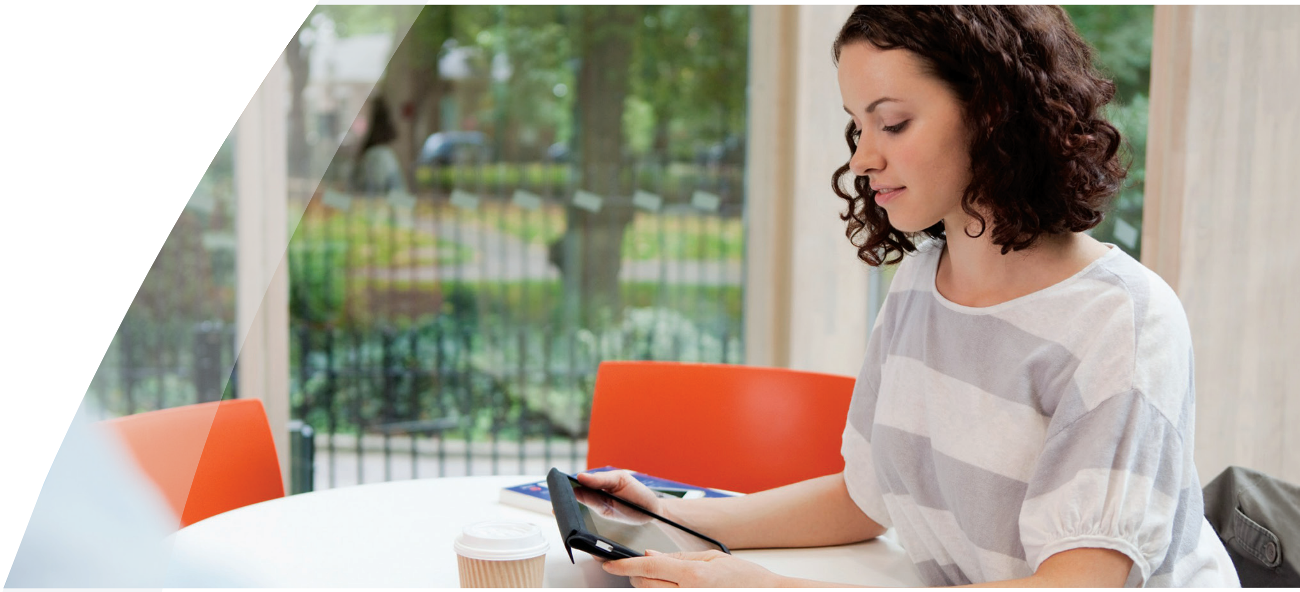
Kurt Salmon

Reinventing Retail Banking in the U.S.



The retail banking industry is in the midst of the most profound set of changes in its history. A challenging economic and regulatory environment, changing consumer behavior, new business models disrupting the traditional order, channel shifts and the rise of digital—these forces are reshaping the industry so dramatically that it will be hardly recognizable in a matter of years. And in this dynamic environment, standing still is no longer a viable option.

Instead, banks must pursue game-changing initiatives, including developing an omnichannel customer experience, transforming branches, redefining pricing for retail products, courting the mass affluent segment and revamping loyalty programs.

To effectively accomplish these strategic goals, retail banks will also need a new set of tools, including improved analytics and market analysis capabilities and an effective test-and-learn approach, all supported by an integrated IT platform.

At first glance, this feat may appear overwhelming but the alternative would be slowly losing relevance and market share to those banks that are able to respond.

A Challenging Environment

U.S. retail banks are facing five trends that are changing the way they do business, putting profitability at risk and driving the need for significant change.

I. Economic and regulatory changes

Yes, the economy is recovering: household balance sheets are displaying solid equity, the housing market is slowly improving and corporate balance sheets are showing gains. However, unemployment remains persistently high and continued political uncertainty may weigh on consumer confidence in the months to come.

Moreover, impossible to ignore are the unprecedented number of regulations taking their toll on bank profitability. Complying with Dodd-Frank, the Durbin Amendment, Regulation E and new rules from the CFPB all come with hefty price tags for banks and, combined with continued efforts to increase transparency, can drag down profitability. Plus, large banks will be hit with a significant cost in their efforts to comply with "too big to fail" living wills, while smaller banks may find their very sustainability in question as a result of the costs.

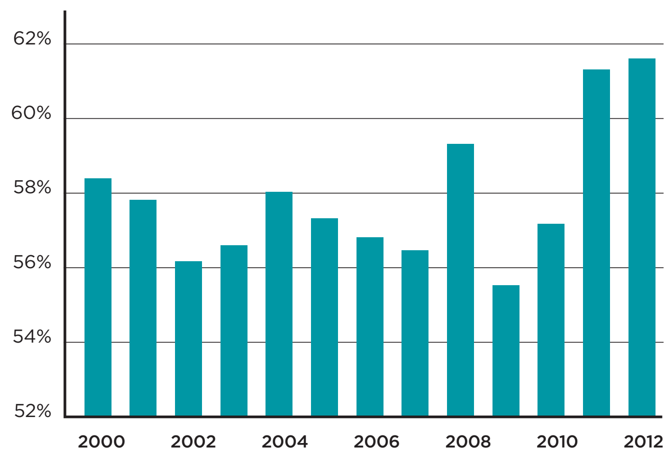
Finally, lower interest rates have squeezed deposit margins, as deposits are historically 100 to 150 basis points lower than federal rates. While banks are flushed with these low-margin deposits, demand for commercial loans has dropped in the wake of the recession.

All these factors add up to cut into bank profitability. Consider that in 2012, the return on equity (ROE) of commercial and savings banks was only 9%, according to the FDIC. Indeed, this is an improvement from the 8% ROE of 2011, but is still a far cry from the ROE enjoyed pre-recession, which ranged from 12-15%.

Regulations are a key contributor to this lackluster ROE. For example, Standard and Poor's Ratings Services has calculated that Dodd-Frank compliance alone could reduce ROE by 2 percentage points at a large bank.

Even more alarming is that the combination of moderate revenue growth, declining margins and increasing costs has driven up cost-income ratios to unprecedented heights.

Banking Industry Efficiency Ratio (%)



Source: FDIC

II. A new competitive landscape

The U.S. remains over-banked—according to the FDIC, there are almost 6,800 commercial and savings banks. However, large institutions are pushing to consolidate in this fragmented market—as the number of branches slightly dropped post-recession, the number of deposits continued to grow.

These trends will likely continue as new entrants shake up the market. The new players—including direct banks, mobile operators, technology companies (like Google and Facebook) and personal finance platforms (such as Mint.com)—are trying to secure a position in the banking value chain. New competitors pose credible threats – consumers are now taking out life insurance policies and using prepaid cards issued by Walmart while capitalizing on home improvement loans from Home Depot. These business models are targeting the unbanked/underbanked/unhappily

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banked customer segments offering a wide variety of banking products to a receptive consumer.

III. Channel shifts to "phygital"

Distribution models overly reliant on branches are becoming increasingly hard to sustain. According to SNL, this is because average monthly transactions per branch have fallen 40% since 2000, fueled by explosive growth in mobile and internet channels. Additionally, the FDIC reported that the number of households supported by each branch has dropped 6.5% since 2003. This has created a system with many unprofitable branches. Consider that 15,000 of the 90,000 branches are unprofitable and account for less than 2% of all deposits.

However, the branch concept is far from obsolete. According to recent research by the Federal Reserve Board, 46% of consumers cited "location of their offices" as the main determinant for choosing their primary banking provider. In fact, branches can be incredibly useful in growing sales, especially among the affluent and SME segments, which tend to be older and less comfortable banking electronically. Plus, engaged customers who visit the branch frequently are more likely to own more products and recommend the bank to friends and are less likely to jump ship. Gallup research shows that among consumers who visit a branch more than once a week, the sales conversion rate is 90%, versus just 64% among those who had not visited in the past six months.

These two divergent factors create a dilemma that is not easily solved. On the one hand, most banks likely have branches that are too expensive and could easily be eliminated to cut costs but this could jeopardize product sales and new customer acquisition.

IV. Changing consumer behavior

Consumer expectations are growing, spurred by new technologies and a proliferation of innovative, personalized customer experiences in other industries, such as retail. Currently, many banks are struggling to rise to the occasion. They have failed to dramatically change their customer experience and continue to carry the stigma of pre-recession excess. Not surprisingly, national banks with branches have an average net promoter score (NPS) of only 13% compared to 88% for USAA, the current leader in "customer delight" according to Forbes. These negative sentiments are further complicated by the presence of social media, which serves as a bullhorn for each unhappy customer and creates reputational risk for banks.

V. Digital adoption

Online and mobile banking are growing rapidly, and bringing with them new imperatives for banks to step up their digital presences. There are 72.5 million consumers now using online banking services, up 514% from 2000, according to Fiserv. Online bill pay is used by 36.4 million, a growth of 674% in the same time period. Mobile banking is also on the rise. In fact, 38% of mobile phone owners use mobile banking, an increase of 100% since 2010. Digital adoption is also changing the traditional purchase funnel, with a growing number of consumers turning to digital channels for research and application.

The Path toward Transformation

In light of these game-changing trends, the industry must keep pace and make some important adjustments of its own in order to remain profitable. We have identified five major areas that banks should be actively working to transform over the next few years.

1. Building the omnichannel customer experience

Customers are using multiple channels to interact with banks, and this trend will endure in the coming years as online and digital channels continue to grow rapidly. In fact, according to a recent American Banker Association survey, 38% of consumers expressed high interest in virtual banking and 56% are keenly interested in social banking. And according to the FDIC, 25% of consumers would like to use their phones to track their finances on a daily basis. Currently, consumers have responded to new mobile features like remote check deposit via photos, real-time expense tracking and money management and location-based features.

Indeed, there is room for improvement by taking a holistic and integrated approach to deliver a seamless omnichannel customer experience. Think of it as bringing the branch to the internet and the internet to the branch. Bringing the branch to the internet includes developing dedicated social media pages for each local branch and customizing the bank's site based on home branch information. Bringing the internet to the branch includes allowing online or mobile appointment scheduling, enabling consumers—and associates—to access all online platforms from the branch and developing digital community announcements and merchant offerings with links back to the branch.

Chase has evolved its leadership approach to support omnichannel integration, shifting from "see more, sell more" to "see more, help more". The management team, customer-facing employees and support team all abide by a set of five rules for a great customer experience and rely on a data-driven approach to solving problems and strengthening branch service. Using these tenets as a foundation, Chase set about improving the customer experience by focusing on significant pain points (including ATM availability and claims processing) and holding roadshows and town hall meetings to reward positive branch customer experience. As a result, Chase's net promoter score increased from 60% to 75% and the cross-sell numbers increased from 7.2 to 7.6.

Going forward, Chase plans to continue to improve the customer experience by developing new technology to upgrade self-service, delivering more 24/7 ATMs, and enhancing service to the affluent and SME segment with specially tailored branches.

Drawing from our experience in this area, implementing a robust omnichannel/digital solution also requires several critical success factors:

- Identifying the right mix of resources and tracking of economics
- Aligning the organization by positioning omnichannel/ digital strategy in the forefront of the business
- Developing the right governance structure and organizational model
- Installing the right set of processes and adopting a test and learn approach
- Providing a strong vision and culture for team members

Further, preparing for the future requires the implementation of a few key digital initiatives. This may include establishing a digital branch or digital flagship, enabling branchless banking, developing personal finance management tools and education tools on multi-devices, and creating innovative payment strategies.

2. Transforming the branch and ATM network

As discussed, even though branches are necessary drivers of new customer acquisition and deposits, today's branch could become more profitable by modifying its size, layout and format. This translates into a high density of smaller branches in urban areas and select flagship branches in key areas with ultra-high foot traffic. When it comes to the actual design and activity of the branch, banks can take a page from retailers in terms of developing spaces that encourage interaction and engagement and are designed to promote conversion and cross-selling. One way to effectively accomplish this is by enhancing customer segmentation—creating dedicated spaces for each segment within the branch so that each customer feels they are being treated as an individual who is given a personalized experience. This personalization carries over into financial review and advice, both of which can help increase cross-selling.

In terms of technology, there will be continued emphasis on investing in self-service kiosks and ATMs as part of branches, plus significant investment in mobile banking application development and promotion. Analytics can help uncover where ATMs— and the branches themselves—should be placed to most effectively target key segments.

Finally, banks should strive to provide services that are more customer-centric, instead of defining them by traditional organizational and product silos.

There is no "silver bullet" approach to branch transformation, as a glance through the programs of several major banks will indicate.

US Bank manages a network of standalone "on-site" branches located in malls, corporate sites and universities. Twenty eight percent of US Bank's branches fall into this category, and they generate 30-40% of the bank's income while costing 20-25% of a traditional branch.

Citibank, on the other hand, is investing billions in building new branches and refurbishing old ones, *Banks should strive to provide services that are more customer-centric, instead of defining them by traditional organizational and product silos.*

upgrading technology and staff training and sponsoring community groups and events, all as part of a larger strategy to better tailor the brand design and customer experience by segment.

TD Bank focuses on convenience—offering more customer-friendly hours in convenient residential neighborhoods and the launch of "green products" to promote environmentally friendly branches. For example, TD Bank is delivering a fleet of ATMs aimed at minimizing its ecological footprint. All of their new "Green Machine" ATMs are backed by wind power and have envelope-free deposit capabilities.

Chase is planning on rolling out 2,000 new branches in the next five years with a focus on key growth areas such as Florida and California.

Bank of America is focusing on mirroring the retail sales environment—its associates sell aggressively and store expenses, including staff, are allocated to whichever products are represented within.

Similar to these competitive examples, banks can set up effective game plans to execute successful branch transformations. This may include branch design, technology integration, service model development, and customer experience. In terms of branch design, small, low cost branches are becoming more popular with banks. In fact, many banks are beginning to leverage retail store concepts and architecture to propel the growth of alternative branches. Banks are also investing in emerging technologies (e.g., automated self-service kiosks, mobile/social media) to deliver integrated technology offerings. In addition, dedicated product offerings for specific segments, such as affluent customers, require the build-out of a separate servicing delivery model. Lastly, and importantly, the drive to develop stronger customer relationships is the topline reason behind the need to transform branches.

3. Ensuring fair-value pricing

The economics of deposit account service charges is quickly becoming unsustainable. According to *American Banker,* after more than a decade of steady growth, average deposit account service charges have dropped 18% since 2009, and show no sign of rebounding post-recession. This drop is driven by a decrease in debit interchange and overdraft fees. Further, 59% of consumers spend absolutely nothing on monthly bank fees. Meanwhile, the cost of opening and maintaining an account (around $150-200 and $250-300, respectively) has not changed for banks.

In this environment, banks must restructure their pricing to ensure that revenue outpaces cost to serve. This starts with a careful re-evaluation of the fair value of services provided. Another consideration is the sensitivity consumers have towards fee changes, particularly when it is not in their favor. Perhaps more important is the re-education of consumers on the actual value of these services. It is also essential to differentiate pricing based on customers' backgrounds and improve profitability by striking the right balance between services that can be delivered remotely rather than at a branch.

Union Bank has had success unbundling its checking account product to deliver individual services for additional fees based on the value of the account. This "build your own" checking account model gives customers greater flexibility and control and helps Union Bank pull in additional fee income.

Identifying the right pricing structure is crucial for retail companies. For banks, several criteria must be considered before choosing a pricing strategy: current market maturity, existing market share, bank commercial strategy, customer price perception and IT impact. Once determined, it is then key to align pricing with a well- defined business strategy and develop a deep understanding of what motivates customers. This exercise may also help establish the maximum price the company can charge for a given product. Parallel to this strategy should be the development of data models and pricing tools, formalization of decision processes, utilization of a test-learn approach, and communication of the value of the package, *all essential to banks' success*.

4. Unlocking the potential of the mass affluent segment

The mass affluent segment holds tremendous revenue potential for banks. Defined as the 11% of Americans with assets between $250,000 and $1 million, these customers' household incomes increased 2% in the last two years and show potential for continued growth in the future.

Likewise, these consumers are more likely to use products beyond just checking, including savings and investment products like brokerage and retirement services.

But today, most banks are not meeting the specific needs of this segment. The primary obstacle for many banks in securing a deeper relationship with the mass affluent is their perception that banks offer a one-size-fits-all value proposition.

Instead, banks that pursue differentiated offerings, services and experiences will be best positioned to woo this segment. This may include developing segment-specific products and services based on customer demographics and behavioral patterns, delivering a dedicated team of advisors with accurate and timely customer information, or leveraging online communities to gain customer insight to enhance value propositions.

Let's take a page from Chase's Private Client program, which delivers a compelling customer experience tailored to the mass affluent segment. First, the branch space itself feels more luxurious. Chase repurposed existing branch space to create more than 3,000 Chase Private Client offices and 400 conference rooms where customers can meet with dedicated teams of advisors and discuss customized products that leverage the reputation of JP Morgan for investments.

From our perspective there are select players who have successfully developed mass affluent approaches and this has created a competitive urgency for banks that have chosen *not* to offer more tailored products and services. To assist our bank clients in addressing the specific challenges of the mass affluent segment and heighten customer satisfaction, we have designed client-centric service models (e.g., dedicated relationship managers), transversal products and services, and dedicated products and services with changeable offers and distinctive customer experience by market.

5. Aligning loyalty programs with the next generation of digital adoption

Loyalty programs need to be reshaped to increase customer engagement through omnichannel offers, cash back programs, events and other services enabled by digital devices and customer analytics.

We expect leading banks will continue to deliver innovative loyalty programs to enhance brand image and customer stickiness and differentiate themselves from competitors in local markets. Best practices include using the program to spur links to products, such as earned points for having multiple products or allowing consumers to redeem points to reduce their credit lines as well as across a full set of products, including funds and mortgages.

Equally important is ensuring any loyalty program is available via mobile devices. This provides additional opportunities for customer engagement through mobile coupons and localized offers while also giving banks the benefit of reduced program costs and increased brand stickiness through daily program use. Social media is also a must for any successful loyalty program because of its potential to increase customer engagement while giving banks valuable data in real time that can be used to broaden customer insights and deliver customized programs.

For an example of a next-generation loyalty program, look no further than Citi's Thank You program. The program is designed to give customers flexibility and control, and lets users share points with friends and features an online 600-retailer mall where points are earned for purchases. Customers can redeem those points for cash back, charitable donations, and gift cards or apply them to their statements, student loan or mortgage payments.

Across the U.S. and throughout Europe, our clients are highly focused on initiating or enhancing their existing loyalty programs with specific investment in market and customer analysis, loyalty program design and implementation, reward program design and go-to-market strategy, and value proposition development.

Getting There

Of course, designing and implementing all of these will require a new set of capabilities.

Leveraging Customer Insights and Analytics

Better data can inform everything from branch design to loyalty programs to pricing. To successfully design and implement more effective customer segmentation and

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customer experience, banks will need to better leverage their customer data. This includes developing and analyzing customer surveys, optimally leveraging bank transactional data and data from other sources, like social media, and using it to define a suite of targeted products or services.

In order to successfully execute these initiatives, banks will need to be able to develop accurate customer segments and strategies and value propositions targeted to those specific segments.

To help our clients improve their customer insights and service and delivery quality, Kurt Salmon partners with solutions provider Yseop which specializes in natural language generation and analytics. Yseop automatically formulates individual recommendations in natural text and delivers detailed and personalized write-ups of customer interviews. These solutions enable banks to better service their customers and improve product sales (e.g., the solution automatically proposes personalized offers based on customer situations).

Developing Dynamic Localized Market Analysis

To succeed, banks will need to develop competitive benchmarking on products and services, market intelligence to capture information on products, channel and customers, and understand market-by-market trends and operating forces.

Developing a localization strategy is essential to compete in a rapidly evolving landscape. Localization requires taking a holistic approach to enhance customer value proposition for specific segments via changes in communication and branch experience, and tailoring offerings to meet customer preferences based on customer insights. To accomplish this, banks must understand the customer, align their localization operational strategy, embed localization as business as usual (BAU) and employ a test and learn strategy.

Integrating the Technology Platform

Winning banks need to develop an organizational model that supports innovation. This will require integrated business and technology platforms across the rapidly growing set of systems that comes with each new customer touchpoint. It is equally important to ensure support staffs develop the skills necessary to handle these new IT systems. To sure up success, banks will need to develop a strong vendor management function and develop specific business use cases and a clear governance structure.

In our opinion, banks should anticipate and prepare to meet the needs of the next generation of clients. These clients are digital natives who have never known a world without the internet. This will motivate banks to move away from traditional banking interactions to direct bank and branchless models. Additionally, banks should enable clients to conduct remote discussions with specialists in branch terminals. These new trends will promote technology platform integration and new service model delivery.

Delivering Effective Execution

Finally, any successful bank will be well-positioned to take strategies from concept through completion. This includes designing a test-and-learn approach, assessing the current operating or service model and developing a transformation plan to fill in the gaps. Doing this successfully will require mapping and allocating resources towards implementation and a strong alignment between the IT organization and overall business objectives.

Conclusion

An unprecedented combination of forces—economic, regulatory, consumer and technological—is pushing retail banks to change.

Kurt Salmon believes that retails banks must be willing to transform their businesses to position for future growth. Retail banks will need to formulate omnichannel, customer experience, pricing, branches, loyalty programs and affluent customer strategies, perhaps borrowing from their retail counterparts to discover how to better meet customer expectations without risking profit. And to effectively accomplish these transformational efforts, banks will also have to strengthen their analytical and market analysis capabilities, integrate technology across channels and develop an effective execution program. This is no easy feat but transformation will be critical in creating competitive advantage for retail banks.

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