Developments in the retail banking sector

Finance, Banks

Critical overview of the retail banking sector

1. Introduction

It is undeniable that strong forces are changing the retail banking industry. These changes are due to several different elements such as shifting customers' expectations, changing technological capabilities, stronger regulatory requirements and fierce competition imposed by non-traditional players. Previously, the industry was rather slow to change, followed more of an evolutionary path. In order to be successful, banks need to prepare themselves to ensure that they are transforming into an innovative institution that is profitable, agile, customer focused and regulatory compliant. The next section will discuss the current competitive landscape of the retail banking industry.

2. The current competitive landscape of the retail banking sector

Banks are special institutions due to the imperative position they hold in an economy and the huge impact failure of this sector may have on society. However, banks are inherently unstable due to their structural fragility. The low ratios of cash reserves to assets means that most of banks assets are illiquid in comparison to their liability. Banks are also highly leveraged meaning they have few fixed assets and have high levels of debt relative to their equity. Banks are heavily interconnected as borrowers and lenders in the interbank network. The next section will analyse the challenges that are currently facing the retail banking sector.

2. 1Challenges facing the retail banking sector

Retail banks are highly complex institutions due to their legacy products, systems and operations. Banks became segmented and complex institutions with different layers of management, departments, products, IT systems and distributional channels. Furthermore, retails banks might also serve multiple markets with different regulations and that further complicates their overall structure and operation and adds to the challenges that they are currently facing.

The challenges facing the retail banking industry can be divided into five main categories, they are (i) customers, (ii) banks’ internal structures and business models, (iii) product simplification and innovation, (iv) competition posed by non-traditional players and (v) regulation. All these challenges are interconnected, and they can pose a significant threat on the future success of retail banks.

2. 1. 1 Customers

Currently, the retail banking industry is facing two challenges in terms of their customers. Firstly, attracting new customers for growth and secondly, banks need to adapt to the changing customers’ expectations that are taking place on the market. These two challenges will be discussed in detail below.

2. 1. 1. 1 Attracting new customers

Banks need to grow therefore attracting new customers is a crucial element for their long-term success. In order to attract new customers, banks need to develop genuine customer centricity (McKinsey, 2016); (PWC, 2017); (Deloitte, 2018); This means that banks need to develop a complete

understanding of their customers and their needs. They need to leave their old sales and product-oriented mindset behind and focus on enhancing customer experience. First-class customer service will lead to customer loyalty and income growth. Banks are still in the old-fashioned view, that by sending customers multiple product offers something will eventually appeal to their customers out of the bundle. Customers' expectations are changing, the industry must realise this trend and seize the opportunities to grow and build outstanding customer service that will attract new customers and enhance customer experience to their current clientele.

2. 1. 1. 2 Changing customers' expectation

It is evident that shifting customers' behaviors are redefining banks' structures and operational models. To address those changes, banks are required to make significant investments into their strategy, technology, operation while placing the customer at the center of their operation. However, it appears that banks do not fully understand and know their customers' wants and needs. Due to the complex internal structure of banks, risk and credit decisions are taken at the product level and not at the customer level, which leaves initiating and implementing changes more difficult.

When looking at the changing customers' preferences, there are four key aspects driving this shift. Firstly, customers are now expecting more. Customers are looking for personalised, relevant, location-based offers from their banks in a timely manner. Therefore, banks need to engage customers and provide them with interactive applications to enhance user-experience. In order to understand customers, banks will need to obtain and analyse

multiple sources of internal and external data. This will allow banks to provide the relevant solution to their customers in a timely manner. To do that, banks will need to redesign their core processes from their customer point of view, starting with a simplified product set. A viable option for banks is to create a multichannel strategy that balances cost and services while focusing on the customer (PWC (a), 2017).

Secondly, the rapid growth of social media and mobility enabled customers to turn to their peers for information and recommendations as opposed to a financial expert in banks. While customers feel that they can trust their banks to do the basics such as keep their money safe, they have lower level of trust when it comes to strategic goals such as receiving unbiased advice (Maechler *et al* , 2018).

Thirdly, customers are now better informed due to the easy access to research and data available online. Consumers have more financial options available online now, for instance, they can compare and purchase alternative financial products and services easier and faster (PWC, 2017).

Fourthly, the rise of social media platforms enables to raise a single consumer voice online. Banks should address negative customer experiences and deal with them promptly by investigating the cause of the problem to ensure that it will not happen again in the future. A strong online presence should help to control customer communication and reputation and to reinforce a positive brand image (Accenture, 2017); (PWC (a), 2017). Therefore, banks should invest in an effective multichannel strategy that serves their customer. In order to provide superior experience to their

customers, banks need to reconsider their internal structure and operational model; this will be discussed in the next section.

2. 1. 2 Internal structure and operational model

Banks are highly complex institutions due to their operational model and products offerings. This created silos in banks, where each department manage their own cost, risk etc. Departmentalization entails different layers of management, products, distribution channels, IT requirements. Most of the retail banks can also be found on different foreign markets with diverse regulations and customer which is further complicating their operational model. Therefore, banks need to re-organise their internal operational structure, to introduce a holistic approach to their operation (Deloitte, 2018); (PWC, 2017); (McKinsey, 2016).

Lean business management techniques such as defining customer's value, which ties back to the point that was discussed above about the importance of banks knowing their customers and serving their needs accordingly, can assist banks to achieve success on the market. A leaner approach to operation can enable the bank to produce new products faster than the competitors and to obtain complete customer understanding through data analytics (McKinsey, 2016).

An effective multichannel strategy has the potential to increase customer satisfaction, to simplify internal processes and to increase revenue. A multichannel strategy is about increasing the number of channels for customers to interact with their retail bank in a consistent manner throughout all channels. However, multichannel strategy is considered a

technological issue due to its nature of different integrated databases as opposed to a successful revenue generator. Due to banks' internal structures, their multichannel distributions are still operating in silos, therefore, they are unable to offer seamless customer journey experience. To successfully execute multichannel strategy, banks need to understand their customers' preferences and, as it was discussed above, banks are falling short on this capability. If banks can understand and anticipate their customers' preferences through data analytics, they can explore value proposition for the different channels and for the different customer segments. Therefore, in order to be successful in the future, banks will need to move from branches to multichannel distributions such as self-services, in-store branches, labs to support their desired customer experience. An optimised distribution network supports the customers' needs and minimises the cost of delivery (Gogus, 2011); (PWC (a) 2017). This will be discussed in the next section.

2. 1. 3Product simplification and innovation

Innovation is essential for retail banks' survival. Retail banks carry many products which involves cost in operation, technology, service and risk and regulatory challenges. Each of their products further adds complexity and cost to the overall operation of the banks. (PWC (a), 2017); (McKinsey, 2016). Innovation can be achieved by streamlining and simplifying current product offerings, in other words, optimising operation.

In order to streamline operations, banks need to ensure that they correctly record all data of their customers as this will enable them to provide tailored offerings to their customers. Effective multichannel approach can assist

banks to decide which segment or processes to invest into that will bring a considerable return on their investment (Bellens, 2016).

Simpler products and portfolios with transparent pricing are essential for banks to consider. The first step in product simplification is to be transparent and communicate values, what differentiates one bank from another in the competitive arena (McKinsey, 2016). While regulation and technological changes are creating opportunities for bank's innovations, they are also creating opportunities for non-traditional players on the market. The next section will discuss the competition posed by non-traditional players in the industry.

2. 1. 4 Competition by non-traditional players

In general, there are two types of non-traditional players on the market, they are (i) FinTechs and (ii) Shadow Banks.

2. 1. 4. 1 FinTechs

FinTech is a term mixing of the words of “ finance” and “ technology”. It refers to the industrial changes that are coming from the convergence of financial services and IT (Kim *et al,* 2015; Neinaber, 2016). FinTech innovations can cover the whole banking value chain or just certain elements of the chain. If FinTechs cover the entire value chain, it can have a significant impact on the banks' business model. However, most FinTech innovations only cover one element of the value chain to provide a faster and more cost-effective technological solution and this allows them to be competitive. FinTechs competitiveness depends on the retail banks' ability to fast develop these technological competencies in-house and successfully replicate these

innovations in line with market shifts. While there are a number of benefits of FinTechs such as convenience, cheaper deals, more options etc., there are also a number of risk factors associated with their products, for instance, unclear rights (FinTechs may use different business models to traditional retail banks and this can make it challenging for the customer to identify their rights should something go wrong) or technology based risks (personal data may be mis-used and customer could fall victim to cybercrime) (Central Bank of Ireland, 2017; Magyar Nemzeti Bank, 2017).

2. 1. 4. 2 Shadow Banks

Shadow banking is a term that was first used by the economist, Paul McCulley, in a 2007 during his speech at the annual financial symposium. The term shadow bank is used for a collection of non-bank financial intermediaries that provide services similar to commercial banks. However, shadow banks do not have banking licenses, and they do not take deposits. They rely on short term funding provided by asset backed by commercial papers. They can also be sponsored or affiliated to banks through subsidiaries or holding companies. They are typically intermediaries between investors and borrowers and they can offer similar products to banks such as mortgages and facilitate credit arrangements. Examples of well-known shadow banks are the Lehman Brothers or Bear Sterns, both collapsed in 2008 during the Financial Crises. Unlike retail banks, shadow banks cannot borrow from the government in case of emergency and their depositors' investment funds are not covered by insurance (Kodres, 2013).

Therefore, regulators are aiming to reduce risk that a shadow bank can pose on the economy should it default. Regulators can increase capital

requirements to reduce sovereign risk. Currently, the shadow banking industry is absent of these rules and possibly will grow to fill the gap on the market. Therefore, this will intensify the competition between banks and shadow banks in the line of providing credit on the market (McKinsey, 2016). Therefore, regulation of the banking sector is essential, and it will be discussed in the next section.

2. 1. 5 Regulation

The new EU regulation, Payment Service Directive 2 (PSD2) is set to change the banking landscape for good. The main aims of the new directive are to drive innovation, transparency, allow harmonised payments within the EU, increase competition through decreased prices for payments while ensuring customer protection and payment security. Until January 2018, only retail banks had access to their customers' data. The PSD2 directive forces European banks to open their infrastructures and share their customers' information, through open APIs (application program interface) to Third Party Providers (TPP) such as retailers, high-tech companies (Facebook, Google) and FinTechs while ensuring the necessary security in connection with the data transfer (PwC, 2018); Magyar Nemzeti Bank, 2017).

In general, Third Party Payment (TPP) Service Providers can be divided into two elements, third party Account Information Service Providers (AISP) and third party Payment Initiation Service Providers (PISP). AISPs receive access to customer's account information provided by the banks. This access is granted by the account holder. AISPs are purely getting access to consumer accounts to receive and analyse their data. AISPs main goal is to analyse

data associated with the different financial transactions, PISPs are allowed to initiate payments issued by the bank, the customer or retailer. PISPs use the information provided by the banks to facilitate online banking payments (EY, 2017). Due to the sensitivity of these data sets, it is essential that the sector is highly regulated.

The level of regulation can influence the competitiveness of an industry and the pace that a particular industry can innovate. If an industry is highly regulated with a significant number of steps introduced for regulatory checks, then it is more challenging to be innovate and it can take longer time to bring a new product or services to the market. The retail banking industry is a unique market as it is highly regulated, yet there are other non-traditional players emerging on the market that are outside of the regulators' authority and applying significant level of competitive pressure to the traditional retail banking sector.

3. Conclusion

Retail banks are facing a number of challenges and they inevitably need to address some fundamental questions such as who their customers are and what are their expectations. They will need to develop a strategy that sets out value proposition to their customers to ensure that they meet their changing expectations. Banks will need to address their capability shortage in terms of data analytics. It appears that while they have all their customers' data, they cannot effectively analyse their data, therefore, they cannot meet their customers' expectations. Competition posed by non-traditional players are also significant. Traditional retail banks will need to

develop strategies to deal with the competition and technological changes while they are remaining regulatory compliant. They will need to position themselves and clearly state what competitive advantages will distinguish them in the marketplace. Most importantly, they are in need to re-organise their internal structure and operational model to enable innovation and long-term success.

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