2013 Retail Banking Industry Perspective

About this time each year, we pause to reflect on the state of the industry, the critical issues the industry will face in the coming 12 months, and how retail financial firms can position themselves to benefit.

In the past year, several trends have continued to weigh heavily on the industry's profitability, particularly macroeconomic headwinds in the form of rock-bottom interest rates and increased capital requirements imposed by regulators in the United States and Europe. The glimmer of hope that this environment would soon change evaporated in September when the Federal Reserve pledged to hold the federal funds rate near zero at least through mid-2015, while at the same time committing to purchase US$40 billion a month of mortgage debt in the latest round of quantitative easing (QE3).

This open-ended low interest rate environment will challenge near-term profits mightily and will demand executives' close attention. But managers must resist fixating solely on the short term. Instead, they should regularly shift their attention from day-to-day activities to study the long-term horizon for new opportunities and position their institutions to capitalize on them. With this in mind, we are encouraging bank leaders to think about three broad priorities for 2013: Grind out profits, build performance into the company's DNA, and identify new opportunities.

Grind Out Profits

We believe industry profits and return on assets (ROA) will hardly budge in the next three to five years, growing just 1 to 2 percent annually. Meanwhile, return on equity (ROE) will remain under considerable pressure, thanks to increased capital requirements from the Fed, Basel III, and other regulators. In this environment, every dollar spent—whether investing in a new product launch, purchasing accounting software, or paying to keep the lights on—is precious. Banks must have the right cost structure in place to maximize the benefits of each dollar, position themselves for growth, and grind out profits.

Efficiency ratios have remained stubbornly high industry-wide. However, we have studied banks in the North American market and found five hallmarks of success among banks with above-average efficiency ratios: (1) clarity on a

winning formula, (2) focus on frontline sales, (3) excellent execution, (4) capabilities built with external partners, and (5) ruthless performance management.

Clarity on a Winning Formula: Where to Over-Invest and Why

Successful banks have a well-defined winning formula and the capabilities needed to implement it. By capabilities, we mean the people, processes, and technologies that differentiate the bank's offering and support its overall strategy. Such an approach requires understanding which of these three aspects to emphasize and—more important—why. Failure happens when banks over-invest in one aspect (often technology) or spread out investments across all three without having a clear view of the desired end state and interim measures of success. They want to be good at all three dimensions and, as a result, are not good enough at any of them.

Getting this right often involves a big cultural shift for banks. It requires the CEO and the executive team to make strategic trade-offs within and across their firm's business portfolio on where and how to spend money.

For example, one large U.S. bank has a value-based and employee-focused approach. The company's mission statement emphasizes employees and talent. Accordingly, it spends relatively little on technology (approximately 2 percent of revenue, compared to an average of 4 to 7 percent for its peer group). Conversely, another bank—which uses a strategy of convenience, innovation, and simplicity—made heavy technology investments tied to revenue targets ($500 million by 2015 from branch technology upgrades, along with IT-driven innovation). And a third, a regional player, uses a low-cost, low-risk strategy. After a number of M&A transactions, it standardized its processes across the entire bank, with strong centralized governance and cost controls to avoid local variability.

All these strategies have succeeded because the firms' management teams have maintained a clear view on what capabilities they need in order to compete, and they allocate investments in those capabilities and manage them in an iterative way.

Focus on Frontline Sales

Since the financial crisis, many banks have tried to improve customer service at the branch level to restore confidence, boost loyalty, and lower attrition. This is an understandable impulse, but it hasn't worked; service does not lead to sales. Instead, banks must balance their investments in service with tangible improvements in frontline sales. Some ways to strike this balance include measuring the sales force on service metrics (such as through client

satisfaction polls and Gallup surveys), eliminating non-sales positions (for instance, one national bank cut about 500 assistant branch managers in April), and investing in self-service technologies so the staff can focus on revenue generation (for example, many national banks are investing in self-service kiosks and ATMs).

Excellent Execution through Lean Methodologies and Digitization

A great strategy is doomed if a bank lacks the tactical capabilities to execute it. Increasingly, this execution relies on using lean methodologies to drive the digitization of processes (for example, rationalizing platforms and enhancing straight-through processing), reducing variability (such as making trade-offs between variety and standardization), and swiftly delivering services and products to the market. One bank streamlined its end-to-end processes and reduced the time required to onboard trading clients by 50 percent. Excellent execution also requires banks to create a culture of continuous improvement. In this vein, a national competitor hired a dedicated lean team from GE to evaluate ongoing opportunities.

Capabilities Built with External Partners

In today's capital-constrained world, it's difficult to free up resources for even the most promising projects. To share the cost and the risk, more and more banks—both large and small—are looking for partners to build capabilities. These partnerships come in many shapes and sizes. Some banks are teaming to create unique products, such as the Costco American Express credit card and the Barclaycard contactless card (in conjunction with Orange telecom). Others are tapping external expertise to design better processes, such as Commonwealth Bank of Australia's engagement with HP to revamp the end-to-end lending process (which led to a best-in-the-industry efficiency ratio of 49 percent). Still others are using partners to perform back-office functions that are not core to their operations (such as finance functions including accounts payable and reconciliation).

Ruthless Performance Management

Steady performance relies on leadership involvement, well-established processes, defined metrics, and clear governance and accountability. High-performing banks use standardized metrics to manage top-line goals; work to understand the causes of underperformance; and plot ways to improve outcomes, transparency, and accountability. These high-performing banks are also quick to confront underperformance, imposing immediate consequences such as budget reductions and staff cuts.

Build Performance into the Company's DNA

Formal operating model changes, such as the ones noted above, are necessary but not sufficient to ensure sustained performance. As banks continue to shift focus from streamlining their organizations to increasing cross-sales and establishing advice-based customer relationships, senior executives are also beginning to take a hard look at the culture of the firms they lead. At a time when greater discretionary effort and urgency are needed to deliver results, employees are exhausted and skeptical; years of top-down programs have reduced trust in leadership at all levels. This exacerbates a situation in which corporate culture has been inadvertently left unattended since the start of the recession.

There is now broad recognition that if they are to win in the marketplace, leaders need to motivate the talent base and shape a corporate culture that reinforces the institution's strategic and operating imperatives. Achieving this scenario builds agility and resilience into the institution's DNA and allows it to overcome gaps in still-evolving operating models. For example, some firms with product-based P&L structures that are seeking to better meet customer needs are finding ways for employees to collaborate horizontally across the enterprise, overcoming structural silos to more accurately identify segment needs and bring the best of the firm to the customer.

In 2013, banks will have to really think about the culture they need in order to drive performance in the long term, and what specific changes they must make to build such a culture. For some, this means tapping into productive, self-sustaining behaviors that support execution of the strategy. For others, it means grafting on a few critical new behaviors and ways of working to evolve the institution's DNA. The simple truth is that culture can be a source of competitive advantage that accelerates and sustains performance; conversely, when culture works against you, it is nearly impossible to get anything done.

Identify New Opportunities

Grinding out profits and building performance into your company's DNA can easily become all-consuming, but leaders need to pursue new opportunities as well. Advances in technology such as digitization, as well as shifting consumer behaviors and expectations, are fundamentally disrupting the integrated banking value chain, creating numerous opportunities for innovation and new revenue streams. Thus far, nontraditional players—which are nimbler than banks—have been better able to capture these opportunities, raising expectations that banks will have to meet.

For instance, PayPal, Square, and Google Wallet are challenging traditional

card issuers through intuitive solutions that offer unique value and rewards to consumers. Nonbanks such as First Data and Amazon Web Services are also delivering low-cost outsourcing and processing solutions internally, helping banks by reducing their need to invest in captive back-office infrastructure. Regulations prevent nonbanks from playing in the middle, so though there is near-term margin pressure on banks caused by the historically low interest rates, banks are safer in the middle office.

In this environment, banks can target new revenue opportunities by partnering with nonbanks in three areas. First, they can offer an engaging customer experience through a rich user interface, personalized offers, and self-service solutions. As an example, one bank is partnering with Facebook and Foursquare to offer unique value to consumers through targeted offers that combine social and transaction data. Second, banks can gain from widening product access by offering financial and nonfinancial solutions across the digital ecosystem and developing broader solutions on their own platforms, such as websites and apps and online branches, to create more value for consumers. Third, banks can develop new ways to generate additional value from assets and capabilities that they already own, such as consumer data and rewards.

The ideal analogy is Amazon.com, which derives the majority of its profits from white-labeling its warehouse and cloud infrastructure capabilities and offering them to third-party retailers. These activities have overtaken Amazon's bread-and-butter source of revenue—direct-to-customer transactions on the front end. We project that pursuing these opportunities can drive significant top-line impact of approximately 10 to 20 percent in new revenue.

We hope you find these thoughts helpful as you consider your strategy for 2013, and we would be happy to discuss our perspectives with you in further detail.

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