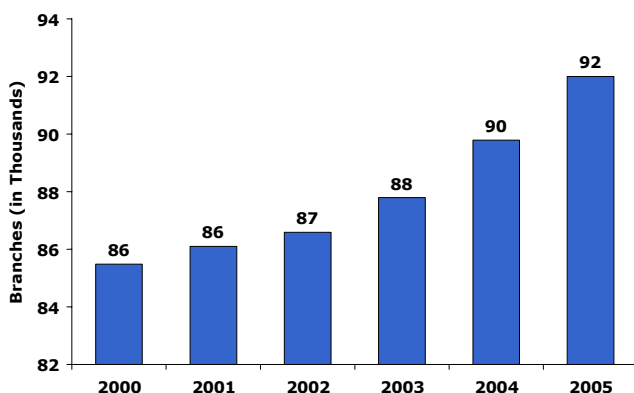
Today, consumers have more choices when it comes to making payments than they ever have before. As a result, managing payments has become increasingly complex—banks need to develop strategies to grow their existing payments businesses and develop new revenue streams, while managing their processing capacity for declining check usage.

- **FIs need to optimize their existing payments businesses.** FIs should eliminate the silo mentality that often limits their ability to maximize payments-related revenue. FIs need to organize around the business of payments and implement tactics to influence how customers choose to pay. Executing this strategy will result in a better-aligned payments business system and increased profitability of existing payment products.
- **FIs need to develop new payments businesses.** Banks need to develop a better understanding of their customers' payments needs. Having accomplished this, banks will be able to offer new payment products and services that provide greater value to customers, while also generating additional fee revenue and net interest margin. For example, Health Savings Accounts (HSAs) and payroll cards are relatively new payment methods that are gaining traction in the market, and that are projected to grow significantly over the next several years.

## Trend #4: Continued Growth in De Novo Branching

Large banks are continuing to open a number of new branches, with the rate of expansion significantly exceeding population growth. The number of branches in the U.S. has grown 1.5% annually over the past five years, three times the average annual population growth rate of 0.5%. There are no signs that this branch growth is abating, as banks with the largest branch networks plan to open as many as 1,324 de novo offices in 2006.

**U.S. Bank Branches, 2000-2005**



**2006 Branch Network Activity  
Top 21 Branch Banks**

De Novo Branches	1,117 – 1,324
Branch Closings	251 – 261
Net Change	926 – 1,063
Total Branches	34,846
% Change	2.7 – 3.1%

Source: Second Curve Capital

Banks looking to expand their branch networks need to be concerned about several factors that may impact the long-term viability of de novo locations.

- **Lower deposit growth:** Retail and small business deposits are projected to grow 2-3% per year for the next several years, significantly less than the 5-6% annual growth seen several years ago.
- **Market saturation:** In some markets, branch growth has been significantly greater than deposit growth, thereby resulting in lower deposits per branch as market demand is spread over a larger number of locations. If net interest margins continue to tighten, this trend could contribute to lower profitability for new branch locations.
- **Declining branch usage:** Consumers and small businesses are increasingly using self-service channels and electronic payments, reducing their need to visit branches. Branch transactions will decline even further as businesses adopt remote deposit capture and consumers utilize ATM deposit check imaging.

### Implications for Financial Institutions

Meeting or exceeding expectations for de novo locations will become increasingly difficult. Financial institutions need to refine their distribution strategies to ensure that new locations deliver their expected return on investment.

- **FIs need to evaluate their distribution strategy.** Banks need to implement a rigorous, analytical methodology in developing their branch distribution strategy and determining where to open new branches and close

or relocate existing offices. As recent research suggests, traditional factors such as household growth and branch density are poor predictors of de novo branch performance. Instead, FIs need to evaluate 'same store sales growth' of their branches, and focus on expansion in markets where their existing locations are performing well. At the same time, institutions also need to re-invest in their existing brick-and-mortar locations and determine how to improve same store sales of lower-performing locations.

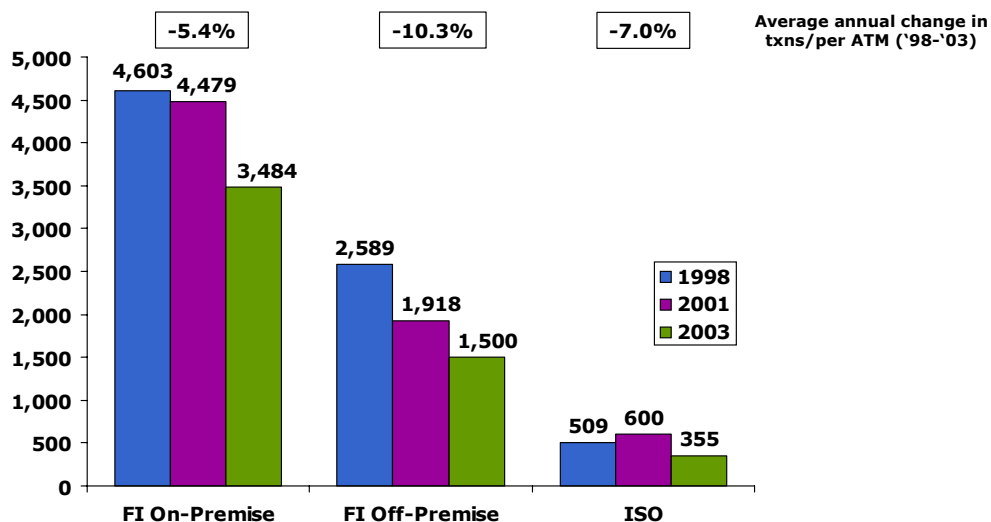
- **Banks may want to reevaluate their branch format.** Given the declining importance of branches for routine transactions, FIs need to reposition branches as sales centers, as institutions such as Umpqua Bank and Washington Mutual have already done. Branch designs should increase customer awareness of the bank's full range of products and services in order to capture additional sales opportunities, while also creating an environment that facilitates greater interaction between customers and branch personnel.

Of course, for leading banks, branch distribution and format go hand in hand, with smaller, lower cost 'spoke' branches complementing and re-enforcing the effectiveness of traditional 'hub' branches.

### Trend #5: Increasing Demand for ATM Access

With 396,000 ATMs in the U.S., consumers can almost always *find* an ATM—the question is whether or not they can find a *free* one. As surcharge fees and foreign fees increase, consumers are becoming increasingly averse to using a different deployer's ATM, and are increasingly demanding free access to ATMs. This demand places pressure on financial institutions to expand their ATM networks to meet customer needs for convenience. At the same time, however, per-ATM transaction volumes have decreased, as deployment growth has outpaced transaction growth, placing downward pressure on ATM network profitability—which, in turn, has made the business case for new off-premise ATMs less attractive.

**Average Monthly Transactions per ATM, 1998-2003**



Source: 1999, 2001, and 2004 Dove ATM Deployer Studies

In response to these trends, FIs are pursuing alternative ways to expand their customers' ATM access at a lower cost.

- **Surcharge-free alliances:** Alliances such as Allpoint provide member institutions the ability to provide customers with surcharge-free access at a larger number of ATMs.
- **ATM branding:** FIs are partnering with independent ATM deployers such as Cardtronics to place their brand names on third-party ATMs, enabling banks to quickly expand free ATM access for their customers at a lower cost than deploying their own ATMs.
- **Surcharge rebates:** Some institutions are refunding surcharge fees incurred by customers at foreign ATMs (in some cases, only for customers with certain types of accounts).

### **Implications for Financial Institutions**

ATM convenience is a very important factor in a customer's decision to select a financial institution. Banks need to develop strategies to enhance ATM access—and banks that choose to invest in ATMs as a strategic delivery channel should focus on increasing the channel's value as a vehicle for enhancing customer relationships.

- **FIs need to develop a comprehensive ATM access strategy.** FIs need to determine how many ATMs are needed in their footprint to meet customer needs and remain competitive. FIs should evaluate different deployment options and determine which approach best fits with their strategic and financial objectives.
- **Some FIs will want to focus on increasing the value of the ATM as a customer touch point.** The ATM is consumers' primary channel for obtaining cash—and to date, consumers have demonstrated little interest in non-financial functions at ATMs (withdrawals, deposits, transfers, and inquiries account for 98% of all ATM transaction volume). Rather than adding new functions, banks that have chosen to invest in their ATMs as a strategic channel should focus on improving and personalizing the ATM customer experience.

As ATM technology becomes more flexible, banks will have more freedom to customize messages and promotions via the ATM. Given the frequency of ATM usage, deployers need to determine how to best leverage the ATM as a sales channel—particularly as fewer customers are exposed to branch sales messaging.

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Success in retail banking will require the development and execution of new strategies that provide compelling value for customers and better leverage bank resources. In particular, senior management needs to take a more holistic view of delivery channels and payments businesses in order to better meet customer needs and improve financial performance. By acting now, financial institutions will be well-prepared for the future of retail banking.

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