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To an Analog Banker in a Digital World

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To an Analog Banker in a Digital World

What happened to recorded music is about to happen to you. But only a few banks are making the right moves from branches to online services.

by Catherine Palmieri

There is a tale I like to tell people in the banking industry about change. According to a family legend, one of my mother's aunts was Henry Ford's neighbor in the early 1900s. Her husband was a successful businessman, and one day Ford asked them to invest US$100 in his Model T automobile. This was equivalent to about $18,000 today—not a small sum to give a neighbor with a harebrained idea. My great-aunt and her husband evaluated the opportunity for some time, and then told Ford no. They sincerely believed no one would ever buy a car; there was simply too much infrastructure supporting traditional means of transportation, and consumers were clearly quite comfortable with their horse-drawn wagons. In other words, they made a rational business decision, based on observations of consumer behavior, the business environment, competition, labor, and demand.

I think of this story when I hear bankers defend retail distribution against online or mobile banking. Consumers, they say, prefer branches. Yet every day, in New York City, I walk past bank branches with no customers inside. Empty branches are all over the U.S., and as financial-services (FS) industry trends continue—as the alternatives of Internet and mobile banking grow—branches will soon become obsolete.

Most bankers I know understand that a major change is taking place with consumers, and that they face imminent disruption from digital technologies. But they don't fully know how to respond. Their backgrounds, which have been typically bound up with the branch-building policies of the past 15 years, have not prepared them for the decisions they need to make today. Naturally, they are ambivalent in the face of seeming uncertainty. For example, should they balance their existing branches with an investment in digital services, or should they start selling off their real estate now? The right answer is different for each firm, depending on its strengths, its customer base, and its current footprint. Those that recognize which aspects of their business are subject to change, and act accordingly, will lead the industry and thrive.

To understand how to distinguish successful digital strategies from those that will not work, it is important to understand one basic principle: Although consumer needs remain constant, technology changes the way those needs are met. The fundamentals of banking have not changed since the Templars, a Christian order of knights living in the 12th and 13th centuries, who ran what was perhaps the first multinational bank in history. The Order of the Knights Templar built their business around basic consumer needs: security and access to cash. Pilgrims from Western Europe heading to Jerusalem after the Crusades were easy prey for robbers, especially given the amount of cash they needed to carry for the trip. Because of a previous role as crusading knights, the Templars were exempted from local laws by papal decree, and this enabled them to create an international financial system. Pilgrims could deposit money in London, and then, with a secret password, go to the Templar office in Paris, Athens, or Jerusalem, and make a withdrawal. Word of the Templar bank quickly spread, and soon kings, princes, and even popes were depositing funds there. The Templars deployed this cash by investing in land and lending to small businesses (investment banking); they were involved in manufacturing, import, and export; they had their own fleet of ships; and at one point they owned Cyprus.

In the early 13th century, the Templar story ended abruptly when the group lost their papal support and privileges, and King Philip IV of France (who had inherited a huge debt to them) turned against the order. On October 13, 1307, hundreds of Templars were arrested for heresy and many were killed; five years later, their grand master was burned at the stake. But their model of long-distance banking lived on; you invoke it every time you use a PIN to access cash at an ATM.

Banking Innovation Basics

All the financial-services innovations since the Templars—including letters of credit, checking accounts, travelers' checks, credit and debit cards, ATMs, online banking, and direct deposit—have addressed the same three basic needs:

- The security and safety of capital, and access to that capital when and where it is needed.
- Leverage, or access to capital to fund growth (either personal or for an enterprise).
- Deployment of excess capital in search of greater returns. Although this activity is highly important to the enterprise holding the capital, it is needed by only about 20 percent of banking customers.

Those needs may not change, but the ways in which banks satisfy them can change dramatically, and often do. The FS institutions that thrive during the next few years will be the ones that understand which aspects of their business are subject to complete disruption—and which aspects will remain intact.

Even 10 years ago, it was possible to see how technologies such as broadband, mobile phones, and Internet video would change the delivery of financial services. As electronic transactions grew more popular, the need for paper (cash and check) transactions and face-to-face interactions would diminish. Much of this shift has already come to pass. Digital download speeds have evolved from 56K dialup modems to 4G mobile capabilities. As of 2011, according to CTIA–The Wireless Association, the total number of wireless subscribers in the U.S. (328 million) exceeded the population (316 million). The default choice in many retail transactions is home delivery. *Face-to-face* has come to mean anytime and anywhere, via Skype, video chat, or, soon, Google Glass. And currencies? Facebook credits, mobile payments, and Bitcoin all demonstrate the rapidity with which digital currencies and frictionless exchanges can emerge.

In that context, it is astonishing how slow many FS firms have been, compared to other industries, in adapting to technological change. While music stores, electronics stores, and other retailers have reduced or even eliminated physical distribution, large banks have expanded it, either through acquisition or by opening their own bricks-and-mortar branches. Even as firms have consolidated, the number of bank branches in the U.S. has risen steadily, reaching a peak of almost 100,000 in 2009. From 2002 to 2012, the top four banks doubled their number of branches. To be sure, all of the largest banks in the U.S. now offer some form of online banking, but most have added branches at the same time. Based on the measurement of deposits per branch (which is a good proxy for the number of customers, because deposits are the core of FS relationships), these new branches have not translated into operational efficiency or a much larger customer base. I know of one major bank which led the industry in deposits per branch in 2004 (more than $300 million) and then lost that leading position to its rivals as it built up its branch network and ignored its digital distribution. Its efficiency ratio of deposits now stands at about $150 million per branch, half its 2004 ratio. Dependence on branch distribution has also been complicated with the Dodd-Frank Act; as revenue streams have disappeared, branch managers seeking a balanced P&L have pushed more aggressive cross-selling of products, even if those products are unprofitable.

In short, although every bank can point to improved performance in some respect, the performance that matters most has grown fastest for the banks that pruned their branch networks and expanded their digital capabilities—especially since 2009. Having fewer branches does not cause customers to flee, nor does it lower assets; it is the first step toward survival.

Yet, many financial institutions and their managers still cling to the myth that customers bank with them solely because of their branch-based distribution. Their consumer research suggests as much. But any good researcher will tell you that consumer behavior often differs from research responses. When Citibank introduced ATMs in New York City in the 1980s, market research found that 99 percent of consumers would never use one to get cash. In the late 1990s, 99 percent of consumers said they would never trade or bank online. Yet today, virtually every bank account holder uses an ATM, 90 million U.S. households bank online, and about 22 million households trade online.

Personal Banking's Future

The shift occurring now in financial services has been seen before in other industries—for example, in recorded music. In the early 2000s, the convenience and lower cost of an MP3 download, the greater choice, and the delivery when and where it was convenient for the consumer all combined to create a tipping point that drove consumers to the iPod. The entire music industry had been organized around the economics of physical distribution: Record labels bundled songs into albums, because the cost of physical distribution (stores and the production of media such as records, tapes, and CDs) could not be supported by the revenue generated by single songs. Suddenly, Internet distribution of songs, videos, movies, and TV shows enabled much broader audience reach at a fraction of the cost, and disintermediation ensued. This soon led to the collapse of the music store industry. Financial-services firms are only now beginning to recognize similar signals in their industry.

One clear signal is the shift to electronic cash in the form of debit and credit cards. According to the federal government, checks and cash represented more than 70 percent of all U.S. financial transactions in 2000; by 2010, that percentage had dropped to 43. Another signal is the generation of people now in their teens and 20s who are used to communicating over mobile devices, with far less need for face-to-face interactions. Especially with intangible products and services (such as any FS offering), they expect merchants to deliver what they want whenever, wherever, and however they choose.

There is often a gap between knowing what needs to be done and knowing how to get there. It is helpful here to remember the Templars and the basic needs that banks fulfill—the security and safety of capital, access to that capital when and where it is needed, and the deployment of excess capital in search of greater returns—but to interpret those needs through the lens of current enabling technologies.

Because of the nature, volume, and velocity of the transactions it enables, and the demographic spectra it crosses, personal banking is at the core of every financial-services relationship. Between bill payments, debit and credit card usage, withdrawals, and deposits, the average individual interacts with his or her bank between 100 and 200 times per year—compared to the same person's six to 12 transactions with investments and one or two transactions with retirement products. At the center of this relationship is the security of capital; therefore, most banks—from the simple ceramic pig to the elite private bank—start with savings or other deposit products. If you recognize that consumers are as interested in security, money movement, cash access, and capital access as they always have been, moving these services into the digital sphere becomes much easier.

Checks and cash represented more than 70 percent of U.S. transactions in 2000, and only 43 percent in 2010.

Precepts for Digital Banking

The following guidelines can help financial-services institutions make the transition to a world in which their customers meet them online most of the time.

• **Choose the right metrics and methods of measurement.** Today, most financial-services firms focus on tracking and benchmarking standard accounting metrics. Every quarterly report provides a comparison to the previous quarter, and gives year-over-year results.

In the past, these measures could easily demonstrate the impact of competition, because most banking competition took place in the same neighborhood. But your most important rivals are no longer across the street. A good example can be found in German banking. Between 1995 and 2005, one leading German bank was able to increase its number of accounts from 127 million to 132 million. Since the trends were upward, the executives felt they were in good health. However, had they measured market share, they would have observed that new online entrants had expanded the market, and they had in fact lost 10 percent of their market share during that time.

Few banks are brave enough to

measure market share these days, much less the contribution of various channels to revenues. In the U.S., online-only banks grew from $3 billion in deposits in 2002 to more than $380 billion in 2011, yet they are often excluded from competitive analyses conducted by bricks-and-mortar banks. And during the last decade, many banks have opted to assign all accounts driven by other channels (such as phones and Internet) back to the "branch of domicile," obscuring the relative impact of online and offline banking. I have a personal example: In 1997 I walked into a Citibank branch in Manhattan to open a checking account. Since then, I've physically entered that branch at most five times, and not once to add an account. Yet the nine Citibank products I have added to the account continue to accrue back to this branch, as if it were somehow responsible for my cross-purchase. As long as this practice continues, it will be impossible for any bank manager to assess the importance of physical distribution to the bank's performance.

One good way to determine the market share your institution may be losing to Internet competitors is to ask your chief digital officer to provide metrics for how many people have visited a product page on your website and then applied for that product elsewhere—the digital equivalent of the foot traffic you're losing to your competitor next door. When I was at Citibank in 2005, we determined that more than 500,000 customers opened an account at ING Direct, an online-only bank (which, after being acquired by Capital One, was renamed Capital One 360 in 2013), just after reviewing our savings account pages. That data provided the impetus for our launch of a low-fee, online-only savings account, called e-Savings, in 2006.

• **Focus on the customer experience.** For a significant number of prospects and current customers, the online portal is the primary door to your customer experience. But when they "walk in" that "door" to open an account, they are often required to mail in their application or use other non-electronic channels. We live in a world of instant gratification, e-signatures, ID verification, and electronic money movement, so if you do not yet have truly *instant* account opening online, drop what you are doing, and enable it *now*. At Citibank, when we implemented instant account opening, we increased new accounts by 472 percent, with only a 38 percent increase in full-time employees. If you need another reason to move rapidly, remember that every online account will cost your bank only about $9 to open, and it will typically drive repeat sales and customer loyalty.

Upselling online should emulate Amazon's one-click feature. Use the data you already have on file to pre-fill applications or reduce product applications to a minimal number of questions. At Citibank, we allowed current customers to open new savings accounts with only two clicks, and we reduced the number of questions required for a home equity instant pre-qualification from 40 to nine.

• **Drive efficiency by offloading routine transactions to lower-cost digital servicing.** At Citibank, we knew that online transactions cost 4 cents each, those conducted via ATMs cost 14 cents, those conducted via interactive voice response $2.53, and those conducted via people at a call center upward of $18. Driving everyday servicing transactions to lower-cost channels can not only reduce your cost to serve, but also enhance customer satisfaction. You can find service offload opportunities by meeting with your call center management every quarter to identify their top 10 call categories. We used this strategy at Citibank to identify low-value transactions—such as address changes, requests for statements and copies of checks, and check reorders—that we could easily move to online and mobile channels. We knew this created greater efficiency but were surprised at the increase it delivered in customer satisfaction. One of the things that most wowed customers was enabling check viewing and printing online—hardly innovative, but our customers thought that was practically the best thing we had ever delivered to them.

• **Treat mobile banking as a unique, separate channel, not a "small-screen Internet."** The great value of mobile technology is that it finally delivers on the Internet's original promise of 24/7/365 access around the world. Mobile banking allows people to do everything anywhere anytime, including reporting fraud claims, making payments, managing loyalty programs, and transferring funds, with very low transaction friction. Make use of mobile's geo-location capabilities for branch and ATM locators, and potentially for basic needs such as identity verification.

• **Segment services by what customers want, not in ways that justify your business strategy.** The traditional business model for many retail banks is based on the business-centric premise that high-net-worth clients deserve intensive face-to-face contact. But that's not necessarily what they want. They want preferential treatment and a high level of care, which may or may not mean sitting in front of a person in a bank branch during business hours.

At Citibank, our segmentation analysis showed that our best customers were our middle-aged, tech-savvy, high-income urbanites and suburbanites. They were devoted to using our online and mobile capabilities, and they loved every innovation we introduced. Today, with the mobile Internet, Skype, texting, and social media at their fingertips, many high-net-worth consumers expect instant communication and delivery, anytime and anywhere. Why would they make an appointment and trek to a branch when they could just FaceTime their banker or investment advisor?

• **Devote 70 percent of your investment to enabling technologies.** Emphasize technological capabilities that help you reach customers without bricks and mortar—or potentially without any human intermediaries. For example, rather than building a large face-to-face sales force, use technologies such as Salesforce.com and Skype to create "high-touch" services that provide a mix of human- and computer-based interactions. You can also use a variety of advanced technologies to further develop your marketing capabilities for competitive advantage. These include segmentation, cross-selling, most-likely-to-respond models, prospect mining through retargeting, next-best-product marketing, product and offer design, CRM, and database mining. The data provided by social media can help you better understand your customers' motivations and intent to buy. Use LinkedIn feeds on job changes or Facebook information on new homes and new babies to trigger loan or insurance offers that will have greater response rates.

• **Use Web-based channels to merge delivery excellence with customer intimacy.** One of your most important steps is to consolidate customer information—for example, pulling in data from one part of operations to another, so it doesn't have to be reentered when a customer is opening a new account. This says to a customer, "We know who you are, and we value our relationship." Unfortunately, it's very difficult to built an aggregated mega-data-warehouse in most institutions, but you can fake it with graphic user interfaces. We used this at Citibank to bring customer data from personal to investment accounts. Your contact center will draw from your customer data in the same way, enabling them to offer investment, retirement planning, insurance, mortgage purchasing, and other guidance, tailored to each consumer's needs and shifting as his or her patterns of activity change. Using customer data this way will also equip you to cross-sell more effectively, to better assess customer profit contributions against the cost of service, and to change your pricing accordingly.

• **Don't abdicate responsibility for digitization to your technology or marketing groups.** Because of its overall importance to your bank, digital technology should be managed as a capability within the business, not as a marketing or branding adjunct, and not as a technology deliverable. Neither IT nor marketing by itself is well positioned to fully realize the complex potential value of the Internet and mobile channels in acquiring new accounts among the tech-savvy younger consumer generation, in promoting cross-selling, and in driving business efficiencies.

• **If you can't innovate from within, partner with others.** The secret to great innovation is that it does not require radical change. Truly great innovations often took place through either a series of baby steps to a goal or a combination of smaller innovations. The iPod, for instance, was not an innovation at all. Akio Morita of Sony had invented the portable music player two decades before the iPod was introduced, and music downloads had been offered by Napster for more than five years. And touch screens? Apple didn't introduce those until 2007 with the iPhone, but Citibank had touchscreen ATMs in the 1980s. The "innovation" was in pulling all these capabilities together in a way that was relevant to the consumer, and most importantly, easy to use.

Partnering with small technology firms can be a great way to deliver innovation rapidly. Your innovation doesn't have to be too far out on the leading edge, if you remember the core needs of banking customers. At Citibank, we partnered with outside firms to deliver our award-winning capability for instant account opening, and to be the first in the country to deliver a downloadable mobile banking app. Of course, innovations like these must be developed in close collaboration with your chief technology officer and the external partner, and everyone involved needs to understand the business objectives. (It helps, too, to be bullheaded, because you will be surrounded by doubters and naysayers, above and below, particularly if you are ahead of the curve.)

We don't know who the most successful financial-services providers will be in, say, 2020, but we can guess that among them will be some that do not exist (or barely exist) in 2013. Powerful disrupters have entered the financial-services fray. Walmart has reloadable prepaid offerings that act like checking accounts. PayPal is enabling payments outside the banking system. Isis provides deposit accounts with payments facilitated through mobile phones. Mint delivers free automated financial advice over the Internet. Lending Tree disintermediates conventional lending, eliminating much of the hassle. Covestor links individual investors with portfolio managers who meet their investment needs. Each of these disruptions has already begun to dismantle part of the traditional financial-services value chain. Today's banks need to act now—to head off the competitive forces that are coming from every angle, and to become disruptive forces, on behalf of their consumers, in their own right. +

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