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BANKING EVOLUTION

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The **Banker** special supplement

BANKING EVOLUTION

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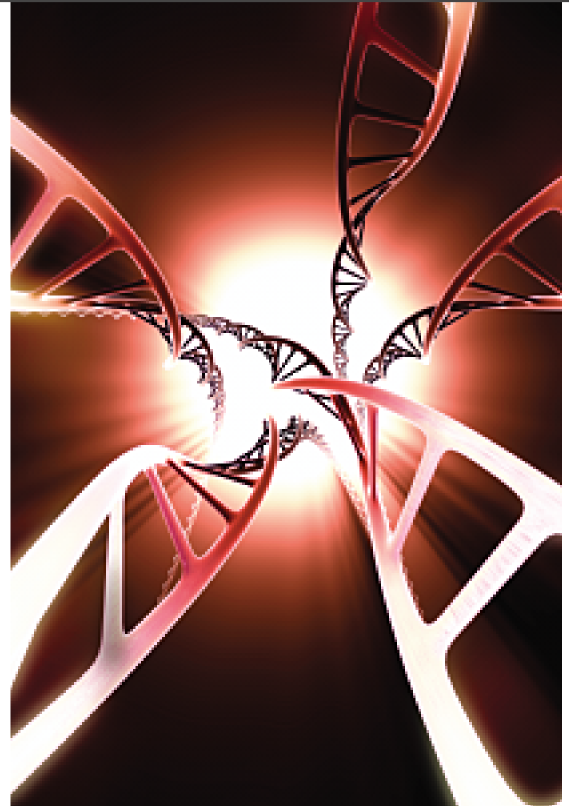

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Not enough progress

Come 2015, customers will be even more demanding and the marketplace more competitive and complex. Banks will have to focus more on innovation and efficiency and make faster progress if they want to keep their clients, says Thomas Balgheim

In 2015, Apple's iPhone will be eight years old, the iPod 14 years old. The iCult will be more prominent and iPilgrims more numerous. Can banks, with many more years behind them, ever claim such a following?

In 1397, Giovanni di Bicci founded the Medici bank in Florence and opened a branch in Rome. More branches followed and the bank developed additional lines of business. Countless prominent local, national and global brands for financial services have emerged since then but few consumers have enjoyed doing business with any of them. What has Apple created in several years that banks have failed to build in several centuries? Do banks have the desire, enthusiasm and ability to address this weakness in years to come or will their retail brands gradually disappear behind a variety of internet shoppers' comparison engines?

The answers to these questions may lie in the industry's willingness to embrace new technology. In 1956, banks replaced handwritten or typed statements with automated ones. They sold automation to their staff as a way to "take all the drudgery out of banking", says David Lascelles, author of *Other People's Money*. But "computerisation required banks to identify accounts by numbers rather than names". This made banking less personalised, which customers resented. Branch managers had more time to focus on selling, but many felt uncomfortable doing so.

The situation has changed little since then. Retail banking employees typically do not want to sell and most customers dislike being sold to. This is primarily because, with the exception of private banking, bank staff do not have the information they need to personalise customer relationships – and their customers know it.

Today, technology can give banks the intelligence for a win/win relationship with customers. But the window of opportunity is small. In the meantime, a weakening credit market – along with regulatory, risk management, and governance demands – could derail banks' progress heading toward 2015.

Nervous expectations

The July report from The **Banker** on the Top 1000 World Banks shows that record profits continue and profitability continues to rise. Additionally, average cost/income ratios across much of the world have declined in the past three years – from 61.15 to 59.91 in the US, for example, and 61.63 to 57.57 in Europe. The **Banker**'s editor-in-chief Stephen Timewell says: "Contrary to nervous expectations, the banking boom may roll on." But will this be the case for retail banks, which face some special challenges?

Of particular concern are new non-traditional purveyors of financial services that are threatening retail banks' market share. These include players such as PayPal, the e-commerce intermediary that now has a banking licence, and issuers of pre-paid payment cards, such as Mastercard's PayPass. Ongoing consolidation in the financial services industry, along with increased regulatory protection for consumer privacy and security, could also dampen the profits of retail banks. And hedge funds and other large investors are actively pressuring some institutions to give more value back to shareholders.

Many leading banks are shoring up profitability by enhancing relationships with customers and improving operational efficiency. Some are collaborating with competitors and other business partners on innovations that will maximise tomorrow's market opportunities. Working on all three fronts may provide the greatest chance for continued prosperity in 2015.

Customer clout

Customers, for their part, have become more demanding of banks and less loyal. Increasingly they select their banks by price, service and functionality rather than any long-term affiliation. A recent study published by US consultant BMC Software found that 60% of Europeans surveyed have changed at least one service provider in the past six months. Of those, 64% have changed their insurance company and 57% their bank. In addition, a majority of respondents would not recommend their banks to other people.

Today, according to international bank ABN AMRO, customers require flexible solutions that are tailored to their needs instead of fixed packages of products. They want to purchase all products via any channel in a single instance and get a clear, up-to-date overview of all their accounts and transactions at any time they wish. They want greater speed in processing transactions and approving loans, greater simplicity when comparing products, and greater convenience when completing administrative chores. They also expect to be rewarded as their relationships with particular banks expand. In the BMC Software survey, a lack of rewards was the prime reason for customer disloyalty.

Aware that banks are making record profits, customers are put off by punitive charges and other account fees. To increase cross-selling, boost customer retention and differentiate their brands, banks need a new approach. This, in turn, requires new technology.

Poorly planned purchases

Research sponsored this year by SAP and the European Financial Management and Marketing Association (EFMA) found that 46% of banks believe their IT

systems hamper their strategic goals (see Figure 1) versus 36% in a similar survey done in 2004.

Although banks have pursued multi-channel, customer-focused business strategies aggressively, they still lack the business intelligence and automated processes that their staff require and their customers expect. Some 66% of banks in the SAP/EFMA study believe that strong business intelligence will be important in 2010. Nevertheless, their progress toward adding business intelligence has been slow. In the 2004 SAP/EFMA study, 14% of banks had regular and consistent processes in place for customer analysis, and 57% expected to have such processes within three years. By 2007, however, only 20% of banks had achieved this objective.

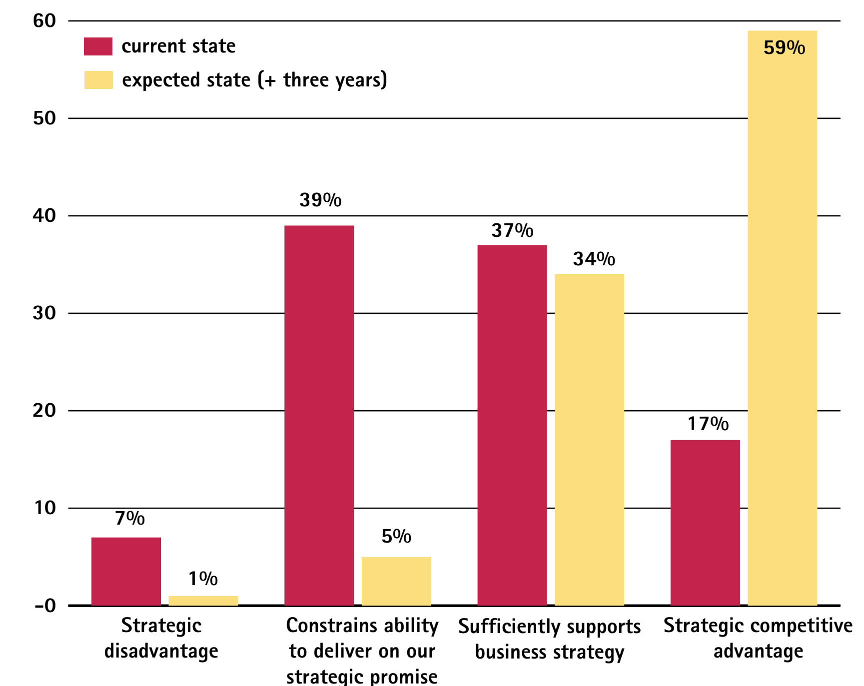
The Retail Banking 2015 global online survey, conducted recently by SAP and The **Banker**, showed that banks regard cross-selling to existing customers as their key driver for growth, especially among private banking and affluent customers. Banks also class satisfying customers in these two segments as very important. To achieve these goals, retail banks will have to make their systems for business intelligence and customer relationship management work harder and consistently deliver higher value.

The problem is not that banks are tight with their IT spending. ZDNet Research estimates that the industry will spend $241.2bn on IT this year and increase IT spending between 2005 and 2010 at a compound annual growth rate of 4.9%. For some banks, these are strategic IT investments that can address the industry's key challenges and deliver visible differentiation in the coming decade. Most banks, however, have yet to optimise their technology purchases.

IT featured strongly in the Retail Banking 2015 global online survey. More than 75% of respondents expected to expand their investments in this area. The branch network was the second-highest area for anticipated investment, identified by 50% of survey respondents.

Innovation and efficiency

By 2015, when customers are even more demanding and the marketplace more competitive and complex, banks will have to focus more on innovation and efficiency.



Source: EFMA/SAP 2007

The customers of tomorrow will be more technically savvy and demand more one-to-one service. They will expect recognition of their culture, nationalism and migration activities, as well as their age and increasing longevity. They will be even more likely to expect banks to safeguard their privacy and protect them against identity fraud.

Meanwhile, a 'louder' marketplace will find a greater variety of institutions selling the same products to a finite number of customers. There will be a larger role for non-traditional players, such as BMW, Ericsson and Zopa (which matches lenders and borrowers online). There will also be new roles for traditional players such as Royal Bank of Scotland, which now offers financial products through Kroger, a US supermarket chain. Respondents to the Retail Banking 2015 online survey expect banks' share of the retail banking marketplace to be much the same in 2015 as it is today.

Technology will be key to these and other industry innovations, helping to blur the line between virtual and 'real' banking. By 2015, banks will probably have to accommodate automatic mini-payments (such as the Oyster travel card in the UK), biometrics and radio frequency identification, and near-field communications – a short-range, wireless technology that may radically change how people pay for goods and services.

Technology will also help banks to create innovative product bundles and focus on specific communities. It will foster greater integration (including cross-border standardisation by regional players), new distribution channels, and optimised risk management (with new tools that adjust price to risk).

Technology will also make banks more efficient as they globalise their IT operations and consolidate back-office activities at the cross-country level. More than 80% of those responding to the Retail Banking 2015 online survey stated that they now use software packages for their accounting, reporting and human resources processes. Leading banks are offshoring IT support and outsourcing or insourcing commodity activities, such as loan payments, mortgages and insurance, to improve efficiency and create market differentiation.

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Winning in 2015

Asked to rate the role of IT in delivering various business priorities, 43% of the respondents identified innovation as the top role (followed by automated front-office tools for customised service, at 34%). Meeting the innovation and efficiency requirements of 2015 requires flexible business models that can handle whatever market scenarios emerge.

Today's mortgage market is a good example of the transformational business that banks may encounter. Reverse-auction services for loans – such as those offered by Lending Tree – have increased product commoditisation and could put additional pressure on mortgage profit margins for the rest of the industry. As the relationship between customer and mortgage provider loosens, opportunities for cross-selling decline. On the plus side, the mortgage-lending process should become more streamlined.

Designing new business models that can quickly adapt to future market trends requires IT systems that provide effective customer intelligence to every corner of the bank's organisation. Among the more futuristic tools for this intelligence are intuitive recognition systems that can easily identify a customer's precise location and needs. Such support will make it possible to construct product offerings and pricing that are truly in tune with individual customer requirements. Efficient channel management that is transparent to customers will streamline communication and enhance operational efficiency. Smart systems for partner management will further buttress banks' business strategies.

Increasingly, financial software vendors are including functions that will help banks to deal more effectively with issues of social responsibility, governance, risk and compliance. Important, too, will be functions that help banks to protect and grow their brand.

Winning through collaboration

Can such technology help retail banks to excite the customers of 2015? Possibly. But individual banks alone will be hard pressed to accomplish this. The industry will need to develop a business process platform that institutions can use to implement their own collaborative and innovative business models quickly and efficiently.

Such a platform could also support, consolidate and integrate a bank's applications and business processes. The platform should help banks to anticipate and optimise, with minimal lead time, whatever business opportunities emerge. To achieve this, banks will need to partner with each other, the IT industry and other significant players – as automotive and energy companies have already done.

One example of such a partnership is the recent collaboration between global banking leaders and SAP. At a meeting with senior bankers several years ago, top managers from SAP drove a discussion about what they saw as a break-up of the banking value chain.

'In 2015, banks with SOA will find it very easy to add new channels to their menu of services'

The discussion focused on newly evolving business models and the tools banks would require to manage and build a profitable future. The banks suggested the creation of forums for debate, which have become a key source in the development of banking applications.

In 2005, SAP collaborated with several banks to develop standards for a service-oriented architecture (SOA). This collaboration has evolved into the industry value network (IVN) for banks, a global community of 130 participants representing 37 financial institutions and software providers. About 24 work groups are now actively defining services and discussing architecture topics.

To date, the IVN for banks has identified more than 180 important services and defined 70 of those services in detail. It has created an SOA taxonomy, developed a service landscape, and identified the strategic and organisational building blocks that banks require for a successful transition to SOA.

The work of the IVN for banks should ensure a non-disruptive, step-by-step movement towards SOA and help banks to integrate new functions and services into their existing IT environments. In its next phase, the IVN for banks plans to expand its work and global footprint, become a more independent community, and present its results for the world's banking market to assess. Through this process, it hopes its service definitions will become an industry standard that will help financial institutions to realise the full potential of SOA.

"SOA gives a bank true agility," says Bart Narter, a senior analyst at international consulting firm Celent. "While monolithic systems are more efficient in terms of computing, an SOA enables the addition of new business processes for serving customer demands that were not imagined 20 years ago. Going forward into 2015, banks with SOA will, for example, find it very easy to add new channels to their menu of services with lower cost of integration, faster time to market and minimal disruption to other channels."

To support this effort, SAP will continue to deliver compelling solutions based on modular, reusable and scalable elements that can be assembled as needed to meet a variety of different strategic or operational goals – without having to write code or develop new interfaces. These solutions can serve as a business process platform that banks can use to become the next-generation performers.

Retail banks appear to have the market positioning, desire and IT spending power to remain prime players in 2015. But to achieve their goals for growth, reaching particular customer segments, and improving their cross-selling results, they must increasingly use their IT spending for collaborative innovation, business intelligence and customer-focused tools delivered on a flexible business process platform. At the same time, they must leverage software packages for accounting, human resources management and compliance to handle traditional industry risks (particularly in the credit area), an ever-changing legislative landscape, and increasing pressure from shareholders for sustainable business practice. TB

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produced better informed customers, who will not suffer poor products, bad service and unexplained fees gladly. Unlike in the past, when banks could dictate terms, the expectations of customers in 2015 are likely to run ahead of the capabilities of providers, whether banks or non-banks.

In short, the new technologies now available and those that will emerge in time will provide customers with a dramatically increased range of potential financial channels and mechanisms.

The customer is king, with an increasing spectrum of choice available from both banks and non-banks that are competing hard for a slice of the retail wallet. And mechanisms such as the internet, the mobile phone, new contactless cards and related near field communications (NFC) devices are only just beginning to be used. By 2015, the current explosion in payments mechanisms will have evolved considerably.

The long tail

As Nick Pilbeam, founder of Itsun, says in his response to The **Banker**/SAP online survey (see page 13): "By 2015, the mobile-to-banking-network tie-up will become extremely sophisticated in its application, though the physical implementation will be very simple. Mobile, contactless chipsets will be available on a widespread basis in cards and mobile phones that will by-pass cheques and credit cards for high volume, low value transactions, numbering into their trillions per year for both developing and developed economies."

He adds: "What is dubbed by the internet generation as 'the long tail' has been in use by the telecom operators for the past century, and the amalgam of the vast volumes of customers and transactions that phone companies are used to processing on a daily basis, brought together with the financial reach and security of the banks, will surpass all recognisable transaction volumes seen today."

Will the internet generation and new technologies transform the retail financial landscape, as Mr Pilbeam suggests? They certainly could. The current paradigm that 80% of all personal payments in Europe are still cash-based and 80% or more of retail product sales across Europe are undertaken through bank branch networks (see The **Banker**, July 2007, p120) will certainly look outmoded in 2015 with new cards, cash substitutes and new channels emerging.

New technologies and mechanisms are costly, though, and the critical issue is who will pay for them? From the provider perspective, the customer may be redefining the rules of the game but someone needs to pay if all these consumer expectations are to be met. Many a good idea or product has failed to materialise because retailers, banks or customers refused to pay for it; many card schemes have failed for these reasons.

Mobile channel

Earlier this year, consultants Deloitte gave a blunt assessment of the mobile in the UK. While the mobile channel is seen as huge elsewhere, especially in many developing countries, Louise Brett of Deloitte noted: "The mass roll-out of mobile as a point-of-sale payment device will not happen in the UK in the foreseeable future." Deloitte was adamant that no-one was prepared to pay for it so it would not happen. It also asked why banks would want to back the mobile channel against, for example, contactless payment cards when the costs were not in its favour.

This Deloitte example highlights the major challenge that retail banks and other providers face in addressing the heightened customer expectations of 2015. Who pays? This question raises a key structural constraint ahead. If customers want a broader range of channels and products, and are increasingly reluctant to pay, then providers have to assess whether the scale of their business can viably absorb the cost.

Just like the issue of increasing regulatory costs worldwide, institutions need to increase scale to stay in the game. So approaching 2015, only the bigger institutions, with the ability to spread the cost of innovation and new technologies, and the niche specialists, look likely to be able to weather the competitive storm. The middle ground players will lose out.

Extending this analysis, people across the globe need banking but they do not necessarily need banks. And in the future the bank consolidation trend is likely to continue, weeding out smaller, inefficient players. Governments, however, need banks if they are to maintain an organised and regulated financial structure. The growth of non-bank financial institutions makes for healthy competition but history shows that sooner or later existing banks and regulators close out the non-banks' initial advantages. Although banks look likely to continue to dominate retail, the quality and sophistication of their products could also significantly improve.

Looking to 2015, a cynic may say that little will change in retail banking. The branch will remain the mainstay of the retail network as the banks' touchstone with the customer, as our research suggests. Key products are and probably will be still sold through the branch even if most transactions by-pass it.

> **By 2015, if not before, the mechanics of banking will have changed significantly**

New mechanics

However, although it can be argued that the core role of banking has not changed, by 2015, if not before, the mechanics of banking will have changed significantly. New technologies, from the internet to mobile to contactless will have breathed fresh air into payment mechanisms and allowed time-consuming chores to be done at the click of a button.

But this comes at a price. As our research shows, IT investment is critical, and 80% of our respondents agree. But not all banks will be able to meet the full range of customer demands of 2015. Size matters and smaller banks will be squeezed out. Better banking is what will be needed in the future and larger institutions with focused technology strategies will be the winners. TB