POINT OF VIEW

RETAIL BANKS
AT THE CROSSROAD

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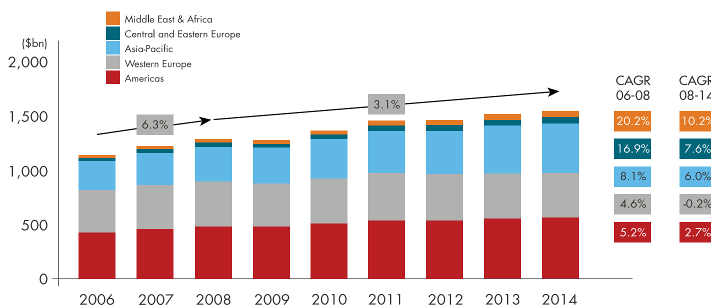
Almost eight years on after the financial crisis, many retail banks' 2015 results still leave investors and financial markets disappointed, in particular in Europe. The transformation and cost reduction efforts highlighted by banks in many of the 2015 announcements are not translating into positive market sentiment.

We have recently seen many banks report mixed financial results for 2015 in a low rate environment. Retail banking income growth has been sluggish in Europe. BCG's Banking Pools[1] data (Exhibit 1) shows that compound annual growth in Western Europe fell to negative 0.2% between 2009 and 2014. We expect that growth from 2014 to 2015 to turn positive but still be sub 0.5%. ECB measures in March, cutting the eurozone's main interest rate to zero, mean that downward pressure on margins is likely to continue for longer than anticipated.

Exhibit 1: Western European revenue growth, in particular, has been hit post-crisis
Global rise of retail banking revenues[1] ($bn)



1. Estimated retail banking for ~2,100 banks based on region-level financial and macroeconomic data. Data for 2015 and 2019 are forecasts; actual revenue estimates for 2015 will be available in spring 2016 following 2015/16 annual report publications.
Source: BCG Banking Pools 2015; BCG Analysis

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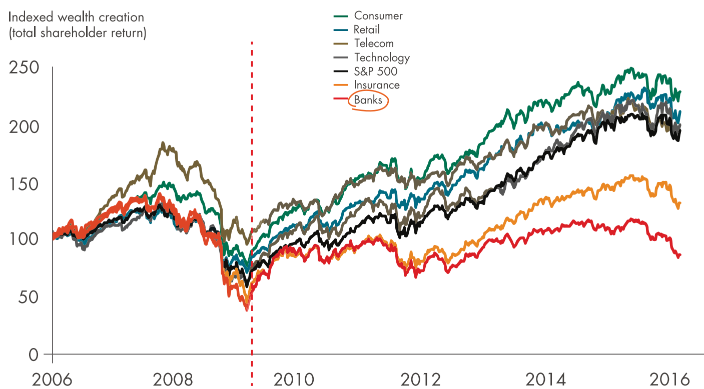
Regulatory costs and fines have risen considerably in many markets, while increased capital requirements place further pressure on return on equity (RoE). As a result of these trends, we see a widening disparity of financial performance across the regions with the best retail banks targeting cost-income ratios in the mid to low 40s, whereas many others struggling to get below 70%.

Overall, if we look at banks' total shareholder return, there is still work to do: return has underperformed compared to other major sectors (see Exhibit 2.).

Exhibit 2: Banks performance has not recovered as much as other sectores post-crisis



Source: Thomson Reuters Datastream – industry's total return indices

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This situation is likely to continue in the coming years. The macroeconomic context remains challenging. In parallel, a changing competitive environment will continue to evolve with multiple new entrants securing profitable segments and putting pressure on the margins of legacy banks.

A need to reinvent the retail banking model?

Retail banks have been holding out for rate rises to allow margin expansion. However, waiting for such rises will not be enough. It is unclear how much banks can increase net interest margins in an era of heightened regulatory scrutiny. Increased savings margins will likely be offset by reduced mortgage margins. As rates rise, an increasing contingent of internet-informed retail depositors, aware of opportunities for better returns, may move their savings to more attractive financial options provided by challengers and innovators.

It seems that retail banks' business models are neither compatible with the long-term economic climate prevailing since 2008 nor with the competitive challenges arising from new entrants. Retail banks now have to reinvent their model. Bouncing back in the game is about comprehensively transforming, and not just adjusting, their core model. From our perspective, a successful transformation should be structured around three sets of actions: fund the journey in the short term, win in the medium term and enable the transformation.

Funding the journey

What levers can banks pull to address revenues and costs issues in the short run? There are of course new opportunities to explore, but traditional levers should not be forgotten, as fine tuning some of them can quickly impact financial results in a positive manner, and hence fund the transformation journey.

For example, on the revenue side, recent BCG experience shows that banks can enhance their retail pricing performance to unlock an average of 14% revenue uplift, by pulling four levers:
- Reduce leakage by putting more discipline in the way discounts or fee-waverers are given to customers
- Optimise price structures and levels on the basis of the value perceived by customers and on competitive dynamics
- Differentiate pricing by segmenting customers, even to the individual level when warranted, according to such criteria as willingness to pay and value to the business
- Improve price realization by, for example, increasing the effectiveness of discounts and promotions

As another example, our Retail Banking Excellence (REBEX) benchmark finds that top quartile performing banks are reducing product complexity across the board to reduce cost, improve sales and simplify the customer sales experience. We find that top quartile banks typically have 25% fewer on sale products and 78% fewer legacy, administer-only products. Sales productivity and customer retention are approximately 40% better in top quartile banks.

Winning in the medium-term

Looking to the medium-term, retail banks need to innovate in their offering and distribution. Established players and new entrants alike are exploring new business models, in order to expand products and services, gain access to customers (via other channels) and accelerate the pace of innovation. The key focus areas remain the same, but what changes is the way to structure the future business as an ecosystem (typically through partnerships, collaborations, incubation or corporate ventures) to develop the following three capabilities:

1. From transactional (commodity) to relational (engaging).

With the proliferation of fintechs and with changing customer attitudes and behaviors, banks could become increasingly commoditized in the coming years. Building deep, lasting relationships by engaging customers on their needs can help mitigate this.

Banks should build multi-product, multichannel relationships with their core franchise customers. This delivers materially higher lifetime value. They should also engage their customers in the full customer journey surrounding life events rather than simply offering products – for example, by designing offerings through an ecosystem of partners that support a family's home move in its entirety, rather than solely financing the purchase. They should also continue to push for fresh and innovative means of developing deeper relationships with customers.

> *“ The distribution models of banks should be “bionic” – digital interaction for speed and convenience; human interaction at the moments that matter.*

2. Re-imagine customer journeys front to back using digital technologies.

Banks should re-design customer journeys to focus on customers' needs and simplify the customer experience by overcoming visible and hidden customer compromises and friction. This should be based on a deep understanding of the natural customer pathways across channels. The distribution models of banks should be "bionic" – digital interaction for speed and convenience; human interaction at the moments that matter.

Digital roadmaps should include middle- and back-office processes, allowing full automation of certain functions while focusing on the front-end customer experience.

Banks should also embed compliance activities within core processes, streamlining compliance as a function rather than bolting it on to existing processes, hence ensuring rather than hindering an excellent end-to-end customer experience.

3. Enhance digital capabilities.

Rather than using the top-down, strategy-driven approach of the past, banks need to innovate to enhance their digital capabilities using build-assess-learn cycles, even when not entirely sure of the outcome. Banks should focus on pilot tests and prototypes that can be developed and rolled out quickly, assessed for performance, and scaled up (or shut down) accordingly. They need to embrace the concept of "fail fast and fail cheap" and build digital capabilities through direct experience. And rather than making a big, strategic bet, they need to manage multiple initiatives, trying out new business models with low sunk costs, killing off the losers, and scaling up the winners. This requires new ways of working not just in Technology but also in the business and a new culture.

Building these capabilities realise immediate value whilst positioning the bank for future adaptation. In our REBEX benchmarking we find that banks that move from a median to a top-quartile position on each of these key goals can reduce operating expense by 15-25% depending on the initial position of the bank. For the median Premier League bank in BCG's benchmarking study, this translates to a pre-tax profit increase of 20-30% and a 5-10 percentage points increase in pre-tax profit margin.

"Banks need to embed a digital culture to disrupt their business, before the attackers do. They should implement a cultural program that clearly supports cross-functional working, collaboration, customer centricity and risk-taking.

Enabling the transformation towards more cost effective industrialized banking embracing new models, new culture and new organization

The transformation of IT and data management underpin these priorities. We find that leading banks are simplifying their IT architecture to boost agility, flexibility and efficiency. Reducing the number of technology patterns and applications can realize savings of up to 15% and also enhance agility.

Banks are also focusing on data management and analytical capabilities, both to increase sales and improve the customer experience, but significant progress still needs to be made. Advanced data analytics greatly increases value creation through improved customer understanding and higher-quality lead generation. More efficient and effective use of information also reduces cost. The very best banks will buy or partner with fintechs to learn from their methodologies, tools and capabilities achieving a step-change in performance.

Integral to these efforts is the need to create agile, simple and highly collaborative organizations. They need to adapt their working styles and incorporate agile approaches to development. This includes deploying cross-functional teams focusing on individual product or service features, working in short-cycles, to enable increased product ownership, fewer errors and faster time-to-market. This means banks must implement far more nimble development processes and become more comfortable making decisions amid uncertainty.

Last, Retail banks need to attract and retain scarce entrepreneurial talent to rapidly drive plans. Generally, this talent will be externally hired or even "acqui-hired" – for example by the acquisition of digital studios. This expertise should not be restricted to expert teams, but should also be embedded in the leadership team. Banks need to embed a digital culture to disrupt their business, before the attackers do. They should implement a cultural program that clearly supports cross-functional working, collaboration, customer centricity and risk-taking.

By executing on these three coordinated sets of actions – funding the journey, winning in the medium term and enabling the transformation – retail banks can reinvent themselves and find a new path to profitability. Opening the door to new business options also means investigating opportunities beyond the financial industry, and embracing concepts that have not been designed for the banking sector. Many retail banks are already investigating in robotics and artificial intelligence to increase the efficiency of their processes and help to further reduce cost. Many are testing the potential of blockchain and the distributed ledger, and collaborating with startups to accelerate the process. We think it is definitely an exciting and promising period, but banks have to be bold: there will be winners and losers; this is no longer the time for incremental changes. ■

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[1] BCG Banking Pools are a proprietary database of the industry's global financial performance permitting assessment by country, region, product, and banking segment, including corporate, retail and private banking, asset management and CIB.

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