Retail Banking:
Innovation distinguishes between the leaders and the followers
7–13 points RoE reduction due to increasing regulatory demands

£20 billion value of unsecured loan market

10–30% of customers contribute

90% of profits

£11.5 billion mis-sold PPI compensation

BANKS SOLD 45 million out of 53 million PPI policies

Shortfall of funding of between £84-191 billion from 2012 to 2016

6.6 million complaints over PPI since July 1, 2009

€15-20 billion prospective annual saving for European banks leveraging online services

Branches represent 40-60% of retail banks operating costs
Introduction

The environment within which retail banks operate has changed significantly since the 2008 global financial crisis. Nevertheless, the transformation is far from complete; retail banks face a wide range of evolving challenges.

Organisations are increasingly conscious of the importance of ‘customer-centricity’. Moreover, as a consequence of the FCA’s conduct risk agenda, firms are mandated to provide an enhanced service, with customers at the heart of their strategy. However, striking the correct balance between regulatory compliance, customer-centricity and technological development will represent a considerable challenge.

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1 Martin Wheatley, Chief Executive, Financial Conduct Authority FCA Risk Outlook 2013
The under-regulation of the banking sector and its lack of transparency were two of the major contributory factors that led to the financial crisis. The natural reaction has been tougher regulation in order to guarantee the fairer treatment of customers, effective competition and the stability of the financial system.

Retail banks must comply with a plethora of legal initiatives that are at different stages of implementation: capital and liquidity requirements, the Mortgage Market Review and the Retail Distribution Review. A proposal that is likely to have a big impact is the structural measure that intends to ring-fence the retail part of the industry. While it is thought that such an organisational change will contribute to the stability of the financial system, it will, however, significantly increase the capital that groups need to hold, and therefore increment the cost of funding.

Numerous miss-selling scandals made evident that risk, responsibilities and rewards were misaligned in most banking institutions. It is indisputable that banks need to review some of their dubious sources of revenue; regulators have launched several measures to redress the situation.

Namely, the FCA’s conduct risk agenda is encouraging business to focus on ‘good profits’; that is, making profits from selling products that are aligned to customers’ requirements. Although it might be problematical to define what ‘customers need’, the FCA’s principle-based approach encourages banks to be proactive and take responsibility for providing products that are suitable, not only at the time of being sold, but also as their clients’ needs evolve.

Customer centricity must now be as important as financial performance; in order to achieve such an objective, a return to ‘traditional banking’ is paramount. Offering less complex and more transparent products will not only reduce the cost of conduct risk, it will also promote the use of digital channels and have a positive effect on the public perception of the system’s fairness. Involving customers at each stage of the product development lifecycle will enhance transparency without prohibiting innovation.

3 Bain Financial Services Brief: ‘What lies beyond the financial crisis for UK retail banks?’
Economics

Increasing regulatory costs, the emergence of challenger banking groups and subdued market conditions are causing intense margin pressure on retail banks. Most of the new rules are to be implemented from now to 2019, which could reduce RoEs between 7 and 13 points\(^5\). Moreover, according to the latest estimations, interest rates are not to rise until late 2015\(^6\). In this panorama, banks face a dual challenge: on the one hand, they must reduce costs in order to remain competitive. On the other hand, they have to adopt innovative and often costly solutions if they want to attract new customers and retain their existing client base.

Technical innovation presents banks with the greatest opportunity to differentiate themselves from their competitors and to exploit the cost-efficiencies associated with digital channels. Internet banking is an undisputed success; nevertheless, used mainly for simple transactions, it has failed to expand its product footprint. The evolution of internet-based banking, particularly the promotion and cross-selling of products, represents an area of noteworthy opportunity: it is estimated that a greater use of internet banking could save European banks between €15 and €20 billion a year\(^7\). Nonetheless, encouraging customers to adjust entrenched habits requires building trust in digital channels.

In order to effectively promote online channels as a new revenue stream, banking organisations need to gain a better understanding of their customers’ preferences. Paradoxically, banks have access to vast amounts of client data; nevertheless, the value of this information is often dismissed. Some banks have already adopted robust analytical solutions that enhance the organisation’s ability to cross-sell; for instance, Santander sends weekly lists to its branches with the name of customers that might be interested in certain products. On the same note, Sainsbury’s bank uses spending patterns and customers’ demographic profiles to direct certain offers.

Despite dramatic innovation on customer interaction methods over the last 10 years, branches remain a preferred medium for complex transactions such as loan agreements or mortgages. Even though they represent between 40% and 60% of retail banks’ operating costs, branches are still the primary sales channel and the best way to build long-term relationships. Customers value expert financial advice delivered in person; however, given their vast cost, branches will need to offer services that a digital channel can’t. Adequate location, superior service and highly skilled staff at a sustainable cost are fundamental prerequisites for their viability.

Customers value the luxury of choice; fulfilling their preferences to interact with their banks is intrinsically linked to their level of satisfaction. Banking institutions will have to adopt segmentation techniques and develop innovative distribution strategies in order to offer the right product through the desired channel.

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\(^7\) The Economist: ‘Special report on Internet Banking’ http://www.economist.com/node/21554746

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€15-20 billion
The fact that Metro Bank was the first new bank in the UK for a century when it launched illustrates the lack of competition manifest in the banking sector. As a result, the FCA’s conduct risk agenda set ‘promoting effective competition’ as one of its primary objectives. Today, challenger banks, Peer-to-Peer platforms and ‘digital ecosystems’ are amongst the new entrants that might disrupt the market.

Challenger banks were initially described as institutions that had the potential to compete with the ‘Big 4’ high street banks for a share of the market. With a business model based on simplicity and customer-centricity, they present themselves as ‘substantially different’. Their size allows them to adapt to change more easily than larger counterparts. Moreover, they certainly enjoy better opportunities in areas such as branch networks or providing tailored products to unexplored segments of the market.

Despite clamour from regulators for greater competition in this space, no challenger has managed yet to become a real contender for the ‘Big 4’. The concentration of the PCA market reinforces this contention.

New liquidity rules have had a huge impact in the amount of capital that banks are willing to lend. According to the Breedon Report, with banks monopolising the lending market, there will be a shortfall of funding of between £84 – £191 billion from 2012 to 2016. Consequently, numerous measures have been launched in order to favour the development of the alternative lending sector.

In this context, Peer-to-Peer platforms appear as powerful players: they represent an innovative way of matching lenders and borrowers needs without any banking intervention. Not only do they offer better interest rates for both parties, they also introduce a simpler and quicker method to access credit. Platforms will be regulated in April 2014, however the industry is already worth £500 million. Whether this alternative lending method will be able to comply with the new regulatory demands is yet to be seen; nevertheless, considering that the unsecured loan industry is worth £20 billion and that consumers are increasingly willing to use Peer-to-Peer services, there are some important lessons to be learnt from this sector.

In addition to the aforementioned, traditional financial institutions are facing unexpected competitors in retail payments. It is important to note that this area of the business contributes to banks’ income through deposits, which represent the major funding source for European banks. Moreover, the new regulatory tendency to facilitate market entry for alternative payment services providers is adding extra pressure.

Unforeseen contenders such as Amazon, Google, Apple or PayPal have started to expand their current offering with views to enter the payments industry. For instance, ‘Google Wallet’, launched in the US two years ago, permits contactless payments. Similarly, PayPal, which operates with a banking licence, has developed a mechanism to authorise credit card payments through mobile devices. Although some banks might not see these ‘digital ecosystems’ as real threats to their business, ignoring their plans to enter the financial services arena would be unwise. According to recent surveys, these brands are perceived as ‘user-friendly, convenient and reliable services’. Therefore, in order to avoid losing an important market share, banks should invest in innovative payment solutions and establish strategic partnerships with new players.
The retail banking industry faces a period of transformation. Those that embrace the opportunities that the technical revolution presents will differentiate themselves from their competitors. However, building a long-term strategy during this time of economic uncertainty and increasing economic demands will be challenging.

In order to comply with the regulator’s principle-based proposals, organisations will have to undergo a profound revision of their product portfolios. Central to these behaviours will be placing the customer at the heart of the business, with the return to a service-driven banking model.

Finally, despite the limited success that new entrants have had in the retail banking industry, large institutions should consider how long they can rely on the relative stability of their business models. Once new competitors manage to overcome trust issues and regulatory barriers, they will use technological innovation to satisfy new customer’s demands and change what ‘good looks like’.

14 OFT – Review of the personal current account market, January 2013
15 Giles Andrews, CEO, Zopa, 2013

75% Current value of the unsecured loan market
£20 billion
Share of the PCA market held by Lloyds Banking Group, RBS, Barclays and HSBC
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