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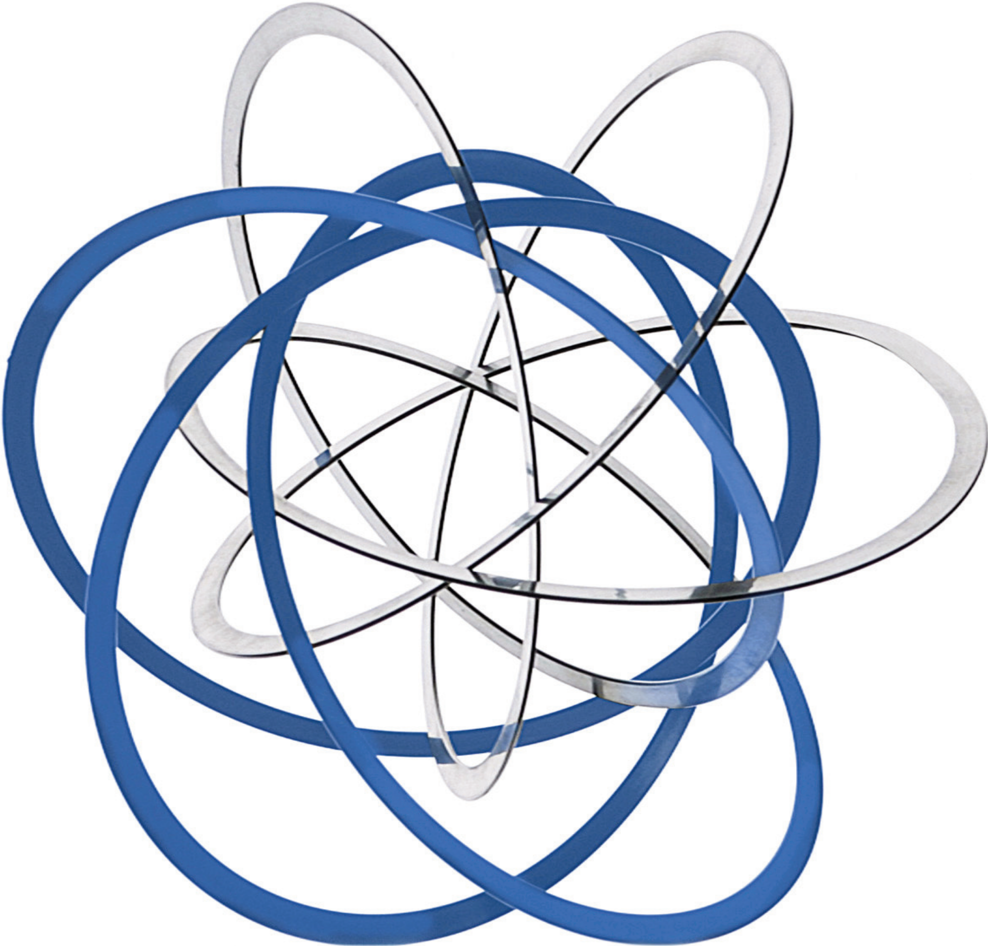
# The fourth dimension
# Building customer-centric business models in retail banking



A Deloitte Research Study

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# Foreword

In 2006-07, banks and building societies were in a race to increase their share of the UK retail lending market. Thanks to low-cost wholesale funding and low interest rates, financial institutions were able to offer competitive prices to a full range of credit-hungry customers.

In 2011, the situation is very different. Today, banks and building societies are operating with a more modest appetite for risk, a higher cost of funding and new regulatory requirements for liquidity and capital adequacy. The priority for banks has therefore been to shore up their balance sheets. With this end in mind, they have been disposing of non-core assets, increasing customer deposits, restricting access to credit and starting to re-price capital-consuming products.

With this focus on balance sheets, traditional paths to growth are constricted. So retail financial institutions are now carefully considering how to succeed in this changed competitive and regulatory landscape.

Based on interviews with senior executives, a consumer survey of 2,104 UK adults, and financial analysis of UK retail banks and building societies, this report seeks to answer the question: "Where next for UK retail banking?"

Nick Sandall
Managing Partner, Financial Services, UK

# Executive summary

### A new competitive landscape is challenging traditional paths to growth

Since the recent financial crisis, pressure on capital and liquidity has led banks and building societies to restrict their lending and to focus on gathering deposits. A more forceful regulatory agenda has also curtailed sources of non-interest income and caused operating costs to escalate. As a result, traditional paths to growth have become more challenging.

Capital-adequacy ratios are now much improved. Yet growth in lending and profitability is likely to remain tough. Senior executives interviewed for this report expect balance-sheet constraints to influence their competitive strategies well into the future.

As banks try to increase their income and profitability, they face some difficult choices. With more restrictive lending and higher operating costs, some customers have become expensive to serve and less profitable. The long-term sustainability of the current *modus operandi*, where a major bank services 10-15 million customers – of which a proportion is unprofitable – is now in question.

### New customer strategies

To overcome the profitability challenge, banks and building societies are seeking to refocus their customer strategies. Interviewees say they will:

1. Maintain capital-adequacy and liquidity positions with highly disciplined underwriting and longer-term structures for deposits.

2. Generate new sources of income by restructuring bank fees and charges, by introducing new products and by improving customer retention.

3. Drive greater operational effectiveness and cost efficiency through more efficient banking processes.

4. Retain and attract the most valuable customer segments by introducing more wealth-management-style products and higher quality service.

Deloitte's consumer research shows, however, that there is a tension between these new plans and what customers want. Over the 12 months to October 2010, UK consumers became more distrustful of their banks, increasingly liable to switch providers and more resistant to higher charges.

### Sharper business models

To turn around customer attitudes, banks and building societies are increasingly focussing on one of two competing business models:

1. **The high-volume, low-cost model** uses a simplified operating model that achieves error-free processing and market-leading (low) charges for customers.

2. **The service differentiated model** uses a more flexible operating model that can tailor service and delivery to customer segments.

Our interviews suggest that most institutions have chosen service differentiation as their favoured path to growth.

### Challenges to service differentiation

While the logic for service differentiation is clear, there are some difficulties too.

Turning around UK consumers' attitudes in the current climate is tough, and high-end customers' attitudes are among the most difficult to turn. They are less loyal than the average customer and harder to retain.

The current operational capabilities of banks are also a challenge. They are often inadequate for service differentiation and for the customer segmentation strategy that underpins the model.

Many high-street banks and building societies are seeking to compete for the high-end customer segment. Incumbent banks and building societies will require defensive strategies to retain their own customer 'sweet spots' in the face of intensified competition.

### Turning customers around

Deloitte's research suggests four areas that provide customer satisfaction and increase retention: safety; value; convenience; and service. In today's climate high-end customers view safety and value as paramount.

To deliver differentiated service, customer insight becomes more important. While basic customer information is enough for targeted marketing, more granular insight is required to create services that are tailored to specific segments or individuals. Banks need to form, and embed, a single view of the customer (SCV). As the data for such a view resides in pockets across the bank, operating models should be re-engineered to facilitate co-operation and data co-ordination throughout the firm.

Deloitte recommends:

- Adjusting banks' operating structures for a more customer-centric model
- Driving co-operation through stronger leadership
- Simplifying the operating model
- Realigning staff and culture to the business model
- Building multi-channel capabilities with simplified product sets
- Integrating client insight data onto one platform
- Building business-analytics capabilities
- Prioritising change
- Improving messaging and branding

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As banks try to increase their income and profitability, they face some difficult choices. With more restrictive lending and higher operating costs, some customers have become expensive to serve and less profitable.

# 1. Traditional banking models are challenged

### 1.1 A new competitive landscape is challenging traditional paths to growth

Retail banks and building societies are currently faced with two sets of challenges to growth: they are struggling to increase their lending volumes under new capital and liquidity constraints; and a more forceful regulatory agenda is having an impact on their non-interest income and also increasing their costs.

a) Restricted lending opportunities

Wholesale funding has become scarce and, when available, is expensive, especially for longer tenors. Combined with requirements for larger liquidity buffers, this has increased banks' funding costs significantly. Such funding has been restricted at a time when low base rates are also squeezing liability margins. In addition, banks have seen capital requirements increase for their personal-loan books, and risk-weightings have also risen. New liquidity and capital requirements have demanded that banks rebuild their balance sheets as a matter of priority.

These factors have caused financial institutions to be more selective when giving customers access to credit, affecting their ability to increase their lending volumes[1]. Many have also entered into a race for retail deposits in order to reduce their dependency on wholesale funding.

b) Lower non-interest income and increased costs

In addition, sources of non-interest income are being squeezed by a more forceful regulatory agenda. For instance, regulations moderating bank charges and restricting sales of products such as payment protection insurance (PPI) contributed to a 14% decline in UK banks' non-interest income between 2008 and 2009[2].

As long as capital adequacy and liquidity positions remain the driving forces behind financial institutions' strategic and competitive decisions, income growth is likely to remain challenging.

Regulation is also significantly increasing banks' costs. Capital and liquidity management is being reshaped under the Basel III requirements, while banks are reassessing product manufacture and distribution as the Retail Distribution Review (RDR) in the UK and the EU's Markets in Financial Instruments Directive (MiFID) take effect. In addition, there are numerous customer-focused reviews underway. According to Deloitte's interviews with senior retail bankers, over a third of all current change programmes are "compliance-driven", and 30% of their Chief Executives' time is now spent on addressing the regulatory agenda.

The combined effect of these forces is that banks find it tougher to generate through-cycle return on equity (ROE) above their cost of capital.

### 1.2 Income growth is likely to remain constrained

As long as capital adequacy and liquidity positions remain the driving forces behind financial institutions' strategic and competitive decisions, income growth is likely to remain challenging. The majority of executives interviewed for this report consider that capital and liquidity will indeed remain a strategic priority for some time to come. They give several reasons for this:

a) **Repayment of government-backed funding:** The Special Liquidity Scheme (SLS) and the Capital Guarantee Scheme (CGS) were instrumental in stabilising the markets during the peak of the credit crunch. As these are due to wind down over the next 12-18 months, many institutions will need to refinance through the wholesale markets, potentially putting further strain on their earnings' growth[3].

b) **Regulatory requirements will keep capital and liquidity on the agenda:** Regulations on capital management (e.g. Basel III) will ensure that banks underwrite only within prescribed capital and liquidity buffers. In addition, changes to capital-allocation rules will make it more difficult to cross-subsidise growth markets and segments by moving capital across divisions and borders.

c) **Building societies may struggle to raise funds:** Mutualised financial institutions have their own funding challenges as they are restricted in raising capital. Without adequate capital-raising instruments, such institutions will be dependent on retail deposits to fund lending[4].

"Banks have been ignoring profitability, focusing on gathering deposits at any price. The industry is emerging from this phase now – and the new pressure is on profitability." – Head of UK Retail, high-street provider

*"Capital will remain an issue. Building societies do not currently have sufficient capital-raising capability. The industry is working with government to produce a capital-raising instrument."* – Head of Strategy, large building society

d) Low consumer savings: Banks seeking retail deposits may be frustrated in their aims by the current low level of UK consumer savings. According to Deloitte's consumer survey, over 40% of the adults questioned have less than £5,000 in cash savings (not connected with retirement) and evidence suggests that such savings are diminishing during these tough times[5].

e) Capital expenditure (capex) is otherwise occupied: Keeping the cost of regulatory compliance in check will be difficult over the next three years. Currently, much capex is diverted from potential growth initiatives to the extensive regulatory agenda.

*"The regulatory agenda has drained our bandwidth for other [change] projects."* – Head of Strategy, large building society

It is clear that capital- and liquidity-related pressures are unlikely to go away. They are likely to continue to provide headwinds for banks seeking to increase their top-line revenues[6].

### 1.3 Banks turn to income and profitability... and face some difficult choices

Interviewees confirmed that, until recently, income and profitability growth have taken a back seat while institutions have shored up their balance sheets and tackled rising impairments.

But banks have now taken a first step to restoring trust with their customers, shareholders and regulators – trust that was lost during the financial crisis. Across UK retail banking, capital-adequacy ratios are much improved, and there has been significant capital raising over the past three years.

Now that UK banks' and building societies' capital and liquidity are in a better position, their focus is, once more, turning to raising income and profitability.

With lending to customers restricted, with bank charges and new income streams subject to regulatory review, and with a regulatory agenda which is placing upward pressure on operating (and financing) costs, many banks have found it difficult to serve their entire customer base profitably. For instance, customers with few deposits, or those with basic needs, or (simply) the price-sensitive, can represent an expense rather than an opportunity.

*"Customers attracting higher charges for overdrafts and late payments are becoming less profitable. These are often in the less well-off categories, and without significant savings in the bank they become less valuable too."* – Retail Strategy Head, high-street provider

The long-term sustainability of traditional banking models, where each major bank services 10-15 million customers – of which a proportion is unprofitable – is under question.

# 2. Two models compete

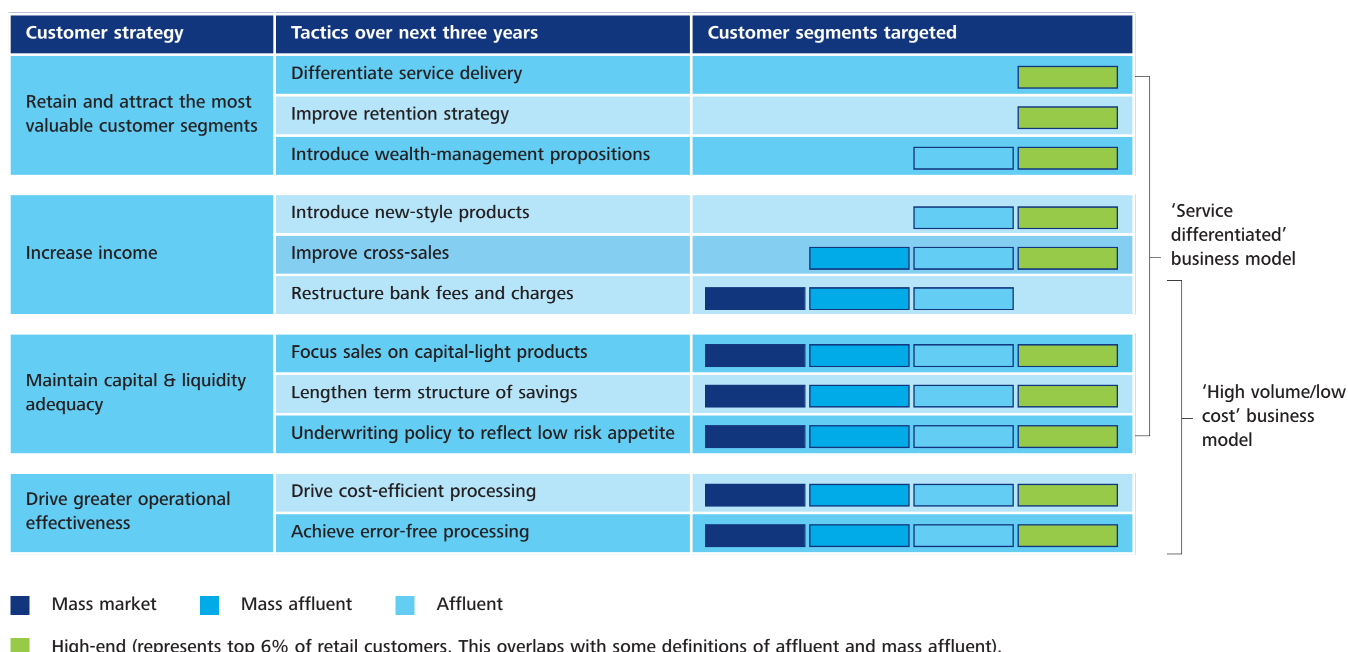
In the search for profitable income growth, banks are reshaping their customer strategies. Two distinct business models are competing in the new, balance-sheet-conscious landscape: the high-volume, low-cost model; and the service differentiated model. Most financial institutions are choosing the latter, differentiating their service for 'sweet spot' core customer segments.

### 2.1 Deploying new customer strategies

Interviews with senior executives reveal an industry searching for ways to serve customers profitably and to differentiate themselves from the pack. Their three-year customer strategies fall into four categories (illustrated in figure 1):

- driving greater operational effectiveness;
- maintaining capital and liquidity adequacy;
- increasing income; and
- retaining and attracting the most valuable customer segments.

**Figure 1. UK banks' and building societies' three-year customer strategies**




Source: Deloitte Research, 2011

a) **Driving greater operational effectiveness**
Many banks and building societies now see operational effectiveness as a way to differentiate and improve profitability. Fixing sub-optimal operating models through improved process management (e.g. using lean Six Sigma or other quality management systems that seek to minimise waste and create more consistent delivery) is increasingly seen by interviewees as an opportunity to bring down the 'cost-to-serve' of each customer (thereby justifying the continued service of more customers) and to facilitate error-free processing.

b) **Maintaining capital and liquidity adequacy**
The need to maintain strong capital and liquidity positions will continue to shape banks' new customer strategies. For example, their growing reliance on customer deposits (to fund lending) has led to a focus on attracting savers and locking them into longer-term savings products. In addition, many interviewees are seeking to base new propositions around 'capital-light' products.

c) **Increasing income**
Almost all interviewees intend to increase cross-selling to drive income growth and customer profitability. Most banks are focused on the practicalities of delivering better customer information to staff at the point of sale as a way to improve cross-sales. Seeking to capture new income streams and opportunities from the RDR, banks and building societies are also looking to introduce new wealth-management products and services[7].

“A £5,000 credit card sitting in a customer’s drawer is not a good use of capital.” – Director, Retail Strategy, large high-street provider

*“At present we are filling two needs per customer. We need to get this up to four or five.”* – Director, Retail Strategy, large high-street provider

With several sources of fee income curtailed (e.g. restrictions on PPI and bank charges), banks are also exploring changes to fee structures and bank charges. The UK’s ‘free-banking’ model (in which a minority of customers incur high charges to subsidise the majority) is slowly being reshaped. Many financial institutions are raising the use of packaged accounts and other added-value accounts (AVAs). In addition to the monthly fees from such accounts, some banks are seeking to move towards more individualised charging[8].

*“There is a waterbed effect: where fees are squeezed we need to shift around the charging structures.”* – Director of Strategy and M&A, large high-street provider

d) **Retain and attract the most valuable customer segments**

Many interviewees consider competing in the mass consumer space as a race to the bottom. They are therefore seeking to attract and retain the most profitable segments. To improve customer retention among target customers, they are seeking to move segmentation beyond the marketing function and into the service itself – to compete on differentiated service.

*“We want to move segmentation into the service model. This may [alienate] the mass market as we differentiate through service. But we have to connect to key segments beyond price.”* – Director, Retail Strategy, large high-street provider

### 2.2 Tension between customers and bank plans

There is currently a tension between what customers want and what banks and building societies plan to achieve over the next three years. UK customers are likely to be resistant to banks’ efforts to deepen relationships. According to Deloitte’s survey, UK consumers’ attitudes have, if anything, hardened since the onset of the financial crisis. They are now:

- **More distrustful of financial institutions:** Consumer distrust of banks has grown since the credit crisis[9]. Some 73% of the adults questioned said that banks were no more nor less safe than 12 months previously (to October 2010), with the net balance suggesting the situation had deteriorated[10].
- **Increasingly switchable:** Few customers feel loyal to their financial-service providers. 18% of respondents moved one or more of their bank or building-society relationships in the 12 months to October 2010. And some 67% of respondents said that they are more likely to seek out good rates and move to another bank or building society than they were previously.
- **Resistant to higher charges:** Customers rarely see the ‘value-add’ in banking services; they have become accustomed to the ‘free-banking’ model. Hence, four out of every five (79%) respondents say they would move their current account if higher charges or a monthly fee were introduced.
- **Unconvinced about ‘total solutions’ or ‘single-bank’ models:** Many customers do not see the value in holding their whole suite of products with a single bank – suggesting difficulties for banks planning to improve their cross-selling rates and share-of-wallet. Despite the fact that 63% agreed that it is easier to keep all accounts in one place, just 29% said they use only one financial-service provider.
- **Seeking instant access:** At a time when banks are seeking to lengthen the term-structure of their deposit base, consumers are demanding instant access to their savings.[11]

## 2.3 Banks are sharpening their business models to turn customers around

While all banks and building societies are seeking to i) maintain capital and ii) generate income in roughly similar ways, two distinct business models are competing, each with a different focus:

- **High-volume, low-cost model:** using a simplified operating model that achieves error-free processing and market-leading (low) charges for customers, this business model competes on value (pricing and charges) and a consistent level of (basic) service.
- **Service differentiated model:** using a more flexible operating model that can tailor service and delivery to customer segments, this business model aims to provide enough 'value-add' to retain the most valuable customers, or to charge a premium.

Figure 2 details the key characteristics of the two approaches.

Many interviewees stated that their organisations have chosen service differentiation – tailored to their most valuable customers – as their favoured path to growth. They are targeting customers with significant deposits, multiple needs for capital-light products, low-risk lending requirements, and a willingness to pay fees.

**Figure 2. Competing business models – 'high volume/low cost' and 'service differentiated'**

| **Business model: high volume/low cost** | **Business model: service differentiated** |
|---|---|
| High-volume, operationally efficient businesses differentiate with error-free processing and low charges for customers. Seeking to win and retain customers on value (pricing and charges) and consistent levels of service. | Providing enough 'value-add' service to retain the most valuable customers, or charge a premium. Resources required for improved service are typically focussed on target or core 'sweet spot' customer segments. |
| **Operating model: simplified**<br>• Simplified operating model arranged for high volume processing, using standardised processes, products and product-sets.<br>• Business units are typically grouped or organised by product lines.<br>• Likely to operate as a single brand (a 'one-brand' bank) denoting their simplified models. | **Operating model: customer-segment focused**<br>• Distribution is tailored to target customer segments.<br>• Business units are typically organised by products, but could be organised by core markets (e.g. local region or customer segment).<br>• Often based on a 'multi-brand' business model to allow each brand to specialise. |
| **Customer segments:**<br>• Focussed on mass market, but serving all. | **Customer segments:**<br>• Focussed on the most valuable customers, but serving most UK consumer segments. Segmentation strategy informs all parts of the business. |
| **Service and delivery model:**<br>• Distribution and manufacturing processes are standardised to provide lowest cost, transparent pricing, products and services.<br>• Simplified and standardised products are offered to all customers, distributed on a multi-channel basis (new products are designed to operate on all channels).<br>• Direct channels are highly developed and used wherever possible.<br>• Pricing and charges are based on flat rates across the customer base. | **Service and delivery model:**<br>• Service and delivery (front office/mid office) are tailored to specific customer segments and have some autonomy to act in accordance with needs of key customers segments.<br>• Supporting functions and manufacturing proceses are industrialsed for some improved operational efficiency and to facilitate multi-channel capability.<br>• Pricing and billing is increasingly based on customer segments or individuals. |
| **Governance, organisation and processes:**<br>• Centralised governance drives improved and transparent performance metrics, cost reduction and standardisation across business units (divisions).<br>• Processes in both front and back office and across divisions are integrated where possible.<br>• Enhanced process management is used (e.g. lean Six Sigma or other quality system). | **Governance, organisation and processes:**<br>• Decentralised governance is typical with performance metrics owned at the local (business unit) level, allowing some autonomy to tailor responses to specific/local target markets.<br>• Moving to stronger centralised governance to build operational efficiency in back- and middle-office functions (e.g. risk/capital management) and to facilitate co-information sharing for improved customer insight. |
| **Information:**<br>• Insights are product-driven. Customer information is aggregated to give performance metrics and strategies for the whole customer base or major customer segments.<br>• Excellence in MI data management is emphasised. | **Information:**<br>• Customer-driven insights are based on target customer segments or specific customers. Data relating to one customer is drawn from many parts of the banks (product-holdings and channels) to achieve a single view of the customer. |
| **Technology:**<br>• Technology is seen as major competitive advantage underpinning operational efficiency across the organisation. Typically banks using this model have undergone fully executed total core replacement programmes to work from a highly integrated platform. | **Technology:**<br>• Technology is seen as central to delivery, but represents just one of several sources of competitive advantage. Technology initiatives can be prioritised according to how they impact target customer segments. Typically banks using this model undergo partial core replacement programmes. |
| **People:**<br>• Operating model designed for automation, providing error-free, cost-efficient processing, improved control and consistent service delivery (reduced human error). | **People:**<br>• Front-line staff (e.g. in contact centre, branch or relationship managers) specialise in servicing target customer segments with enhanced, relevant product and service knowledge. |

## Many interviewees stated that their organisations have chosen service differentiation – tailored to their most valuable customers – as their favoured path to growth.

According to Deloitte's consumer survey (carried out in October 2010), high-end customers with significant savings or income fit this bill. Just 6% of those questioned have savings of more than £50,000, and only 3% of respondents have a gross personal income of over £50,000 per annum. Some banks label this group mass affluent or affluent[12].

These high-end customers have been the winners from the recession, having increased their savings more than average over the 12 months to October 2010. They also have more complex needs to fulfil and a greater capacity for capital-light products, and they are more open to certain types of banking fees.

Therefore, many UK retail banks and building societies are seeking to deepen relationships with target customer segments, predicated on improved service. In this respect, the market is moving from breadth to depth.

Banks will, however, continue to serve segments outside their core target customer markets. None appear to have plans to exit entirely from the mass consumer market.

For some banks, the service differentiated model may be compelling because it better fits with their current operational capabilities. For several interviewees, re-engineering their operations for a high-volume, simplified operating model is not a pragmatic route to differentiation. Large, complex incumbent banks, with many millions of customers each, may find service and process improvement for all customers a tall order. Focusing scarce resources on improved service for their most valued customers may be a more realistic option.

### 2.4 Service differentiation focused on 'sweet spots'

Banks are targeting customers with significant deposits, multiple needs for capital-light products, low-risk lending requirements, and a willingness to pay fees. With their own customer data, each bank and building society can define which customers fit this profile.

The logic for targeting these high-end customers is compelling. High-end segments have:

- **Fared better during the recession:** Over the 12 months to October 2010 the segment was almost twice as likely to have increased their savings (37%) than the average (20%).

- **More complex needs to fulfil:** High-end customers are more likely to have complex needs (which are required for improving cross-sales and the sales of packaged products, etc). They typically hold a greater number of products and demand more sophisticated financial products and services.[13].

- **Greater capacity for capital-light products:** High-end customers are also more likely to use wealth-management products and services. For instance, high-end consumers were twice as likely as the average to switch from cash to equities in the 12 months to October 2010 (although this is based on a small sample).

- **More open attitudes to certain types of bank fees:** Although more price-sensitive to savings rates, high-end segments are more likely than average to accept monthly fees/charges from their financial-service providers[14].

## Many UK retail banks and building societies are seeking to deepen relationships with target customer segments, predicated on improved service. The market is moving from breadth to depth.

# 3. Obstacles to delivering service differentiation

Banks and building societies face two important hurdles in moving to a service differentiated model based on high-end segments: customer attitudes and current operating models.

### 3.1 High-end customer attitudes are among the most difficult to turn around

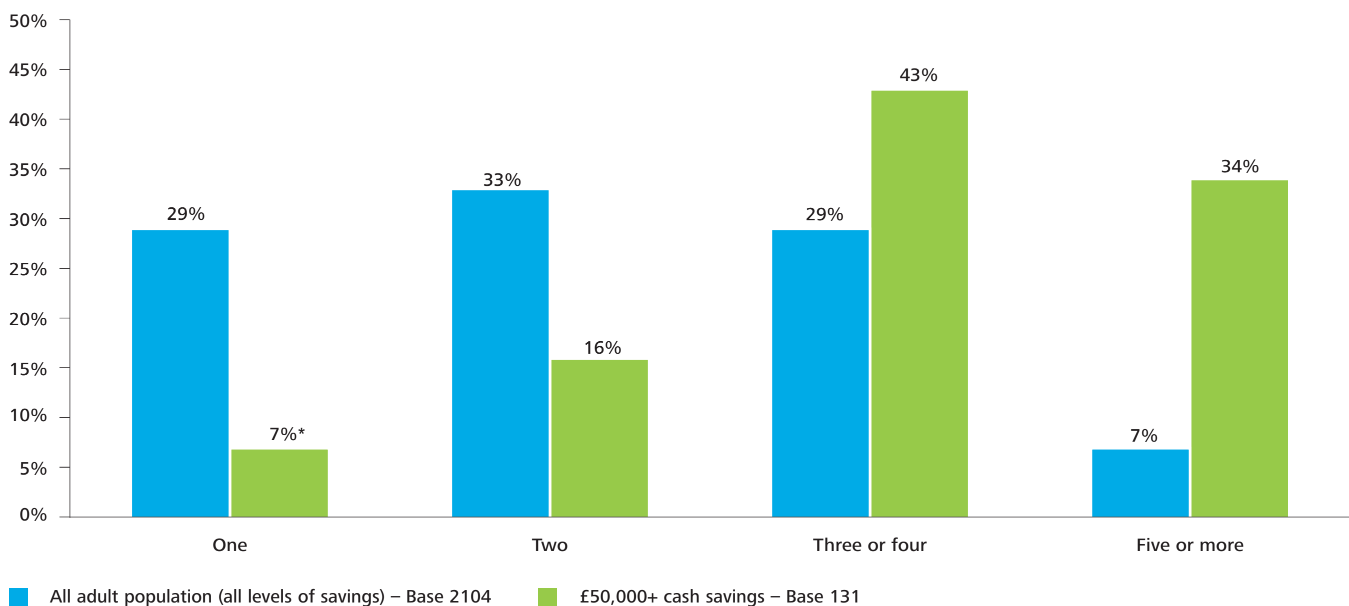
Despite the attractions of high-end customers, their behaviour and attitudes make it difficult to gain enough customer insight on which to base truly differentiating and tailored services. For example, high-end customers are less loyal than average. While 62% of all adults questioned have one or two relationships with financial-service providers, 77% of high-end customers have financial products from three or more banks or building societies[15]. This makes customer retention difficult.

High-end segments are indeed harder to retain. Typically prompted by higher rates offered elsewhere, they are more likely to switch providers than the average. Some 79% of switchers in the segment changed provider in order to get a better rate, compared to 66% of all adults questioned. The high-end is also the most open to using new market entrants.

In addition, high-end customers are the most likely to state that they have not been rewarded for their loyalty. While 68% of UK adults questioned do not believe that banks have worked harder to retain their business since the financial crisis began, for high-end consumers that figure rises to 82%.

Without good retention, trust and loyalty, improving customer insight is very challenging. And without insight, banks are unguided in how to differentiate their service.

**Figure 3. How many banks/building societies do you hold financial products with (e.g. current account, savings account (including ISA), loan (including mortgage))?**




Note: * denotes small sample size
Note: percentages do not add up to 100 as respondents chose all that applied. Rounding applies.

Source: Deloitte Research/YouGov, October 2010

While 68% of UK adults questioned do not believe that banks have worked harder to retain their business since the financial crisis began, for high-end consumers that figure rises to 82%.

## 3.2 Current operational capabilities are inadequate for the new models

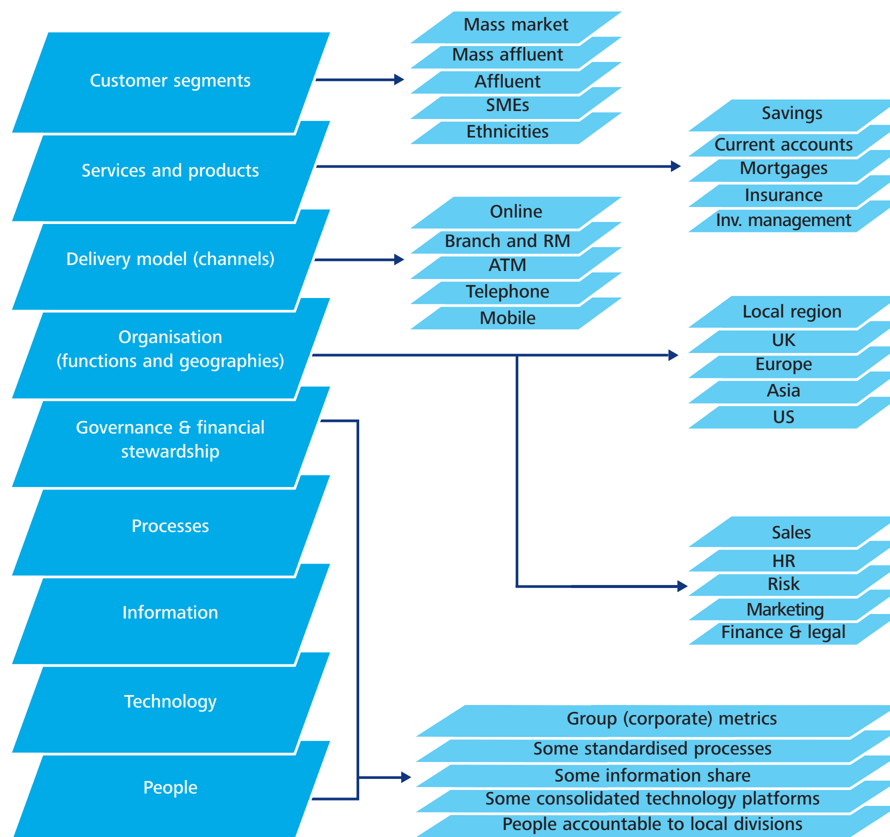
Banks' operations often hinder their ability to understand customer needs and to deliver tailored pricing, products and services. They often have complex layers of operations that struggle to work together. Branches, for instance, have been complemented by ATMs, telephone call centres, online channels and, more recently, mobile technologies and social media channels – each based on the latest platforms available. But these are rarely able to 'talk' to each other.

*"We have several platforms in mortgages, and have been speaking about integrating them for a decade."* – Retail Strategy Head, high-street provider

Figure 4 provides an illustration of the complexity of retail banks' operating models using Deloitte's Target Operating Model (TOM) framework. It shows how current operating models struggle to achieve the co-operation necessary for improved service.

For those seeking to differentiate services, their current operating models can cause significant problems in constructing sufficient customer insight. For instance, a channel (e.g. online), a product line (e.g. mortgages) or a function (e.g. underwriting) may store information about a customer's use of the bank. But without co-ordination, banks are unable to reproduce a holistic view of the customer segments. And without such a view, defining which customer segments should make up the key target market is no more than an educated guess.

**Figure 4. Current operating-model issues in retail banking – duplication and silos cause lack of cooperation**




**Current operating models**

- **Based on a "bolt-on" adaptive model:** Businesses, new product-lines, (divisions) and customer channels can be bolted on to respond to growth opportunities, new technologies and needs of local markets.
- **Decentralised operating structures:** Divisions (business units) are given significant autonomy to grow their businesses or adapt to local needs.
- **Complex layers:** Each division or channel has many of its own (discrete) processes, IT systems and functions.
- **Co-operation difficulties:** With complex, layered operating models, legacy issues can build. Databases are often held at the local level in systems that do not dovetail with wider platforms within the bank and are unable to generate consistent management information (MI). Staff, often operating within the silos of their locality, product-line, channel or function may have few incentives to share information across boundaries.

  This means that teams struggle to co-ordinate a single view of the customer. And customers dealing with different parts of the bank experience inconsistencies and duplicated processes.

Source: Deloitte Research/Deloitte Consulting MCS, 2011

### 3.3 Now is the time to fix such issues

Interviewees highlighted three main operational issues which frustrate their segmentation plans:

- **Lack of consumer insights:** They complained of a lack of deep consumer insights on which to base decisions and to build tailored propositions.
- **Poorly co-ordinated services:** They said that current IT platforms struggle to deliver error-free processing or full multi-channel service[16].
- **People and culture:** Interviewees also suggested that customer-facing staff often need much more support in meeting the needs of target segments. They lack the skills, training, incentives, appropriate customer data and, sometimes, the autonomy to meet the expectations of target customers.

Now is the time to fix such issues because competition for the best customers is likely to intensify. Almost all high-street institutions are seeking to compete for this segment. Incumbent banks and building societies will therefore require defensive strategies to retain their own customer 'sweet spots'.

In addition, new entrants are also likely to compete in the most profitable customer markets. With fresh branding and few legacy issues, they may cream off the most desirable customers[17].

*"Incumbents have benefited from a flight to quality. Our job is now to retain and extend this in the face of intensifying competition."* – Director, Retail Strategy, large high-street provider

Almost all banks are engaged in major change programmes to address such issues. However, the regulatory agenda and the recent round of integration (following the financial crisis) appear to be slowing down progress.

*"Much of our change capability is tied up in global integration projects…"* – Director of Strategy and M&A, large high-street provider

Incumbent retail financial institutions must retain and lock in their most valuable customers now, building trust and loyalty before the competition intensifies further.

Incumbent retail financial institutions must retain and lock in their most valuable customers now, building trust and loyalty before the competition intensifies further.

# 4. Turning customers around

Deloitte's consumer research suggests that customer retention, trust and loyalty can be rebuilt on four customer-centric principles – safety; value; service; and convenience. However, these concepts mean different things to different people. Banks seeking to differentiate their service must grasp what customers really want, and then build propositions accordingly. Improved customer insight is crucial not only to this process but also to defining which customers to target (i.e. which are the most valuable).

### 4.1 Safety, value, service and convenience are required to lock in customers

Deloitte's consumer survey indicates that customers need to be satisfied in four areas before their trust and loyalty can be gained:

- **Safety:** e.g. the financial soundness of the bank, access to their savings as and when required;
- **Value:** e.g. competitive or appropriate product pricing; reasonable and fair charges;
- **Service:** e.g. quality products and services delivered through customers' preferred channels; and
- **Convenience:** e.g. easy access to service; error-free processing; flexible, multi-channel operation.

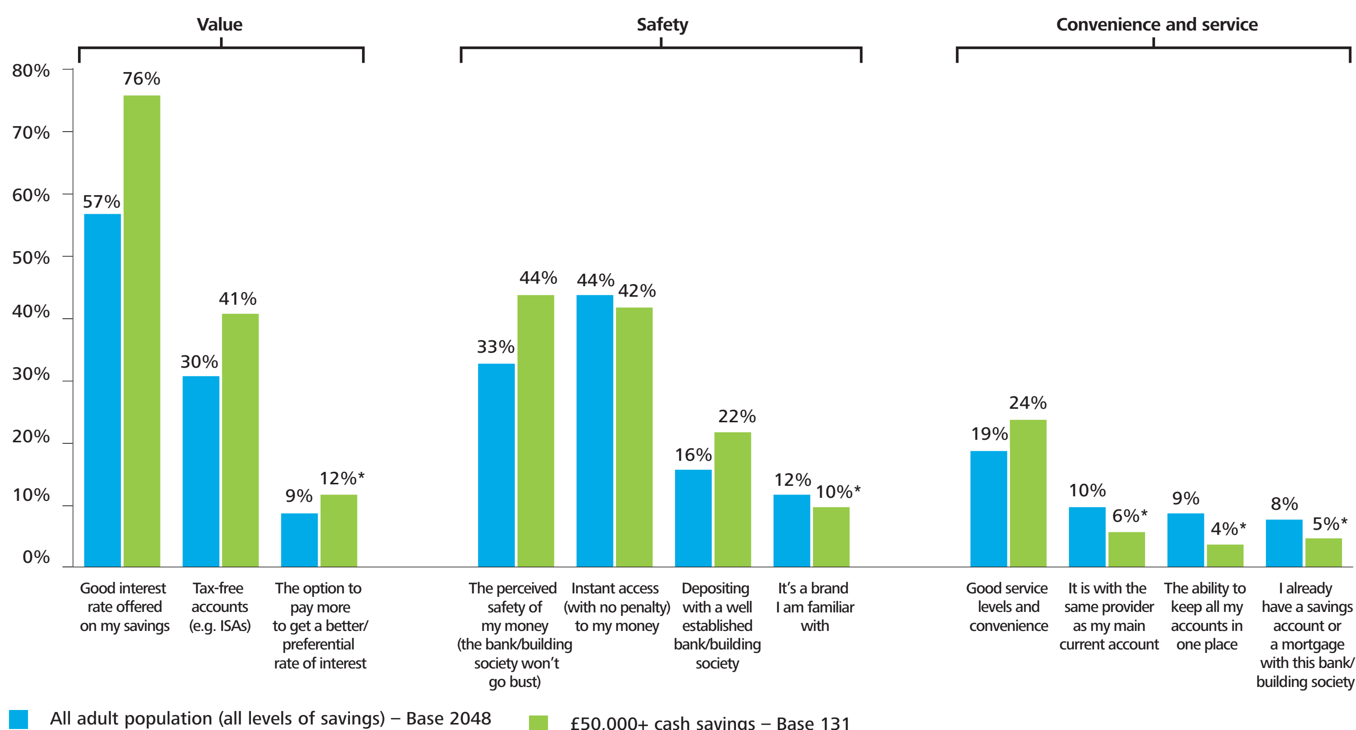
### 4.2 Safety and value are crucial for high-end customers

**Safety:** Customers are now highly aware of bank safety (i.e. financial soundness) when searching for a savings or current account. According to Deloitte's survey almost two thirds of UK consumers do not believe banks are financially sound[18]. When searching for a savings account, high-end customers are more concerned about safety than the average (44% listed safety as a top-three consideration compared to 33% on average). Banks could improve their consumer messages about financial soundness. The good news on capital adequacy, for instance, may not have reached, or been properly adapted for, a consumer audience.

**Value:** With a struggling economy and low interest rates, consumers have become extremely price-sensitive, and high-end segments are significantly more price-sensitive than average. 76% of them say they would choose a savings account on the interest rates offered, against an average of 57%.

**Figure 5. Savings and current account preferences for high-end customer segment compared with the average UK adult consumer, October 2010**

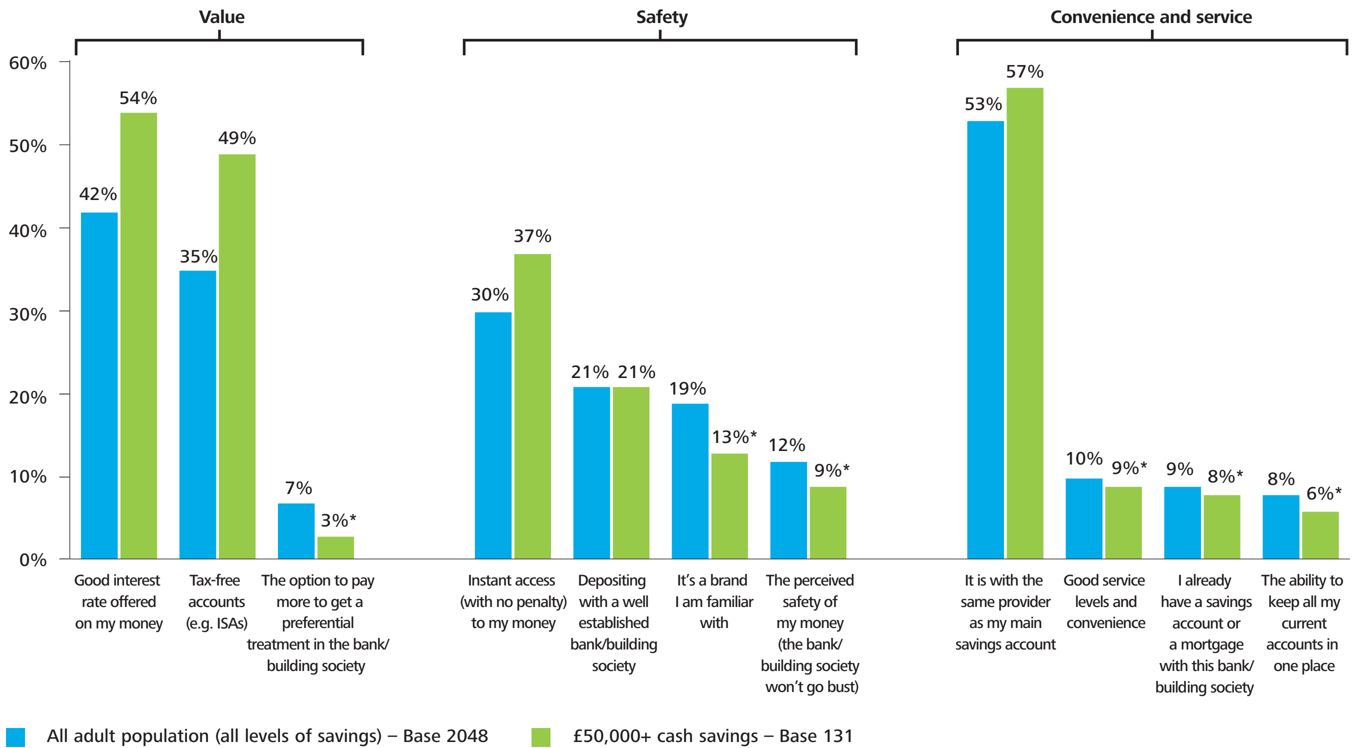
When searching for a savings account, which factors do you consider from the following?




Note: * denotes small sample size
Note: percentages do not add up to 100 as respondents chose all that applied. Rounding applies.

Source: Deloitte Research/YouGov, October 2010

When searching for a current account, there are a number of factors to consider. What are the key factors from the list below?




Note: * denotes small sample size
Note: percentages do not add up to 100 as respondents chose all that applied. Rounding applies.

Source: Deloitte Research/YouGov, October 2010

### 4.3 Convenience and service will become key considerations in time

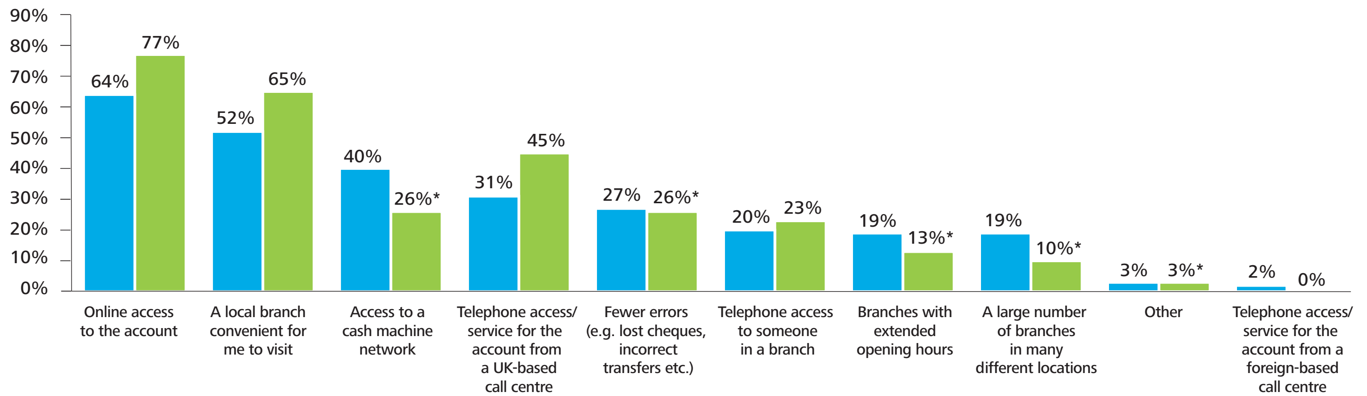
**Convenience and service:** In the current climate, service and convenience have been relegated to third/fourth place. Just 19% of consumers say they would choose a savings account based on service. When banks are better able to demonstrate financial stability (and able to offer better rates on savings and lending products), service and convenience are likely to become key considerations again.

Online channels are now a crucial part of the service for most customers when searching for a savings or current account. Figure 6 shows that high-end customers are even more wedded to the internet (77%) than average (64%)[19].

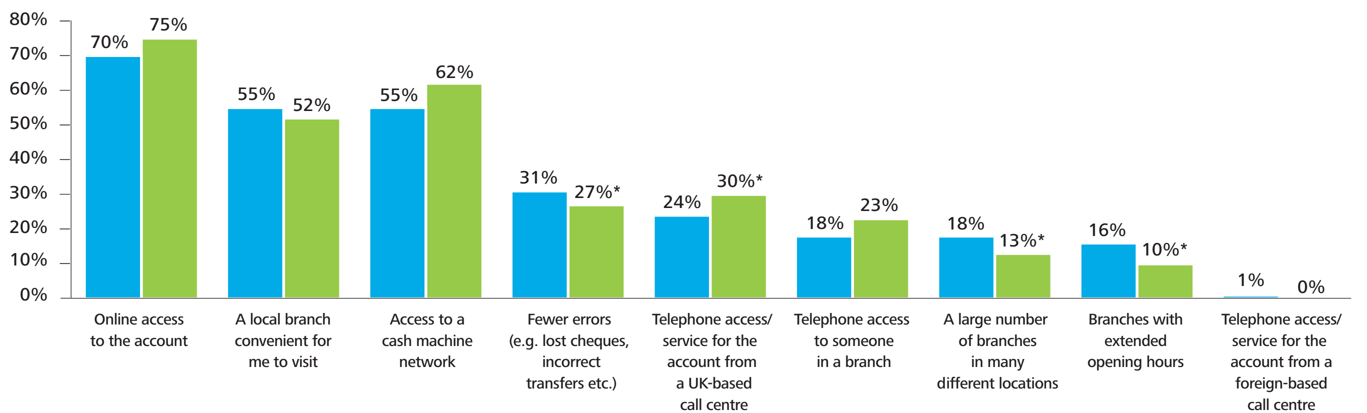
Such consumer data, while interesting, is not enough. Banks must mine their own rich data sources to achieve the granularity required for more sophisticated segmentation strategy.

**Figure 6. High-end customers' channel preferences (against average) for savings and current accounts**

You stated that good service levels were one of your top three most important factors when searching for a savings account. What are the key factors from the list below?




You stated that good service levels were one of your top three most important factors when searching for a current account: which from the following are key?




All adult population (all levels of savings) – Base 868
£50,000+ cash savings – Base 71

Note: * denotes small sample size
Note: percentages do not add up to 100 as respondents chose all that applied. Rounding applies.
Note: it should be noted that online statistics may be slightly exaggerated due to the limitations of our survey – conducted over internet

Source: Deloitte Research/YouGov October 2010

### 4.4 A new phase for customer segmentation

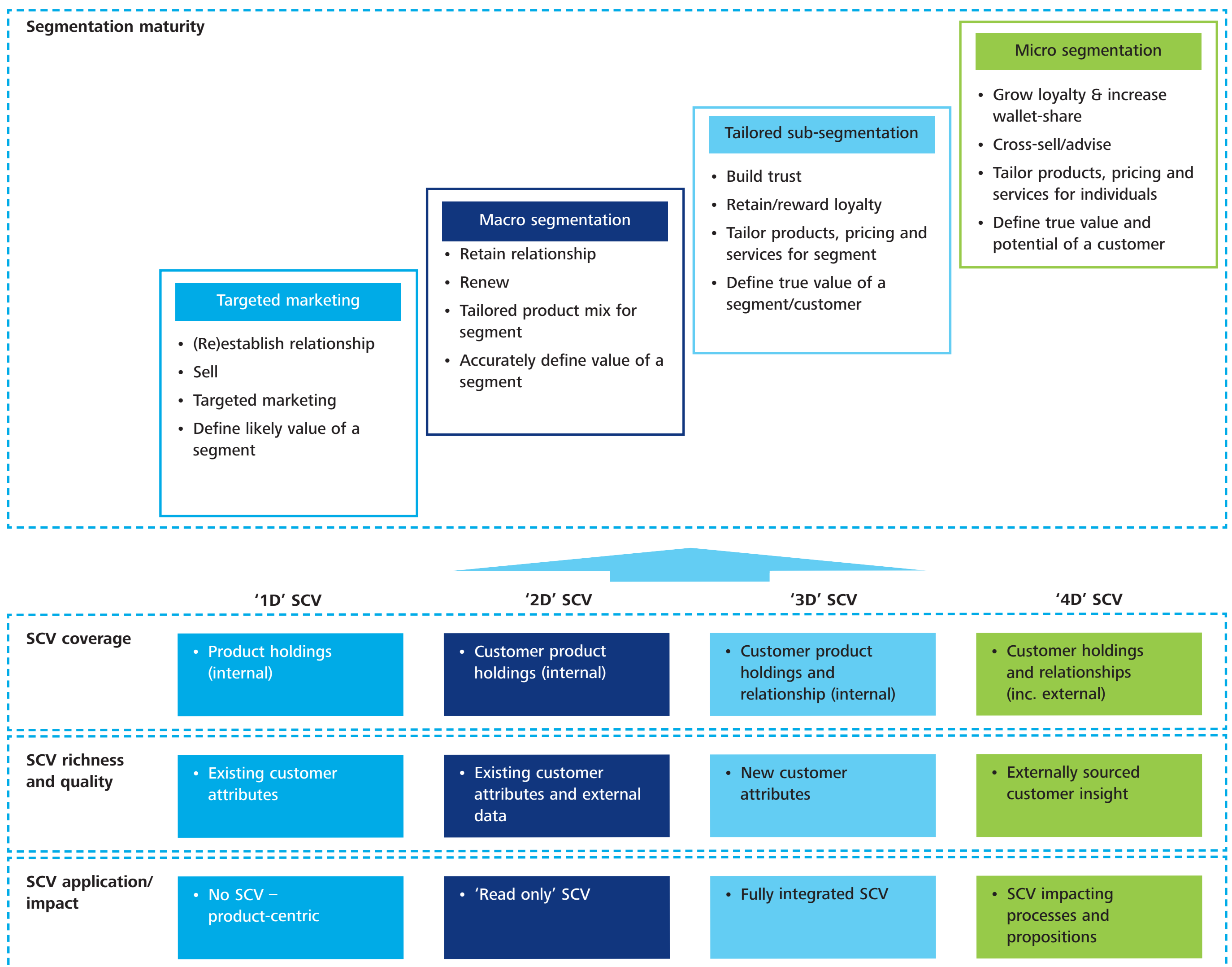
Segmentation strategy (which underpins service differentiated models) is moving into a new phase of maturity within UK retail banking. For many years it has been used as a strategic marketing tool – informing campaigns and product-pricing. In the new retail banking landscape, however, more mature segmentation strategies are being deployed to move segments and individuals up the value chain: from customer acquisition, to retention, to trust and loyalty. Banks seeking to cross-sell and grow share-of-wallet among their key segments will need to encourage customers to progress through such stages.

### 4.5 A single view of the customer is essential

For customers to progress through the life-cycle (value chain), banks must gain sufficient customer insight to accurately define the value of a segment and its product/service requirements (i.e. its preferences for safety, value, convenience and service). For this, most banks are seeking to build a single customer view (SCV).

At its most basic level, SCV represents an integrated view of products owned by customers. As it becomes more advanced, it also establishes how customers make day-to-day use of their products, and it builds a picture of a customer's attributes, behaviour and attitudes, both inside and outside the bank.

**Figure 7. Segmentation strategy requires SCV support**




Source: Deloitte Research, 2011

“To determine what we can invest in each customer, we need to create a lifetime view of the customer. People need to be rewarded for their tenure. This is critical to retaining and growing share-of-wallet.”

– Director, Retail Strategy, high-street provider

Figure 7 shows the relationship between segmentation maturity and the required level of SCV. It illustrates four levels of customer insight: progressing from one-dimensional (1D) insight to a fourth dimension (4D).

There are three aspects to assessing the maturity of a bank’s SCV: coverage; data richness; and application.

a) **Coverage (or the extent) of data:** Extensive customer insight typically resides in discrete pockets across the organisation. The SCV brings this data together:

- **1D: Product holdings (internal):** Customers may hold several products, but there is no central place where resulting data is integrated to form an overall view.
- **2D: Customer product holdings (internal):** A central view of the customer is created. Data-sets from all products held within one bank are integrated to form a single customer view.
- **3D: Customer product holdings and relationships (internal):** A more fully integrated data-set is built from all banking products, services, functions and channels. The definition of the customer may become wider than a single entity – to include family, friends or businesses.
- **4D: Customer holdings and relationships (external):** The single view extends beyond one bank’s boundaries, giving a perspective of the whole customer and his/her product portfolio.

b) **Data richness and quality:** A single customer view should also contain personal insights over and above an individual’s product holdings and channel interactions:

- **1D: Existing customer attributes:** Personal insights here are based on existing customer attributes, such as addresses, relationships or life-stage.
- **2D: Customer attributes and external data:** 1D personal insights are enhanced by external data sources (e.g. ACORN, MOSAIC, credit-reference data).
- **3D: New customer attributes:** Personal insights are further developed through an analysis of transactional data. For instance, a loss of/change in monthly salary inflow might hint at redundancy, job loss or promotion.
- **4D: Externally sourced customer insight:** More insights can be gleaned from external social data and social media – for example, from brand perception, satisfaction and reactions to market developments.

*“We are using attitudinal and behavioural modelling techniques to arrive at more granular views of customer segments.”* – Retail Strategy Head, high-street provider

c) **Application and impact:** The value of SCV should also be judged by the extent to which it i) can be used to build real-time customer insights; ii) can be embedded in bank processes; iii) can inform strategy; and iv) can improve processes and propositions. As customers are not static, insights are predictive and based on an understanding of where customers are in their life-cycle:

- **1D: No SCV (product-centric):** with minimal customer-centric data, a product-centric view of the world steers the customer proposition.
- **2D: ‘Read-only’ SCV:** a basic single customer view has been created but on a ‘read-only’ basis, supporting marketing initiatives with static data.
- **3D: Fully integrated SCV:** client-insight management is based on centralised master data-sets, supporting marketing initiatives and strategic targeting with real-time data.
- **4D: SCV impacting processes and propositions:** insights are real-time, detailed and robust enough to influence, inform and be integrated into the customer proposition. Leading financial services providers are using customer insight and feedback from social media channels to facilitate the design and market testing of new and innovative products and services.

Banks seeking to move to individualised pricing, billing and charging structures that reflect the true value (and cost) of the customer to the bank will also require SCV[20].

### 4.6 Where are UK retail banks with SCV and what are the pitfalls?

In the 1990s, large banks sought to build basic segmentation capabilities based on macro insights of broad-based customer segments. These capabilities were rolled out to cover entire product ranges during the early 2000s. Deloitte considers that banks have now progressed to building their segmentation strategies on a two-dimensional customer view, and they are seeking to move into 3D. For instance, retail financial institutions are practised at bundling products for major segments (e.g. current-account bundles, access to special loan rates, etc.). But these are often static. To follow through on their new segmentation strategies, banks and building societies need to achieve a 3D/4D SCV for their core customer segments.

*"We can work out ROE by customer segment now – based on common attributes. We are building a model to do this on a more granular basis."* – Head of UK retail, high-street provider

Banks and building societies can and do spend vast sums striving for 3D/4D customer insights. The investment required for SCV can be optimised in three ways. All too often banks focus on the data coverage and richness of SCV, without giving sufficient attention to its application and impact. Ensuring project leaders devote enough time to fully embedding the SCV is key. And using approaches from 'business analytics' can help to focus the data requirement. For instance, using a hypothesis-led approach to data analysis can help to determine the key data-points that banks require. Finally, by focusing SCV exercises on core or target segments first, capital expenditure can be more tightly focused.

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# 5. Operating models will be central to segmentation success

Banks have adopted new customer strategies, but few have adequately realigned their operating models to deliver or execute the new strategies. For instance, improving customer insights and building service differentiation for specific segments requires co-operation from many parts of the bank. Financial institutions seeking to achieve a service differentiated business model may need to adjust their operating models to facilitate such co-operation.

Deloitte recommends:

- **Adjusting banks' operating structures for a more customer-centric model:** Organisational (operating) structures in UK retail banks are typically product-led (e.g. mortgages, credit cards, current accounts), leading to a sales focus and a proliferation of product ranges. Operating models may become more customer-centric if they work through customer-segment-based divisions (e.g. the mass affluent, SMEs, HNWIs) serviced by product teams.

- **Driving co-operation through stronger leadership:** Without centralised co-ordination, initiatives that seek to build customer insight from all channels, product teams and functions (and then build customer services around those insights) will be difficult to complete. Stronger group (corporate) or country-based leadership may be needed in developing initiatives based on customer insight in order to encourage co-operation among divisions/functions/channels. However, decentralised operating models should remain intact, allowing service and delivery teams enough autonomy to be able to adapt to local or customer-segment needs.

- **Simplify the operating model … selectively:** Banks and building societies' operating models suffer from complexity. For instance, they may have thousands of product variations, each produced for a specific customer segment to work on specific channel in a specific region. Such complexity reduces multi-channel capabilities and overloads front-line staff. Banks should simplify and standardise processes, starting with product sets. However, those seeking a service differentiated model may deliberately protect the autonomy of certain distribution processes (from being standardised) in order to allow the teams closest to customers a degree of flexibility in responding to their needs.

- **Realign staff culture to the business model:** Executing a differentiated service model for specific segments may be difficult if customer-facing staff are not equipped to deal with high-end (or core) customers. Front-office systems and staff should be developed so that staff have i) sufficient skills to deliver improved service to high-end clients; ii) improved relationship-development skills; iii) enough data to know the requirements of customers at the point of sale/advice; iv) a degree of autonomy to adapt to local customer requirements. Such cultural change requires a fresh look at incentives, and it needs top-level leadership.

- **Build multi-channel capabilities:** Many banks are struggling to draw up a full picture of the cost-to-serve of each customer because their interactions across all channels and products are not easily collated. Without this, it is difficult to understand the true value of a customer to the bank and the most appropriate product and service bundles. Channels need to work together and to be closely aligned to get the full picture.

  At the same time, channel optimisation is key to bringing down the cost-to-serve. Multi-channel capabilities should be predicated on simplified products that can work on any channel and that can more easily feed data into the customer-insight process. Self-service channels (especially online) should be the base around which all channels (and products) dovetail. As online services are now central to the customer experience, especially for high-end segments, they should be designed to reflect this.

- **Integrate client insight data onto one platform:** Most financial-service providers have a host of un-integrated legacy IT systems. These may not dovetail with core infrastructure, leading to process errors, higher costs and pockets of data that prevent single customer view. Investment in technology (platforms) to enable SCV is a significant challenge for large banks with complex systems. Banks competing on a segmentation basis may choose to focus on tactical IT interventions – on those systems and processes that have the most impact on target customer segments. Working with pre-existing change projects (driven by the regulatory agenda) may also be beneficial.

- **Build 'business analytics' capabilities:** Banks' analytical capabilities for customer data are typically patchy – strong in some areas (such as credit products) but poor in others (such as transaction flows). This creates customer 'blind spots' where little of the customer's activity is known. Banks should identify and plug gaps in data that relate to their chosen customer segments and make more strategic use of data in R&D activity. Analytics should be driven by asking the 'right' questions (i.e. they should be hypothesis-led so that only relevant data is collected/processed). A clear strategy to use analytics should emanate from the top so that it is embraced by the whole organisation.

- **Prioritise change according to customer-segmentation strategy:** Making fundamental changes to the way that retail banks operate is an expensive business. Segmentation enables banks to prioritise their investments, focusing only on those operations that have an impact on target customer segments.

- **Improve messaging and branding:** Switching customers to a different service or pricing model according to their segment risks offending some. Any customer transition from one segment to another should be handled sensitively, as some customers who are not target customers now may become so in the future.[21] Some banks, basing their business models around several distinct brands, are using these brands to actively manage the segmentation of customers.[22]

  In addition, messaging to consumers may not be addressing the real concerns of customers at present (i.e. safety and value). Regardless of segmentation, banks need to convert their good news on capital adequacy into consumer-friendly messages.

  *"Growth will not be through growing the total number of customers. We have [X] million customers, with about half a million in the [high end] … Our strategy is to create a true value proposition for our chosen segments. This risks being more unpopular."* – Head of UK retail, high-street provider

Making fundamental changes to the way that retail banks operate is an expensive business. Segmentation enables banks to prioritise their investments, focusing only on those operations that have an impact on target customer segments.

# End notes

1 Over the past two years banks have significantly re-priced credit. This has boosted their margins and helped to mitigate some of the negative impacts on income growth. However, there is a limit to how far such re-pricing can be pushed, and it is unlikely that it can be relied on to drive income growth in the future. In addition, banks have avoided sales of wide-margin (but capital-intensive) products such as credit cards, other unsecured lending and higher risk products.

2 UK Retail: Driving profits for the next decade, Deutsche Bank, July 2010; UK Banks, from Famine to Feast, HSBC Global Research, 21 October 2010.

3 According to the Council for Mortgage Lenders (CML), the collapse in wholesale funding markets left a £300bn gap in UK mortgage funding, Council for Mortgage Lenders, Feb, 2010. That gap has been filled temporarily by government funds through the SLS and CGS. By 2014, both of these schemes will have expired. Lenders will need to refinance this £300bn over time.

4 Although building societies can issue permanent interest-bearing shares (PIBs), there remain complex issues relating to their liquidity and level of subordination.

5 According to Deloitte's consumer survey, some 23% of savers said that they had to dip into their savings each month to make ends meet (over the 12 months to October 2010). Deloitte Research, 2011.

6 Banks now regard right-sizing their balance sheets and securing their funding as the minimum entry criteria to the market. At the same time they are turning their attention to optimising their returns.

7 If successful, this strategy has the potential to dis-intermediate other financial-service providers (such as IFAs).

8 Individual charging that reflects the actual cost of servicing each customer.

9 In addition, many customers blame banking institutions for the structural deficit in the UK. In October 2010, some 69% of the adult population agreed that "the current debts of the UK government are largely due to the bail-out of the banks".

10 Many large high-street incumbent brands enjoyed "a flight to quality" during the financial crisis. However, the flight could reverse if consumers' fears about safety/financial stability diminish over time.

11 Deloitte's survey suggests that 61% of consumers are less willing to lock away savings for a long period of time than they were 12 months ago.

12 Whatever the segment nomenclature, high-end customers are more likely than average to be married or widowed, have fewer children (within the household), and to live in London. High-end savers are likely to be over 55 years old (or male and aged between 40 and 54), have ABC1 social status and read the Financial Times, The Times, or The Daily Telegraph.

13 It should be noted that SMEs are also heavy users of banking services.

14 Of those who moved relationships in the past 12 months 15% cited the "introduction of fees/charges onto my account" as the main driver. However, those switchers with savings of more than £50,000 were only half as likely to switch due to fees/charges (7%). Note: this trend is based on a low sample size.

15 One-third of those with more than £50,000 in investable (cash) assets have five providers or more. Understanding the real potential and value of a customer or client is difficult for institutions unless they know what holdings customers have with each of their financial providers. Without this insight, banks can only guess what their share of wallet is and how to increase it.

16 Yet about a third (31%) of consumers listed "fewer errors" as a top-three requirement when searching for a new current account.

17 Although few senior bankers perceived new entrants as a threat in 2010/11, many suggested the threat depends on how quickly and effectively new entrants can ramp up their operations.

18 According to the Deloitte survey, some 63% did not agree that banks are now financially sound (as of October 2010). Customers are also more reliant on their savings. This makes the financial soundness of their banks and instant access to their savings more significant factors in choosing accounts.

19 The cost-to-serve customers through online channels is significantly lower than other channels (particularly branches). Certain sub-segments of high-end customers are therefore likely to have a lower overall cost-to-serve than customers who have fewer assets and a greater preference for branch visits.

20 In the corporate/business space, by comparison, some banks have been investing in relationship-based pricing/billing capability, not seen in the retail space.

21 For instance, In a recent study of U.S retail banking, Deloitte identified a new customer category born out of the recession: 'first-time defaulters', predicting they would likely become prime customers and should be managed as such. See, First-time Defaulters: An under-appreciated customer segment for lenders?", Deloitte Center for Financial Services, Deloitte (US), 2010

22 Without information about the whole customer portfolio it is very easy for banks to unwittingly throw away target customer segments as they embark on enhanced segmentation strategy, classifying certain customers and treating them accordingly. For instance, a saver with £10,000 in savings with one bank, may have £200,000 with another. The challenge is to win greater wallet-share. Also, sensitivity must be employed during the classification process as customers with an undesirable profile right now may change their profile over time.

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