



Retail Banking at an Inflection Point



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The Changing Landscape

Retail banking is at an inflection point. The industry has undergone more change in the past 5 years than in the past three decades. New competitors and operating models. Increased regulatory burden. And perhaps most importantly, changing consumer expectations and channel behavior.

The cross-currents are significant: where to win, what strategies to use, and how to best realize the future.

We surveyed industry leaders to gain their perspective on the challenges ahead. Their insight has been combined those of our management team to provide this point of view.

- 386 financial services executives participated in the survey, including 21 who provided more extensive commentary and discussion
- 48% of respondents were CEO's or C-Level executives at financial institutions, primarily Community and Regional banks

We hope you find this report useful in solidifying your strategies. We would be please to share additional insight, as appropriate to your challenges and situation. Please feel free to reach out to us to start the dialogue.



David Kerstein
President
Peak Performance Consulting Group



Re-Shaping Retail Banking

Community and Regional Banks are facing a difficult challenge: low interest rates create margin compression, retail banking fee income is declining, and expenses are increasing.

1. **Pressure on rates and margin.** While core earnings have improved, they are well below expectations and aspirations. The industry is profitable, but Return on Equity and Return on Assets has not returned to pre-recession levels.

As one survey respondent stated, *“What we’re doing now isn’t working anymore. We have to take a different approach.”*

What will propel the industry to pre-recession earnings? Low interest rates continue to put pressure on margins and decrease revenue available for reinvestment in the new channels and services our customers of the future demand. Rising interest rates will improve loan yields, but it will also create competitive pressure on deposit rates, limiting expansion of the net interest margin.

Finding topline revenue growth is the core issue facing the industry, and this begs for new pathways for success.

2. **High cost of compliance.** 48% of C-level survey respondents stated that the cost, and time, required to manage regulation was a major barrier to improved earnings. As evidence, M&T Bank reported that the cost of compliance increased 450% in the past three years to over 16% of Fiscal Year 2014 operating expense.

About 400 rules have been issued under Dodd-Frank, and there are more to come -- only about 60% of those mandated have been finalized. Nevertheless, there are indications that the situation may have stabilized, at least for typical community and regional banks. Financial institutions have now been through several post Dodd-Frank examinations and the CFPB’s priorities are known. Bankers may not like the regulatory regime but this is now “business as usual”, and its impact – and cost -- is generally understood. While there are proposals by the Federal Reserve to reduce the burden on community banks, we do not expect a significant improvement in the overall regulatory environment.

CEO Ranking: Most Important Factors Impacting Revenue Growth in 2016-2018

- 1 Pressure on rates and margin
- 2 High cost of regulatory compliance
- 3 Fees continue to drop
- 4 Changing customer preferences makes branches less efficient
- 5 Increased competition from non-bank competitors

3. **“No Fee Zone” expanding.** Community Banks are particularly dependent on deposit related fees, which represent over 20% of total fee income. By contrast, larger institutions have been able to use their scale and scope to diversify revenue

Financial institutions are simply unable to charge for services that were once common sources of profit. Overdraft fees have been severely constrained by regulation, and this has called into question the underlying economics of Free Checking which is dependent on “free” being offset by usage fees. Furthermore, consumers are resistant to imposition of new fees, limiting options for revenue replacement.

The situation will only worsen. New regulations on how overdraft fees are disclosed and charged will further limit this source of revenue. Early analysis of alternative regulatory scenarios suggests reductions in the range of 25-50% with the impact beginning in late 2016.

4. **Changing customer preferences are making branches less efficient.** Perhaps the single most important threat facing the industry is the fundamental change in the way consumers and small businesses use branches. Monetary and routine service transactions are being displaced by on-line and mobile. Branch transaction activity has been declining 4-5% per year on average, and at an even greater rate – in the range of 8 to 10% -- at many institutions.

Changing usage of distribution channels:

“There is still a lot of disagreement within the industry and our bank as to how quickly the shift from physical to digital is taking place. That is leading to a hesitancy of resource investments which could longer term be a huge stumbling block for the prosperity of the industry.” SVP, Regional Bank

Consumers value branch presence – 64% rate locational convenience as the primary determinant in choosing a bank. But they clearly don’t use them with the same degree of frequency or for the same purpose as they did in the past. And that means that the number of branches, their average size, the way they are staffed, and the way their services are marketed, needs to change.

5. **Competition will increase from non-traditional players.** Bankers are worried about the number of new entrants in the payment, consumer banking, and business banking space. There is cause for concern: we counted 38 different non-traditional competitors in the payments space alone, of which 10 were new in the last year.

Up to now these competitors have been mostly “nibbling around the edges”, as one bank CEO described it, but the introduction of Apple Pay significantly heightened awareness of the threat.

Apple’s marketing prowess, combined with retail point of sale technology upgrades, was viewed by many as the tipping point in the adoption curve.

The impact of non-bank competitors:

“The fear is that Apple Pay and Google Pay reduce, if not eliminate, the need for banks to provide the payment stream. How do we compete with that? Not sure what the solution is at this point. Once the consumer leaves or never comes in to the system, will they ever join again? Jury is out but I am not optimistic.” CEO, Community Bank

Charting the Course

Banks are hungry for growth. Hungry for new customers, for deeper and more profitable relationships with existing clients, for better alignment of expense against revenue opportunities.

Our survey identified four priorities for retail and community banks to win in the new environment:

1. Transforming distribution
2. Improving customer revenue
3. Attracting the digital customer
4. Simplifying business models

Different banks may emphasize different strategies, but every bank will need to address each of these elements to be successful.

Executives agree -- all were rated in the top 5 in importance.

- 79% of C-level respondents indicated they were increasing investment in digital channels, especially mobile banking, in order to attract younger customers
- 78% are focused on improving staff sales skills and sales effectiveness in order to generate improved revenue
- 68% have initiatives around simplifying business models
- 60% view improved analytics and segmentation strategies as a top priority to leverage customer relationships
- 56% have initiatives planned or in place to reduce branch distribution cost



In the following sections we highlight imperatives and explore strategic alternatives. We hope this will be a catalyst for further discussion about the needs of your bank.

Transforming Distribution

The question is not whether bank distribution channels are changing, but how much they will change, how fast these changes will occur, and how aggressively the industry should respond.

Walk in to any bank branch today and the answer is obvious. Where are the customers? It is the rare branch that is busy and it is unusual if there is a line waiting to see a teller. Sales productivity is low: the average branch opens 20-30 new accounts per month, or 1-1.5 accounts per business day.

Migration to digital channels is moving quickly. For example, Fifth Third Bank implemented consumer remote deposit capture in 2012, and by the first quarter of 2015 it had grown 36% of all deposits. We expect this trend to accelerate as younger, “digital native” consumers mature.

How should your distribution model evolve with changing customer trends?

- **Design an optimized distribution network.** It’s about managing distribution, not managing branches. Your distribution network should be matched against the needs of the local market. Take a disciplined, fact driven approach to creating the plan that fits your bank.

Industry leaders have moved beyond broad market-level information to identification of optimal micro markets and trade areas for investment. Is your distribution – facilities, people, and marketing -- aligned with the highest priority opportunities? Which sub-markets have the greatest potential for growth? Are the right product resources and staff skills in place to insure success?

Planning for success means reallocating resources that were designed for basic monetary transactions to a future where digital and physical distribution are more closely aligned with growth, customer value, and customer preferences. It’s an evolutionary journey that requires a roadmap informed by the right tools and metrics.

Changing Role of the Branch

- 1 The rise of digital channels requires a re-thinking of the optimal mix of brick and mortar branches.

The branch is still the primary sales channel, and the place where all of the bank’s services and promises come together. But customer behavior is in transition, and banks need to become more proficient at providing a true omni-channel experience.
- 2
- 3 While it is primarily about the customer, it is also about our staff and internal capabilities to effectively execute, and that means that staff roles and patterns of behavior also need to change.

- **Develop the right mix of facilities.** Branches will be smaller with fewer free standing branches with drive-ups. Three basic models are emerging: traditional full service hubs in a limited number of high opportunity locations; neighborhood branches in strip centers or other traditional retail spaces; and smaller, highly automated express branches.

Re-thinking the mix is significant. Associated Bank's branch network rationalization resulted in 28% fewer branches and 36% lower branch FTE. A branch-by-branch action plan to address legacy real estate issues enabled the bank to shift to smaller, lower cost and more visible retail facilities that better matched capacity needs.

- **Re-think branch staffing.** It is clear that banks will need fewer tellers in the future, and this has significant implications for roles and structure. Most branches will need only universal bankers, capable of performing both sales and service transactions. This represents a fundamental change in the way branches are staffed and managed, with implications for hiring, training, incentives and compensation.

Implementing Universal Banker:

"With hindsight, staff resistance was less than we thought, the payoff was greater than we expected, and we should have implemented this sooner and more quickly." EVP Retail, Regional Bank

There are significant improvements in cost efficiency. New roles are typically limited to only 3-4 levels of branch staff who handle all banking center functions. In addition, these branches need fewer supervisory staff, with branch managers capable of managing 2-3 branches, and equivalent improvements in regional or district manager span of control.

The model is efficient and productive. PNC achieved savings of one person per branch as it shifted its model, and one regional client achieved a 20% improvement in per-person sales performance. And there are implications for back office efficiency: reduced training cost (fewer levels to train), fewer support processes required, and fewer systems procedures to manage.

- **Create a Customer Experience Hub.** The customer contact center is even more important in an omni-channel environment. Customers now use more channels than ever before but they expect consistency across channels – centralized contact centers are well positioned to provide this.

Re-thinking the “Call Center” as a “Customer Experience Hub” has many benefits. These include improved customer experience, with consistency that bridges physical and digital channels, and improved productivity as staff focuses on building deeper customer relationships.

Customers are adopting touchpoints at an ever faster rate and financial institutions can ill-afford creating new silos. This broader role for the traditional contact center enables faster implementation of new channels and technologies, such as video conferencing with product experts, remote teller management for low transaction branches, or on-line chat to simplify access. But achieving the potential of the Customer Experience Hub requires different management strategies and operational metrics. New training, knowledge management, and simplified customer interactions designed for more complex cross-channel interactions will be required.

Growing Revenue

78% of our survey respondents reported that improving branch sales skills was their primary strategy for increasing sales. But in the past, investment in training has not been sufficient to reverse the downward trend in branch sales productivity.

Sales skills are important, but only as part of an overall management paradigm that includes the following strategies:

- **Change the customer acquisition model.** Historically banks used direct mail to generate inquiries and lobby management to drive sales. Staging of customer traffic patterns, placement of signage and merchandising, and coordination of teller referrals were the keys to a robust branch sales process. But direct mail is increasingly less efficient as customers communicate by text and email. Fewer customers are visiting branches and that translates into fewer natural sales opportunities.

Banks need to re-establish the branch as a destination, a place where people want to go, versus an infrequent errand. Simple presence in the community doesn't automatically create attraction, but requires more focused programs built on micro-market analytics that target the right tactics to the right trade areas.

Umpqua Bank pioneered this approach and it is noteworthy that their marketing spend, measured as a percent of assets, is only 65% of the industry average. PNC Bank has employed similar strategies, and this enabled them to drive branch traffic and acquire accounts at lower cost.

- **Expand relationship depth.** There has long been a disconnect between customer willingness to consolidate multiple relationships at their primary financial institution and banks' ability to effectively execute strategies that accomplish this goal. The opportunity is compelling. 55% of the owners of small and medium sized enterprises are willing to consolidate their personal and business relationships at the same financial institution. Consumers report similar willingness. Yet we know that the majority of balances are not consolidated.

The Gemini Strategy – finding account “twins” and consolidating them into a single higher value relationship – is a powerful tool to enhance value. These prospects are “findable”. Targeting strategies can identify clusters with a high potential for consolidation. This has produced up to an 85% improvement in household profitability when combined with the right sales process and product bundling.

Core revenue growth.

“What we’re doing now isn’t working anymore. We have to take a different approach.” C-level respondent, Regional Bank

- **Utilize data analytics to Improve fundamental product economics.** Checking account economics will improve with rising interest rates, however as the economy grows these gains may be offset by competitive pricing pressure. Financial institutions have two levers to press: the first is improved pricing analytics that build revenue; the second is improved cost drivers that reduce delivery and service expense.

Analytic tools exist to predict consumer how customers value financial products, and what price they are willing to pay, with a high degree of accuracy. These tools can help identify specific fee, balance and service combinations that customers prefer. A large regional bank used data analytics and market research to successfully restructure checking account pricing, resulting in a net increase of over \$100 million in revenue.

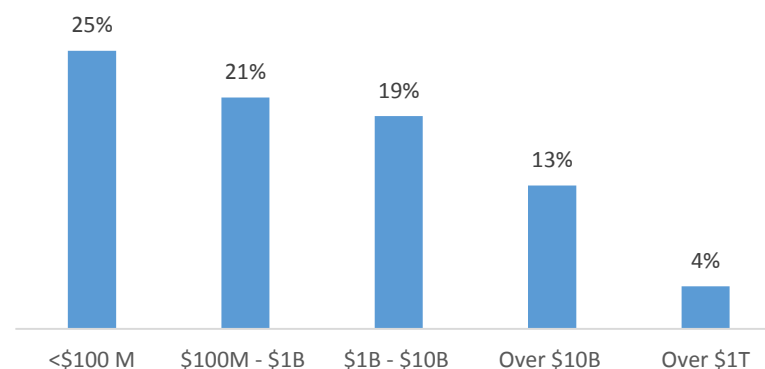
The second opportunity is to encourage more profitable customer behaviors – more profitable channel usage and more profitable transaction activity. Shifting customer activity out of the branch changes the profit dynamic while at the same time encouraging greater interchange income can offset declines in overdraft and other miscellaneous fees.

- **Diversify services.** Community banks are more dependent on deposit fees compared to larger institutions, and this makes them vulnerable to a transactional model where consumers acquire low margin products from their primary bank but use specialized providers for higher margin loans and investments.

But that tide is changing. First Commonwealth Bank re-entered the mortgage business. Peoples Bancorp (Ohio) has thriving wealth management and insurance subsidiaries. Several community banks are gearing up credit card operations. Texas based Frost Bank has even dropped the term “Bank” from their name in favor of “Frost: Banking, Investments, Insurance.”

Community and regional banks have a unique opportunity to leverage a diversified financial services model. They are large enough to acquire the necessary talent pool, but small enough to create a “one-bank” model that avoids the silo’s that impede larger financial institutions.

Community Banks Dependent on Deposit Fees
(Deposit Fees as % Total Fee Income by Bank Asset Size)



Source: FDIC 2015 data, Peak Performance Analysis

Attracting the Digital Customer

“Digital Natives” – the Millennial generation -- are already a larger cohort than the Boomer generation. The leading edge of is now in their 30’s and reaching an age when they have stable jobs, are forming families and buying homes. By 2020 they will have greater savings and investments than Boomers.

Millennials are critical to growth. Approximately 10% of households switch banks annually, but the propensity to switch varies widely by age group. Older customers are more likely to have long-established banking relationships and their average switching rate is only about 3-4%, usually as the result of a service issue or move to a new location. On the other hand, younger customers switch at a rate of 15-20% annually.

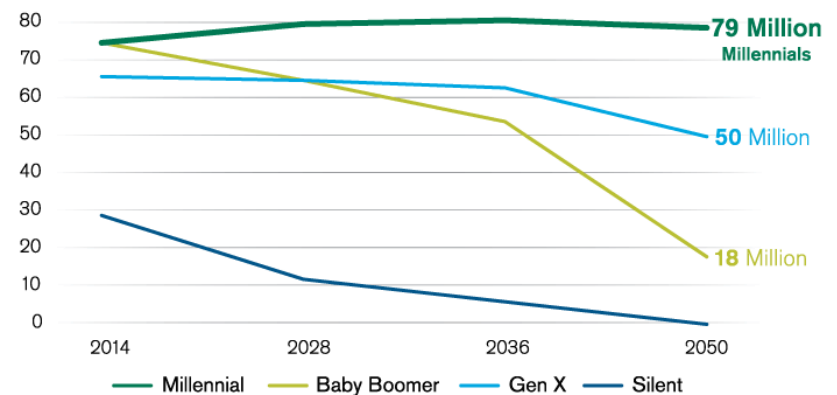
What does it take to profitably attract, serve and grow with these customers?

- **Create the right experience.** Millennials have never experienced a world without digital connections. They grew up owning cell phones, using computers at home and at school, and communicating on social media. They are accustomed to researching products and services on-line before they buy and are highly influenced by reputational comments on social media. Perhaps even more importantly, they expect instant access and fulfillment, with low tolerance for delays and inconveniences.

Millennials don’t want to be served in the same way as their parents. One of the biggest hurdles to success is the lack of understanding of this segment’s needs. If you don’t understand their attitudes and behavior, then you can’t serve them effectively. Barclays Bank’s Digital Eagle program (named for the eagle on the bank’s logo) is a model for skill certification and cultural change. Over the past several years, Barclays trained over 12,000 staff as digital experts to help customers and internal staff understand how to use the bank’s on-line products. But they also serve another function: helping both staff and customers get more comfortable with technology.

Millennials are Largest Population Group Population by Generation in millions

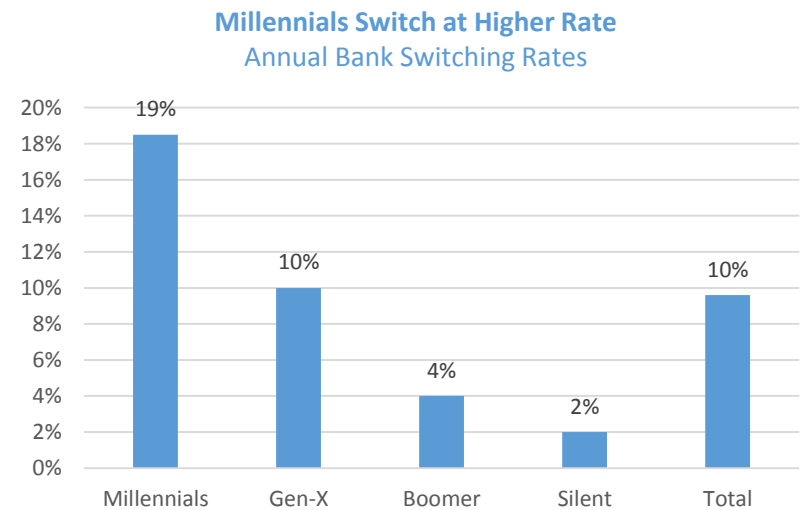
Population Projections by U.S. Generation



Source: Pew Research Center, U.S. Census projections

- **Innovate and learn.** We are in the midst of an extraordinary period of change, much of it driven by new technology. The banking industry is no stranger to innovation. What's different today is the amount of change and the speed of customer adoption. As a point of reference, it took 28 years for credit cards to be used by 50 million people, 12 years for debit cards to achieve the same penetration, but only 5 years for PayPal to reach that level.

Financial institutions need to embed innovation in their organization in a way that encourages agile test-and-learn strategies. Start by benchmarking initiatives against rivals in order to identify opportunities and maintain a competitive edge. Think about innovation broadly as a process, not just in the context of specific ideas or IT investments, but in terms of the overall customer experience.



Source: Pew Research Center, AlixPartners,

Simplifying Business Models

Banks have complex business models with multiple lines of business, and processes that are often “spaghetti wired” from legacy systems that are not fully integrated. Our survey respondents recognize this issue, with 68% stating that they had initiatives in place to simplify business models.

How can banks eliminate complexity and do more with less?

- **Eliminate the blizzard of choice.** The profusion of information has created a blizzard of choice. Ironically, the more choices available, the more customers are seeking straightforward, easy to use solutions that fit the way they choose to bank.

The downside of greater “choice” is that it makes the value proposition more confusing, and leads customers and sales staff away from a decision based on strongly perceived benefits to a more simplistic decision based on price.

Customers will pay for value. Advances in research techniques make it easier to make accurate predictions of the price customers are willing to pay for combinations of features, benefits and fees. Fine tuning to the way customers perceive value can add 10-20% to product revenue.

- **Keep it simple.** Banks need to re-think the customer journey. As touchpoints have grown, so has complexity of linkages between processes. The root cause of poor customer experience almost always stems from these process disconnects because they result in duplicative and inconsistent procedures, for example having to enter the same information on multiple systems, or at multiple times in the customer discussion. A recent mapping of customer touchpoints for a regional bank’s deposit products showed that customers interacted with the bank through seven different channels, each with about eleven discrete points of contact.

What Leaders Are Doing

- 1 Optimizing the number of branches, the average size, how they’re staffed and how they’re managed
- 2 Re-allocating resources to growth sectors: underpenetrated segments and geographies, new digital channels
- 3 Using advanced customer analytics to optimize pricing and services
- 4 Deepening customer relationships by identifying triggers to attrition and eliminating friction points
- 5 Identifying cross-selling opportunities between internal lines of business and eliminating disincentives to true “one bank” delivery

In today's digital world, financial institutions are still burdened by paper processes and duplicative entry that create "leakage" in productivity and embed expensive re-work into the system. And this is often further complicated by de-centralization or regionalization of certain processes.

Standardizing and simplifying processes is also a key to managing compliance. In the past year, banks as different as Arvest and Fifth Third started moving away from a de-centralized model, designed to be responsive to local markets, in favor of more consistent and more easily monitored operating systems.

Embedding these changes is not a function of technology, but one of management and culture. There is often a strong pull for headcount and "one-off" processes to re-appear. Creating a culture of simplification will require that banks make their interaction processes subservient to how customers shop, buy and use services.

Taking Action

Don't wait to get started. The slow but steady pace of change can lull us into the belief that we can take more time. Delay only means a more aggressive and expensive response will be needed later. As Netflix CEO Reed Hastings noted, *"Companies rarely die from moving too fast, but they frequently die from moving too slowly."*

Where to start? Ask yourself the following questions:

- Strategic
 - ✓ Are we positioned in the most attractive markets?
 - ✓ Does our business mix provide better growth opportunities?
 - ✓ Have we identified the best growth opportunities and are we winning in the most attractive spaces?
- Operational
 - ✓ Are we consistent?
 - ✓ Are we organized to win and do we encourage the right behavior?
 - ✓ Are we operationally efficient and have we addressed complexity?
- Customer
 - ✓ Have we closed the "back door"?
 - ✓ Are we improving relationship depth?
 - ✓ Are we maximizing the tenure of our relationships?

How can we help?

Peak Performance Consulting Group: Solutions for Banking

About Us

- Exclusive focus on banking and related financial services
- Disciplined process to help clients create value in today's complex environment
- Broad industry experience with leading financial institutions ranging from community banks to top 10 financial institutions
- Results oriented: we consistently deliver programs that have high multiple returns

Consulting Services

- Branch and Distribution Network Transformation
- Sales Improvement
- Marketing strategies and efficiency
- Product pricing and revenue strategies
- Operational efficiency
- Change management

Solutions and Analytics

- Peer benchmarking
- BankPower® market and distribution analytics
- Neighborhood Marketing Programs
- Risk management assessment and tools



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