

BANKING 20|20

A STRONGER FUTURE FOR FINANCIAL SERVICES

White Paper

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EXECUTIVE SUMMARY

Given the policy changes introduced since the crisis, and changing patterns of customer behaviour, banks are going to have to reinvent themselves. Over and above structural changes such as international retrenchment, they're going to have to become more agile, more customer-focused, more tech-savvy and less reliant on branches. If they remain hide-bound by legacy IT systems and silo-like structures they will risk losing relevance.

This white paper explores the factors that are driving change across the industry and looks at the practical implications for banks and financial services organisations.

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INTRODUCTION

After rescuing banks and building societies during the global financial crisis of 2007–08, policymakers are determined to push through reforms designed to make banking safer and avoid the need for further taxpayer-funded bailouts. These reforms are going to impose extra costs, challenges and uncertainties on the sector. Combined with other developments, including rapid technological changes, changes in consumer behaviour and rapidly increasing use of social media, they mean that banks are going to have to reinvent themselves or risk losing relevance.

Banks including HSBC, Lloyds Banking Group and RBS are already selling off overseas and non-core subsidiaries and refocusing on their core markets. But structural changes are not enough. Banks are going to have to become more agile, more customer-focused, more tech-savvy and less reliant on branches, whilst ensuring that the branches they keep are more aligned to customer needs. Banks that remain tied down by dependence on heterogeneous, legacy IT systems and silo-like organisational structures are going to struggle. As new entrants with enticing service propositions make their presence felt in the UK market, existing players that fail to adapt risk being left behind, losing customers, prestige and shareholder value.

1. PLUMPING UP THE CUSHIONS

The core policymaker and regulatory response to the banking crisis has been to require banks to carry greater quantities of loss-absorbing capital, with “strategically important financial institutions” expected to carry even more than smaller banks.

Basel 3 requires all banks to raise their minimum ratio of core tier one capital to risk-weighted assets from 2% to at least 7% by 2016–19, at the same time as tightening up on what can be classed as capital. In late June, the Basel-based Bank for International Settlements urged countries to raise additional capital ahead of the Basel 3 deadline and advised national regulators that Basel 3 rules should be treated as a ‘minimum’ standard that they can surpass if they wish. The UK’s Independent Commission on Banking wants to set a higher minimum capital ratio of 10%.

The UK’s Financial Services Authority is taking a tougher line on liquidity requirements than other regulators, and is keeping a close eye on the liquidity of UK banks, with a focus on yardsticks like the three-month stressed outflow (which requires banks to hold a ‘liquidity buffer’ equal to 35% of three-month outflows based on the FSA’s own stress tests).

The overall message is that banks are going to have to raise significant amounts of fresh capital, whilst being much more vigilant of their liquidity. One option would be for them to pass the extra costs on to their customers – as some have threatened to do, in the hope of persuading regulators to water down the reforms. But in the long-term that would be to shoot themselves in the foot. Their actual response is likely to be to seek to make their businesses much more efficient, by ruthlessly driving out operational costs – by becoming much more sophisticated in their use of IT, developing agile and integrated communications infrastructures, reviewing executive pay, restructuring, and refocusing their businesses on what suits consumers, not what suits them.

This will include selling off ancillary and poorly performing operations. Larger banks are already quietly reducing the size of their branch networks and seeking to streamline their operation by stripping out layers of management.

The need for deeper capital cushions, stuffed with better quality capital, is also going to trigger a fierce battle for deposits. In a special report published on 12 May 2011, The Economist said:

“Regulators love [deposits] because they are ‘sticky’: ordinary savers tend not to move their funds around. So banks that wish to survive, never mind prosper, will have to compete a lot harder than they used to for the deposits and cheque accounts of millions of retail and small business customers.”

However, the requirement to raise fresh capital is likely to put some business models at risk. In an article on investment banking published in June, The Economist said:

“Many firms will gradually come under more pressure from shareholders to do one of three things with their investment banking units: exit, consolidate or slash employees’ pay.”

2. FENCING OFF THE INVESTMENT ARM

The ‘ringfencing’ proposals from Sir John Vickers’ Independent Commission on Banking will force banks to run their retail and investment banking arms separately, with no further scope for cross-subsidisation. This will have dramatic long-term consequences for the banking sector. It is possible that, as with the ‘Beer Orders’ (which limited the number of pubs large brewers could own in 1989), ringfencing will eventually lead to full separation, with the banks’ retail and investment banking arms coming under separate ownership.

Whereas the retail arms will be eligible for government bailouts in the event of a crisis, the trading and investment banking arms will not. The proposal is going to drive up the banks’ borrowing costs, force them to further reduce leverage and loan to deposits ratios, and may leave some banks’ investment banking arms unviable. Analysts at HSBC have estimated ringfencing will cost Barclays, Lloyds and RBS between £8 billion and £10 billion in increased funding costs. Overall, however, ringfencing will present a bigger challenge to ‘universal’ banks such as RBS, Barclays and HSBC than ‘narrower’ banks like Northern Rock and Lloyds.

The move will force banks to pursue further efficiency gains, make substantial improvements in risk management and substantially improve their information and communications flows. Delivering timely and accurate information about capital, risk, liquidity, leverage, asset price valuations and possible future impairments to the people who need to know, including risk managers and senior executives, will be the new imperative. Banks will also seek to develop information systems that can see through the blind spots that arise due to banks’ silo-like structures. These are areas where new entrants that are not burdened by unwieldy legacy systems will have a head start.

3. CLIPPING THE GIANTS’ WINGS

RBS and Lloyds Banking Group between them are being forced by the EC’s internal market commissioner to sell some 1,000 branches, which together encompass about 7.5 million customers, as a condition of continued state aid. Customers of the 632 Lloyds branches that are being sold will have their accounts transferred wholesale to whoever emerges successful from the current auction, irrespective of individual preference or choice (customers of the 318 RBS branches have already had their accounts transferred to Santander). In this context, some dissatisfied customers will inevitably vote with their feet, creating additional opportunities for new and recent market entrants.

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4. BRING ON THE COMPETITION

According to the Treasury Select Committee's April 2011 report, *Competition and Choice in Consumer Banking*, five banks – Barclays, HSBC, Lloyds Banking Group, RBS and Santander – have an 85% share of the UK's personal current account market. The Treasury Select Committee wants to see this reduced and is urging the government to make the promotion of competition a statutory objective of future financial regulation (it is not at the moment), believing that greater competition will force the banks to refocus on their customers' needs. There are several new(ish) market entrants – including Virgin Money, Tesco Bank, Metro, Handelsbanken, Aldermore, and NBNK Investments – eager to lure customers away from existing retail banks. As these 'challenger' brands gain credibility and scale, existing players will have to shape up. They will no longer be able to rely on customer apathy to maintain market share. The YouGov research commissioned by Cable&Wireless Worldwide found that 43% of customers describe their relationship with their bank as uninformed, frustrated or annoyed. Cable&Wireless Worldwide recognises that:

“Customer demands relating to online banking, customer service and trust have increased. Customers want greater immediate, direct control of their money in a world where banks are not as secure as they once were. At the same time they are demanding better treatment from their banks.”

However, the YouGov research also reveals that customers “remain cool or lukewarm at best towards new entrants, with their preference being for new banks backed by strong, established brand names like Tesco and Virgin.” The research suggested a fundamental problem for new players is that they only tend to compete in narrow areas of service.

5. PAY-AS-YOU-GO

Mobile banking will become a key battleground in retail banking. Globally, mobile payments are set to nearly triple, from \$240 billion today to \$670 billion in 2015, according to a recent report from Juniper Research.

Visa will launch a 'digital wallet' later this year, in partnership with banks and mobile providers. PayPal already has 100 million accounts worldwide and predicts that digital currency will be accepted everywhere in the US by 2015. During an opening address at the GSMA Mobile Money Summit in Singapore, Visa's head of mobile innovation, Bill Gajda, said Visa wants to transform mobile devices into 'true digital wallets', arguing “we're at the dawn of the next generation of mobile money – maybe 'mobile money 2.0'. As an industry we've moved past what software we're going to buy and can now talk about what we're going to do.”

Mobile telecoms firms and handset manufacturers (with app stores) are also making inroads into the rapidly growing market, with the development of easy to use mobile payment systems. Research carried out in the Asia-Pacific region by Amdocs found that:

“95% of all telecoms operators have an active, defined strategy towards mobile payments, with billing on behalf of app stores, virtual goods, and prepaid top-ups the top three most popular markets being pursued.” [Report from Australia's Business Spectator]

This clearly presents a major challenge for incumbent banks. Commentator Chris Skinner believes they will be able to retain their dominance of payments systems, but only by offering what he terms “Transactions+”, meaning “everything that goes with the transaction: the cash dispenser, the online access, the contact centre focus, the budgeting system, the app”. Skinner added:

“For banks that understand this, they are creating stickiness elsewhere in the system. For banks that don't understand this...goodbye.”

6. GREAT EXPECTATIONS

Bank customers increasingly expect to be able to access the same range of products and services irrespective of whether they're visiting a branch, dialling a call centre, getting money out of an ATM, banking online, or accessing their accounts via mobile internet.

But the banks are hampered by legacy organisational structures that prevent them from fully recognising this agnosticism. In *Bank 2.0: How Customer Behaviour and Technology Will Change the Future of Financial Services*, banking expert Brett King said:

"The problem remains...that the owners of these channels internally within the bank rarely, if ever, talk to one another. In fact, in most instances, the different channel owners see one another as competitors for budget dollars, customer mind-share and share-of-wallet."

Currently customers' experiences – and the range of products and services that are made available to them – are totally different dependent on which channel they're using. The challenge for banks is to offer a seamless service and range of products, and to engage with their customers in the same way, irrespective of channel (although collecting cash from small businesses, for example, will remain restricted to branches).

If the banks are to pull this off, they are first going to have to overhaul and 'flatten' their internal structures. They will then have to develop much more flexible and agile IT and internal communications infrastructures, and new ways of working.

Banks will, for example, look to develop IT interfaces that enable them to take a more complete, or holistic, view of each customer's financial position and needs – including current account balance, deposit account balance, mortgage position, personal loans outstanding, used and unused overdraft facilities etc. – irrespective of the channel being used.

7. BRANCHES OF THE FUTURE

But what does this mean for branches? Will their role be increasingly sidelined, as predicted during the dotcom bubble of 1997–2000? David Furlonger, vice-president of IT research firm Gartner, believes so. He recently told the Banktech conference in Sydney that a combination of transformational technologies and industry pressure to reduce costs means that branches could well become a thing of the past:

"You will see more and more devices to shift people from the physical to the virtual world. And with rapid advances in financial services technology, you have to wonder whether by 2020 there will be any bank branches at all."

However, a great many others, including Mary Beth Sullivan, managing partner of US-based management consultancy Capital Performance Group, believe that branches will remain critical distribution points for driving future revenue growth. If Sullivan's right, reinventing the branch and reorienting the skilled resources within it is going to be critical. In an article published in June 2011, she wrote:

"As an October 2010 Bain & Company report made clear, service is the most important factor in determining loyalty and willingness to recommend a bank to a friend, and friendliness is the most important service factor in this equation – and this is hard to automate. While loyalty alone won't guarantee deeper and more profitable customer relationships, it's a great place to start."

Whilst 'friendliness' might be tricky to automate, technology can, and should, be used to create a more personalised interaction at the point at which the customer makes a decision.

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8. SELLING MORE INTELLIGENTLY

Indiscriminate cross-selling is the bane of many consumers' lives. A classic example of what can go wrong appeared on Twitter in July, when Manchester-based journalist Louise Bolotin tweeted: "Dear Tesco, I wish you wouldn't send me "money off petrol" offers when I don't have a driving licence." Rather than continue to risk alienating and losing valued customers with a scattergun approach, banks will look to pursue a much more targeted and personalised approach built around individuals' circumstances and needs.

Relationship managers and sales staff will have to be given new tools, including full information on the products and services already in an individual customer's portfolio. This is not difficult to achieve with modern technology but will transform the experience, making it possible for the bank representative to develop a tailored sales proposition to suit the customer.

Banks will probably deploy a mixture of relationship managers with a deep knowledge and understanding of each customer's needs maintained through a 'consultative selling' approach, for higher end customers, and – taking their lead from tech-savvy retailers like Amazon – a greater use of technological solutions including CRM (customer relationship management) and CEM (customer experience management), for mass market customers.

The FSA's Retail Distribution Review, which takes effect in January 2013, will open up an "advice and distribution gap" in the UK. This will present both opportunities and threats for banks. A KPMG report published in September 2010 predicted that, owing to the compliance burden and other complexities associated with offering fee-based advice, together with the level of fees that may have to be charged, fee-based advice may be a non-starter for mass market customers. The accountancy firm predicted that some banks will withdraw from the advisory business altogether, but added that:

"Those banks that can offer a multi-faceted distribution capability, streamlined advice/product/engagement models, and leverage effective customer data techniques stand to make significant gains."

Ernst & Young also believes that some banks will withdraw from the market. In a survey published in January 2011, it said banks would need to charge their customers approximately £200 an hour for advice just to break-even. Some will follow Barclays in withdrawing from the advice market altogether, focusing instead on developing execution-only solutions ('wraps' etc.) for mass-market clients.

9. MAKING ACCOUNTS MORE PORTABLE

Banks are going to have to make it easier for customers to switch banks. Policymakers see this as an essential step if the market is to become truly competitive. In a report published 2 April 2011, the Treasury Select Committee said the switching process must become simpler and easier:

"Effective competition will remain elusive unless urgent steps are taken to improve price transparency and comparability and the switching process."

Policymakers want to make it as easy for consumers to switch banks as it is for them to switch telecoms or energy suppliers, believing this will kick-start full-blooded competition in the sector and drive up standards of customer care.

Banks that make breakthroughs in this area, for example by developing portable account numbers – which the Financial Services Consumer Panel says would be a “great leap” towards better competition – and redirect mechanisms that would automatically transfer direct debits and standing orders to a customer’s new bank, stand to gain real kudos.

10. BECOMING MORE SOCIALLY AWARE

Christophe Langlois, author of the recently published *A Practical Guide to Social Media in Financial Services*, believes that:

“The benefits of leveraging social media go well beyond marketing. Blogs, YouTube, Twitter and Facebook have quickly become essential tools to manage reputation, foster innovation, develop new products, strengthen customer relationships and satisfaction, drive customer advocacy, aid recruitment, and increase market share.”

Banks will increasingly find it impossible to manage their reputations and stay relevant unless they fully engage with social media (and I would add LinkedIn to Langlois’ list). This will not come easily or naturally to some institutions and they will also have to be careful not to contravene regulatory constraints. But those that fail to take the plunge risk being increasingly marginalised from key parts of their customer base. Just putting a toe in the water is not enough.

Banks such as Citi are already using social media as a cheap and immediate means of gauging and responding to grassroots opinion. The US-based bank has trained 100 customer service representatives to track and respond on Twitter to customer queries and complaints. Banks will need to develop sophisticated analytics to penetrate the ‘noise’ and establish the true focus of customer concerns, and then learn to respond quickly rather than allowing resentment to build or fester.

But banks will have to be careful not to offend social media etiquette or invade people’s privacy. At a recent Marketforce *Social Media in Financial Services* Webinar in London, Clare Francis, head of content at Moneysupermarket.com, cited a YouGov poll that revealed that 77% people do not want to be contacted by their bank via social media. But Francis said:

“This is going to become huge. Ignore it at your peril, but think carefully before jumping in. Make sure that you’ve got a firm strategy and rules of engagement – including who’s allowed to tweet who isn’t allowed to tweet”.

Banks will also need to develop analytics and metrics to assess the success or failure of their social media activities. Econsultancy’s research director Linus Gregoriadi says:

“Whether the objectives are around hard financial targets or softer, brand-building goals, companies need to have metrics in place which help them to measure their success and build the business case for further investment.”

Banks that successfully integrate their social media activities and their online presences with traditional channels including ATMs, call centres and branches will have a much greater chance of staying a step ahead of the competition.

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11. REBUILDING TRUST

Online price comparison sites, which are subject to far less regulatory scrutiny than banks, are the most trusted financial institutions, according to a Datamonitor survey. Banks and building societies, however, currently fall far behind, having arguably done themselves massive reputational harm in the run up to the credit crisis. Perhaps they have much to learn from the comparison sites, particularly when it comes to things like speed, convenience, fairness and transparency.

Transparency is critical. Much of what banks do is far too opaque, and gives the appearance of being done in time-honoured ways to suit the banks, rather than their customers (the speed taken to clear cheques and BACS payments is just one example). The Cable&Wireless Worldwide commissioned YouGov research revealed that customers expect terms and conditions to be clearly stated and not buried away in the small print. Banks like Triodos and Co-operative Financial Services have shown that being more open and transparent with their customers brings real benefits (both banks differ from the norm in that they provide retail customers with information about their corporate loan books).

According to the Financial Times, lending at Triodos's UK arm rose by 20% last year, and by almost the same again in the first four months of 2011, while Co-operative Financial Services increased the size of its corporate loan book by 40% in 2010, and last year saw 80% more retail customers switch their current account to the bank than in the previous year.

Lloyds' decision to compensate millions of customers who were mis-sold payment protection insurance is the sort of dramatic initiative banks need to win back trust. As Neville Richardson, chief executive of Co-operative Financial Services, told the Future of Banking Commission:

“It shouldn't be about treating customers fairly because the FSA says so, it should be in the DNA of your business.”

12. ETHICS FROM THE TOP

The UK banking sector got its priorities all wrong in the run up to the October 2008 crash. An obsession with short-term profit caused some of the UK banks to take their customers for granted and to squander depositors' cash on 'casino' activities. The successful bank of 2020 will avoid falling into these traps by pursuing longer-term goals, such as offering customers value for money, satisfaction, and access to their bank and cash 24/7. Instead of a narrow, legalistic, compliance-based interpretation of what is right, bankers will need to focus more on ethics and it's going to have to come from the top. Stephen Green, ex-chairman of HSBC said:

“No banking business can afford to do without a board-led, senior management-supported, ethical approach to behaviour – to understand that there is a purpose to the business that you do, which is not simply measured by short-term profitability...is profoundly important.”

The Future of Banking Commission recommends that, in addition to developing a Good Financial Practice Code, bankers should receive compulsory formal training before being permitted to fully practice in their profession. This should include training in the ethical behaviour expected of the members of their profession, including how to resolve conflicts of interest.

13. INCENTIVISING STAFF

The successful bank of 2020 will need to ensure all its employees are fully committed to the change programme it has embarked on, at the same time as accepting more flexible working practices. Staff incentivisation programmes will need to be redrawn; rather than rewarding customer-facing staff for sales and punishing those who fail to meet sales targets, the successful bank of the future will develop incentive programmes that reward staff for customer satisfaction, for the fair treatment of customers, and for the fair resolution of complaints (these are among the recommendations of the Future of Banking Commission).

CONCLUSION

The successful bank of 2020 is going to look very different. It will no longer be so obsessed about the maximisation of short-term profits, but will be scanning the horizon in pursuit of longer-term goals, including a relentless focus on giving customers better value for money, providing a much more personal customer experience, and making it possible for customers to access their bank – and indeed their money – 24/7, in the most convenient way and irrespective of the distribution channel.

To boost their efficiency and to drive down operational costs, banks are going to have to jettison many of the clunky and customer unfriendly procedures and processes of the past and adopt a much more agile use of IT.

They are also going to have to become much more transparent and more ethical. It's going to be a big challenge, but if they remain where they are, they will risk withering on the vine and being unable to resist the advance of hungry new challengers.

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