Looking ahead

Top trends in retail banking – 2014

Content

Market forces are driving current banking trends 1

Customer-centricity: From aspiration to action 3

Productivity: The new path to profitability 6

Service diversification: Time to explore new revenue streams 8

Market disruption by non-traditional entrants 10

Banks’ response to top trends is key to a sustainable future 13

Market forces are driving current banking trends

Increasing regulation. A sluggish economy.
The emergence of non-traditional market entrants.
Increasing domestic competition. Shifting customer needs.

As banks look for opportunity in an increasingly challenging, competitive and restrictive space, market forces like these represent a clear and present threat to revenue, profitability and growth prospects. Indeed, these forces are currently shaping the most significant trends in retail banking, including:

1. **Customer centricity:** The era of "customer centricity" as a generic and aspirational organizational value is over. In a banking landscape characterized by uncertainty and sluggish growth, winning the battle for the retail customer will be essential. A combination of enablers, including: Big Data, analytics, organizational commitment, and integrated channel strategy will be key to customer-centric banking strategies that sustain top-line and margin growth.

2. **Productivity:** As top-line growth slows, a renewed emphasis on transformational efficiency gains is becoming apparent. Unlike basic cost-cutting, this preoccupation with productivity focuses on both sides of the equation – revenues and costs – to drive sustainable gains and competitive advantage.

3. **Service diversification**: As low interest rates, earnings volatility and limited growth opportunities continue to impact the industry, financial institutions are looking to diversify their businesses. A desire for stability, growth, and higher margins is driving banks to pursue non-interest, fee-based income to supplement their traditional deposit-taking and lending model. To that end, wealth management and payments represent two important focus areas for banks in the year ahead.

4. **Market disruption from non-traditional entrants:** The parameters of the traditional banking landscape are becoming progressively blurred. As technological innovation democratizes the competitive playing field, companies like Google and PayPal will become greater threats to the long-standing incumbents of the financial services industry: banks. In fact, it's not just the technological giants posing a challenge – small and agile start-ups from Silicon Valley and beyond are actively seeking to disintermediate large financial institutions.

This paper discusses these trends in more detail, examining their relationship to powerful market pressures, their impacts on banks and the banking industry, and strategies for financial institutions to remain competitive and drive continued growth.

Customer-centricity: From aspiration to action

The 21st century customer

Today's banking customer lives in a complex, fast-paced, technology-driven environment. This is not the customer of a decade ago. This increasingly knowledgeable, sophisticated and demanding customer expects a banking relationship that delivers convenience, customization, control, collaboration, convergence and consistency.

- **Convenience** – access to information and the ability to perform transactions through whichever channels of interaction they choose.
- **Customization** – tailored solutions with a high degree of personalization based on individual profiles and preferences.
- **Control** – increasing control over management of personal finances and purchasing decisions, supported by data and analytics tools.
- **Collaboration** – the regular exchange of ideas and feedback on banking activities through online communities, in real-time.
- **Convergence** – technological innovation and adoption (e.g., smartphones) that increase the breadth and sophistication of tasks performed within and across channels (e.g., mobile, online).
- **Consistency** – a coherent and consistent experience with seamless integration across bank channels.

These new, dynamic, 21st century customers present banks with a host of challenges and opportunities; their growing list of expectations must be tangibly incorporated into current and future retail banking strategy.

Why banks must win the retail customer

In a banking landscape marked by low interest rates, increased regulatory scrutiny and unclear growth opportunities, winning a greater share of the retail customer's business is paramount to driving growth and financial returns. Moreover, re-orienting around the customer is as much a defensive strategy as an offensive one. As customers become more sophisticated and raise their product and service expectations, the risk of not being customer-centric will soar. Customer centricity is no longer a vague, aspirational ethos – it is table stakes for how banks must run their retail operations. Success on the retail customer battleground will be achieved only by those banks that steadfastly commit to tangible "customer centricity" investments and initiatives.

> Customer-centricity is no longer a vague, aspirational ethos – it is table stakes for how banks must run their retail operations.

How leading banks are organizing around the world

Data & analytics – While data collection has been a focus for banks over the past several years, it has taken on renewed relevance. Financial institutions are collecting larger and more complex data sets to provide the "raw material" for more sophisticated analytics programs. They are looking for a wide range of customer data, including attributes and demographics (who customers are), preferences (what customers want), behaviours (what customers do) and value (lifetime customer profitability).

As technological innovation continues and data capabilities improve to provide a single, holistic view of the customer, financial institutions will become increasingly adept at targeting and serving their customer bases. Organizations that are able to harness the power of these Big Data sets to deliver sophisticated customer interactions and product/service offerings will win a greater share of customers' business. In particular, delivering the right offering, at the right time, to the right customer, through the optimal channel will become a point of competitive differentiation. The customer experience will similarly improve as banks improve their ability to identify, craft, and deliver personalized experiences.

Service delivery – Exceptional service is largely achieved by effectively deploying sales staff and by executing a channel strategy that delivers the desired customer experience. In leading organizations, customer-facing staff are empowered with the right tools and training to make front-line decisions that address customer needs. They also have access to data-driven insights and customer records, allowing them to have personalized conversations with customers. Additionally, leading customer-centric organizations understand that channel roles must be clearly defined. Based on these definitions, channels can then be optimized to effectively and profitably sell to and service their varied customer bases. Banks must continue to build the capabilities necessary to enable a truly omni-channel distribution model - one where customers can operate seamlessly within and across all channels.

Performance measurement – Performance measurement in highly customer-centric organizations includes the identification, measurement and tracking of metrics that assess the customer experience. Examples of such metrics include the Net Promoter Score (NPS) as well as customer profitability, acquisition, retention and attrition rates, all of which measure progress against customer-based objectives. These metrics are actively monitored by senior management, and timely action is taken to address their outcomes. Key business leaders and sales staff are also measured against customer-centric metrics, with the results incorporated into performance-based compensation even at the senior executive level.

Operational alignment – Operational alignment around the customer is critical to delivering a customer-centric strategy. Most importantly, banks must consolidate ownership of all banking channels under a single executive owner. This ensures that banks have the mandate and practical organizational structure to execute an integrated channel strategy that reduces organizational silos, enhances sales and service capabilities, and prioritizes customer experience.

Product innovation – Sustained product innovation in truly customer-centric organizations is driven by insights gained through either analytics or feedback from customers via market research, customer surveying, or sales data. This requires strong coordination between sales, marketing and product design functions along with a standardized stage gate product development and management process that uses customer insights as a critical input. R&D is heavily emphasized and funded in the form of internal initiatives and external partnerships to institutionalize a process to find the "next" innovation.

Brand management – Leading customer-centric organizations engrain their brand into organizational culture by aligning all business elements with brand identity and core values. Brand image and values permeate all levels of the organization and extend across customer touch-points. This engenders a consistent customer message and experience where customers and employees alike "live the brand."

The future of customer-centricity

Customer-centricity has become a tangible, action-oriented strategy that places the customer at the centre of organizational investments, initiatives and day-to-day operations. Financial institutions that establish the organizational commitment, build the necessary capabilities and execute the strategy effectively will distinguish themselves from the competition. With "white space" limited and long-term growth prospects uncertain, winning the battle for the customer will be critical. Customer centricity - executed concretely - is a winning strategy that savvy banking organizations should embrace.

Productivity: The new path to profitability

Improving productivity has become a major focus for Canadian retail banks, not because banks suddenly became more conscientious with their processes, but because the luxury of unimpeded top-line growth has diminished. Productivity gains are now recognized as a key lever to protect and increase profitability.

Canada's base interest rate[1] has held steady at 1.00% since September 2010 and looks unlikely to change in the short-term.[2] This represents both an unprecedented stretch of consistently cautious monetary policy and a significant constraint to potential retail bank revenues, as many underlying products are tied directly or indirectly to this rate.[3] This low rate of return may have been overcome by banks under different circumstances; however, coupled with modest loan growth, increasingly restrictive fiscal regulations, high costs of compliance, slowing population growth and historic levels of competitive pressure, domestic revenues at Canadian retail banks will come under pressure.

Many banks have already begun the fundamental shift from doing the right things to doing the right things the right way. Productivity is more sought-after than traditional operational efficiency and cost-cutting tactics because it considers both revenues and costs – a more holistic approach to organizational profitability.

Productivity inherently avoids cost reduction that impacts revenue, making it a naturally popular metric in an intensely competitive retail banking space where increasing revenue is essential. For the most part, productivity gain targets are comprised of non-revenue-impacting NIX (non-interest expense) reduction. Organizations launching a productivity initiative should be pursuing two major goals: the optimization of FTE (full-time equivalents) and the reduction of supplier spend.

FTE reduction is synonymous with "cutting costs" and "operating lean," language often met with derision from the media, government and public who remain focused on job creation and protection. This reaction is not always justified. FTE optimization is focused on deriving the maximum potential output from all required inputs. The process may find that a desired output can be achieved with less input; however, oftentimes, FTE can be re-allocated towards higher margin, value-added activities, and may in fact lead to higher-paid workforces.

Productivity = (NIX* / Revenue)

where a lower score indicates higher productivity

*NIX is non-interest expense

Despite the importance of FTE optimization, the more significant productivity goal is that of reducing supplier spend. A strategic sourcing initiative or program is the most effective way to reduce supplier spend, and this is where Canadian retail banks face a significant challenge. The preconceived notion of sourcing is that it is a back office administrative function without strategic value. Throughout productivity initiatives, however, strategic sourcing is essential to realizing target NIX savings. Strategic sourcing makes use of eight different, critical levers.

1. Rate/Unit Price Reductions
2. Cost of Category Ownership Reductions
3. Cost Avoidance
4. Demand Management
5. Cash/Working Capital Easing
6. Specification Rationalization
7. Vendor Consolidation
8. Negotiation

While the complexities of sourcing exceed this paper's scope, banks have realized its importance and are striving to improve. Yet even after they start consistently treating sourcing as a strategic function rather than an administrative one, many organizations still face the substantial problem of measuring and incentivizing productivity gains. Today, one would be hard- pressed to meaningfully measure supplier spend in a retail bank because most managers, operating based on their CapEx and NIX budgets, are not expected to manage cash flow. This is a practical problem. What is not measured cannot be rewarded, and thus incentivizing productivity gain becomes quite difficult – in fact, this is a major roadblock for banks today.

Presently, productivity is not typically addressed as a business-as-usual area of focus, and productivity initiatives are addressed on a project-to-project basis. Organization-wide understanding of productivity's importance remains in its early stages, and what is not measured does not get done. Finding a way to tie performance evaluations to productivity gains is the first step down the productivity path; it could also help redirect employee focus as revenue gains and targets becomes increasingly difficult to achieve. The most successful organizations will be those that quickly recognize productivity as a key solution to weathering current and future market conditions. When productivity becomes business as usual and the sourcing function becomes a strategic one, Canadian retail banks will drive better financial outcomes while increasing their competitiveness and agility.

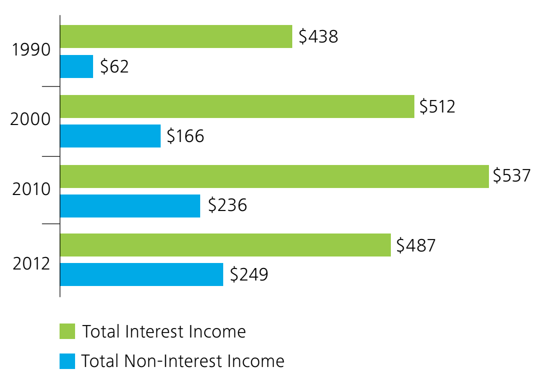
The most successful organizations will be those that quickly recognize productivity as a key solution to weathering current and future market conditions. When productivity becomes business as usual and the sourcing function becomes a strategic one, Canadian retail banks will drive better financial outcomes while increasing their competitiveness and agility.

Service diversification: Time to explore new revenue streams

Recent developments in the financial sector's operating environment have placed banks' traditional business under threat. Already challenged by unsustainable consumer debt and growing price sensitivity among consumers, banks have been further pressured by low prevailing interest rates and increasingly stringent regulation. A number of regulations, including the Dodd-Frank Act of 2010 (which applies only to the U.S. but could signal something similar in Canada) have limited the fees that banks can charge consumers. Furthermore, increased capital requirements imposed by Basel III will lead to increased funding costs, negatively impacting operating margins. In order to seek margin stability and growth amidst challenging market dynamics, banks must explore opportunities outside the sphere of their traditional businesses and expand into alternative revenue streams.

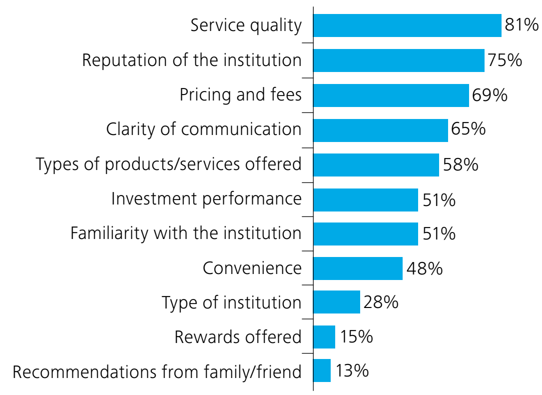
Many banks are shifting their focus and investment dollars toward non-interest income products and services, such as wealth management, payments and insurance. The fee-based revenues these products offer can also yield potentially higher margins and lower interest rate exposure while providing more opportunities for growth, innovation and entry into untapped markets.

Growth of non-interest income across US banks ($B USD)[4]



With the continued expansion of global wealth, the wealth management business is a highly profitable segment for banks as its fee-based revenue model provides a high degree of stability. While banks have traditionally played in this market, competitive pressures are leading them to re-evaluate their growth strategies. Many have begun to strategically align their offerings to profitable client wealth segments. The affluent segment is especially attractive, as it is expected to double in size globally over the next decade, with Canadian wealth among millionaire households rising from $3.35 trillion in 2011 to $6.77 trillion in 2020.[5]

Banking values as ranked by wealthy clients[6]



To address this market of high-net-worth and ultra-high-net-worth clients, banks are seeking to establish credibility in private banking, family offices, and other private wealth management service offerings. As wealthy clients prioritize service quality, many banks have opened dedicated branches catering to clients meeting a specific wealth threshold, where they can provide increased access to expert advisory services and exclusive offerings. Meanwhile, to better address the needs of mass- and mid-market wealth clients, banks are leveraging technology to provide services such as self-directed brokerage platforms, on-demand advisory services and customized investment reporting – all via the online and mobile channels. By re-aligning their wealth management service models, banks are able to achieve growth across client segments and target high-margin segments while managing the overall cost to serve.

Outside of their existing businesses, banks must also actively determine their role in non-traditional, high-growth sectors, such as online and mobile payments, social media and advertising. Over one billion smartphones shipped in 2013[7], making the mobile channel an integral part of customers' lives and an important service channel for banks. While many banks have strong traditional payments businesses, a multitude of non-bank players are innovating in the mobile payments space. To avoid disintermediation and to capitalize on this new revenue opportunity, some banks have launched mobile payment solutions independently or in partnership with mobile networks and e-commerce providers; many have found an additional revenue source in merchant-funded offers. Vendors such as Cardlytics leverage banks' substantial payment transaction data to generate retail offers for cardholders. Because banks provide the presentment channel, they receive a fee every time an offer is redeemed, while also benefiting from increased cardholder engagement and card usage.

While there are several service diversification opportunities for banks, improperly managed investment in the growth of new or renewed service offerings poses a risk to existing business. The impact and risk to the organization should be considered across three key dimensions:

People – Launching a new service offering is effort-intensive and requires comprehensive planning and expertise across both the front and back office. Given the current industry focus on organizational streamlining, initial instincts suggest diverting effort from existing operations into new offerings. However, banks must be willing to invest up-front to establish a strong foundation for success. Furthermore, as clients become increasingly discerning, service levels and product knowledge will be critical to any new offering's success, making careful selection of customer-facing talent critical.

Processes – The added complexity of a new offering places strain on many back office processes. For example, if the operations required for a new service already exist, integration becomes critical to success. Streamlined client onboarding, account integration to enable seamless service bundling and access to the full breadth of distribution channels are necessary to achieve high quality of service. Ensuring these processes are scalable enough to handle the resulting increased business volume is also imperative.

Technology – Systems must be able to easily access important customer data. Customer insights and analytics will be a key driver of customer segmentation, which facilitates cross-selling and up-selling of offers. Furthermore, data-driven insights can be leveraged to continually fuel product development and the delivery of superior customer experience.

Banks looking to effectively diversify and grow new revenue streams must plan with scalability in mind – in all critical areas – to minimize negative impact to existing business.

Market disruption by non-traditional entrants

Competitive intensity in the retail banking industry has exploded throughout the past half-decade as market disruption has become a growing reality. Powerful non-traditional competitors are entering the market at an increasing rate.

Market disruption has flourished under three prevailing conditions:

1. Customer need is more divergent and varying than ever before.
2. Technology is democratizing the customer and levelling the playing field
3. Convergence is becoming the "new normal" as companies transcend their "original" industry

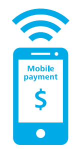
Customer needs have become more divergent because the population has become more diverse. There are more very young and very old people; more people are marrying later, choosing not to marry, divorcing, forming alternative families and living comparatively unconventional lives; career changes are more common and expectations are higher – all these dynamic social realities create a population with wide-ranging needs and expectations. It also makes it more difficult to cater to the entire population with standard offerings.

Competitors are poised to exploit this situation. The Internet behemoths are mounting their challenge on many traditional bank revenue lines, and they pose a major threat to the Canadian financial sector's balance of power. The customer is at the centre of the struggle and will inevitably ask: what can a bank do for me that no one else can?

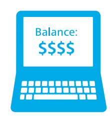
Traditional banks are still feeling the after effects of the 2008 financial crisis. Public opinion has largely recovered, but long-term consequences may be severe as customers begin to realize they don't have to cast their lot with the banks. As technology-enabled customers become more knowledgeable, two things will happen: they will demand lower costs for unspecialized products, and they will begin seeking more personalized products and specialized services. The direct effect of these behaviours will be reduced margins on traditional mass offerings and the introduction of personalized products by both traditional banks and new competitors. New competitors, however, since they are themselves highly technology-enabled, may be able to access these customers more effectively.

Technology is democratizing access to customers. Until very recently, it was exceptionally difficult to access a customer's "wallet" unless you were a major bank. This has changed, and while the democratization effect is most apparent in the payments space, it is impacting a number of traditional banking strongholds:

Payments – The largest and most impending threat to traditional banks is the disintermediation of payments as tech industry giants introduce mobile payment products such as Google Wallet and a large looming potential threat, Passbook.

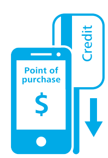


Retail Banking – Mint.com has launched a retail banking offering and will continue to invade this traditional profit line. Providers of simple, low cost, mass solutions will seize the opportunity to move up the value chain.



Wealth Management – Covestor is an online platform that opens up traditional money management services to a wider public. Value-add wealth management offerings are accessible to more than just the affluent now; those new services provided by companies like Covestor are increasingly resonating with customers.

Point of Sale – New entrants such as LevelUp are challenging traditional revenue streams with simple card readers that are simple to use and more cost-effective for merchants. To incent merchants to use its mobile payments and rewards system, LevelUp eliminated MDR (merchant discount rate) fees for debit and credit cards to achieve a state of what it refers to as "interchange zero". While LevelUp's new economic model is in its initial stage it poses a threat to the significant revenue financial institutions receive from merchant-funded payment transactions.



Market disruption by non-traditional entrants (cont'd)

The emergence of serious banking competitors is a real problem. Four of the Big Five major retail banks are in the top 10 largest Canadian companies (CIBC is 13th), and our top three banks represent our three largest companies. The tech giants that are entering the market, however, such as Google (358 B), Apple (499 B) or even Facebook (134 B), are the first major contenders with comparable resources.[8] They are not only large but have some inherent advantages. Apple, through iTunes has payment information for ~600M customers on file. Even more troubling is the emerging infrastructure capability of technology companies. Google is laying fiber-optic cable, and the decreasing cost of server space will allow companies to use secure data for currency transactions.

This shift may well culminate in a widely adopted norm that becomes indispensable to Canadian businesses and consumers. Hong Kong's Octopus card, with an adoption rate around 95%, offers an instructive precedent. Canadian retail banks should seek a stake in these transformational businesses/schemes, or have their proprietary technology adopted – before a new, third-party standard becomes widely accepted.

Canadian retail banks are in for a fight, but they can defend their position by moving quickly to develop proprietary technology and by flipping traditional strategy on its head. In the past, they have used standard mass offerings to drive customers to their value-add, high-margin and personalized offerings. Now they risk losing customers unless they can integrate their full range of offerings and incent customers to stay, either by making switching too costly or by providing a higher level of service.

Another important strategy will be to explore non-traditional partnerships designed to drive customer adoption. For example, CIBC recently partnered with Rogers, a mobile network operator, to launch Canada's first NFC-based mobile payment solution in 2012. In the US, Bank of America is partnering to provide merchant-funded offers through its BankAmeriDeals program, thus sharing the cost of offering value-added services while building customer loyalty. Such innovative, non-traditional partnerships will be critical if Canada's retail banks are to sustain success in the face of competitive inroads from new entrants.

Canadian retail banks are in for a fight, but they can defend their position by moving quickly to develop proprietary technology and by flipping traditional strategy on its head.

Banks' response to top trends is key to a sustainable future

Canadian retail banks face a shifting market environment full of complex, evolving challenges. The four top trends we've identified: customer centricity, service diversification, productivity, and market disruption from non-traditional entrants, are the direct result of market forces impacting banks' profitability and reflect the measures banks are taking to address these market conditions. Banks are at a critical juncture as slow economic and organizational growth, expanding customer needs and expectations, and a rapidly emerging range of customer options threaten their traditional sources of revenue. Understanding and addressing these trends with innovative solutions are a must if Canadian banks are to remain competitive, relevant, and financially successful in the uncertain decade to come.

Understanding and addressing these trends with innovative solutions are a must if Canadian banks are to remain competitive, relevant, and financially successful in the uncertain decade to come.

Our team

Rob Galaski
Partner, Consulting
rgalaski@deloitte.ca
416-601-4594

Vipul Lalka
Senior Manager, Consulting
vlalka@deloitte.ca
416-601-5959

Matthew McWhirter
Manager, Consulting
mmcwhirter@deloitte.ca
416-775-8642

Sapna Mehta
Senior Consultant, Consulting
sapmehta@deloitte.ca
416-601-6135

Christopher Ho
Consultant, Consulting
chriho@deloitte.ca
416-775-7353

References

1. Bank of Canada Overnight Rate
2. Widespread belief of many of the nation's top economists as well as Deloitte's POV
3. Most prominently deposits and mortgages (two major drivers of bank profitability
4. FDIC http://www2.fdic.gov/qbp/index.asp
5. Deloitte Centre for Financial Services, The next decade in global wealth among millionaire households, May 2011
6. Deloitte, Growing pains in wealth management and private banking, 2012
7. International Data Corporation http://www.idc.com/getdoc.jsp?containerId=prUS24645514
8. Market Capitalization of Google, Apple, and Facebook as of December 17, 2013

Additional sources

- Bank of Canada
- Canadian Bankers Association
- Conference Board of Canada
- Deloitte Centre for Financial Services
- Deloitte Global Benchmarking Center
- Deloitte Subject Matter Experts (SMEs)
- Economist Intelligence Unit (EIU)
- Gartner
- Forrester Research
- Office of the Superintendent of Financial Institutions (OSFI)
- Statistics Canada
- Thomson Research