

The Changing Banking Environment: Consumers and Channels

The banking landscape is in the throes of change. The economic difficulties of the past two to three years, changing demographics, the maturing of the Internet and rise of mobile phone uses have materially altered the environmental context within which the banking industry operates. These changes span the customer/market environment, the competitive environment and the regulatory environment. Banks now face some new realities, forcing them to confront anew questions around customers (and, by implication, products and services) and channels.

The Changing Banking Landscape

The continuing economic crisis and the regulations emerging from or following this crisis will continue to hit the bottom line of many banks directly. Changing demographics – in particular, the transition of Baby Boomers out of the workforce and Gen Y into the workforce – bring about new attitudes and behaviors. Finally, the maturing of recent technologies (the Internet) and the rise of new ones – most notably mobile banking and social networking – add new opportunities as well as risks. The paragraphs that follow describe these customer and channel changes in more depth.

The Consumer marketplace

The consumer marketplace for banking and other financial products has been altered significantly as a result of the economic downturn. Some critical areas of impact include:

Decreased wealth, income and industry profitability

Consumers and business alike were impacted by sharp declines in the values of equities, bonds and real estate during the decline of those markets. Between October, 9, 2007 and March 9, 2009, the S&P 500 lost 56.8 percent of its value. *Wells Fargo Investment Advisors* [May 1, 2009] notes that, using post-war bear markets as a gauge, “losses in the S&P 500 Index in excess of 40 percent have taken roughly five years to recover to their prior peaks.”

On a global scale, *The Times of London* [2/11/09] reported that:

“When equities bottomed on 21 November 2008, the MSCI World index had fallen 55 percent since 31 Oct. 2007. This worked out at a global loss of \$21 trillion, or \$ 21,000 for every individual in the developed world. Since 2000, the MSCI World index has lost a third of its value in real (inflation-adjusted) terms, while the major markets all gave returns of between -4 percent to -6 percent each year.”

While financial assets were falling, real property assets were also falling. Home prices have fallen 30 percent or more since peaking in 2006, and could fall further through the end of this year, if not well into 2011. Finally, at the same time, personal income – which was already stagnant (as measured by median income) in the decade leading up to the recession – probably fell 5 percent or more during the recession. [*U.S. News and World Report*, 4/6/10] High unemployment levels are likely to continue to constrain growth in personal income for some time. Recent estimates by the White House Council of Economic Advisors projects an average unemployment rate of 10 percent throughout 2010, declining to 9.2 percent and 8.2 percent in 2011 and 2012 respectively. As a result, the Federal Reserve Bank reported that -- due to this “perfect storm” of losses in financial markets and property markets combined with a flat to declining income – United States households experienced, by an order of magnitude, the greatest loss of wealth in the 57 years that the Federal Reserve Bank has been keeping such records. The loss in wealth in 2008 versus 2007 was 18 percent, or an estimated \$11 trillion dollars; the “dot com” bust, by comparison, resulted only in a 3 percent loss of wealth in 2002. [*New York Times*, 3/12/09].

To be sure, this loss in wealth and income is taking its toll on banks. In their 2010 study, “Private Banking: After the Perfect Storm,” Booz & Company reports: “Since the beginning of this crisis, the wealth management industry has lost 25 to 30 percent of its revenue because of a lower asset base, cautious market behavior, and a shift toward low-margin financial products.”

On top of this loss of wealth – and perhaps because of it – consumers and businesses alike are deleveraging. Consumer and business borrowing levels in the U.S. are still showing declines since peaking in 2007. *Money* magazine [July 2010] reports that, between March 2009 and March 2010, outstanding credit card debt fell from \$935 billion to \$853 billion (a drop of 8.8 percent); consumer revolving debt levels have fallen for 18 consecutive months. At the same time, the personal savings rate in the U.S. has been increasing.

The loss of wealth (and therefore investible assets), subdued personal income levels and deleveraging by consumers and businesses all point to potential industry overcapacity and leaner times ahead for many banks. However, that is not the entire story. New regulations introduced or being considered for introduction (see the article on regulatory reform in this issue of “*On Financial Services*”) foretell both increased costs of compliance and, more importantly, the potential loss of significant consumer-based fee income due to direct market controls. Taken together, these factors portend a smaller market for financial services products and potentially leaner profits for many institutions in the years immediately ahead.

Changing Demographics

While the impact of economic events of the last few years have jarred the consumer banking and wealth management businesses, a quieter storm centered around customer demographics has also been brewing in the background.

Banks’ focus on Baby Boomers – driven by both their vast numbers and visions of generational transfers of wealth – is beginning to shift to their offspring. Much has been written about the rise of Gen Y (a.k.a., Echo Boomers or Millennials),

the group of roughly 70 million individuals born between 1978 and 1998 (as defined by www.brassmedia.com). The good news, according to a February 2010 study by Cisco, is that members of Gen Y need and want advice about how to manage their finances, and they also trust banks to help them and to be their primary providers of financial advice. The potential bad news is that the preferences and behaviors of Gen Y – around a culture of social networking, an affinity for technology, social causes and the like – may indicate that banks need a new or added approach to retail banking that leverages some of the preferences (e.g., self-service) and/or tools (e.g., virtual and community-based advice) that they and their peers have adopted elsewhere in their lives. [Cisco, *"The Next Growth Opportunity for Banks"*, February 2010]

Channels

While changes in customers are driving industry change, changes in channels – largely driven by technology and adoption of technology – are also occurring.

Banking channels have traditionally revolved around branches, call centers and ATMs. More recently, online banking has come to the fore. Indeed, a 2010 Fiserv study on Consumer Payment and Billing Trends found that 72.5 million U.S. households (80 percent of all households with Internet access) use online banking, and 36.4 million households (40 percent of all households with Internet access) use online bill payment. An August 2009 survey by the American Bankers Association asked 1,000 consumers what banking method they used most often. Thirty-two percent of respondents said online banking, 28 percent said branches and 22 percent said ATMs. Not unexpectedly, when compared to prior surveys, the number of respondents who chose online banking increased, while those who responded branches or ATMs decreased.

Against this backdrop, another nascent potential channel is emerging: mobile banking. Based on its 2010 Mobile Payments research study, research firm Javelin Strategy found that 20 percent of consumers surveyed expressed an interest in conducting banking using their mobile phone. A 2009 Fiserv study found that 43 percent of Gen Y planned to perform mobile banking activities in the next year. Javelin projects that 49 million U.S. adults will conduct banking activities using their mobile devices this year. Increased penetration of smart phones – combined with faster networks – is expected to drive this number higher in coming years.

Besides providing a convenient platform for mobile banking, mobile phones also have the ability to change the payments landscape. The various contactless payment capabilities provided by smart phones (be they consumer-to-business or consumer-to-consumer), represent potential opportunities for some banks and threats to others.

Finally, the rise and growing importance of social networking – whether a true channel or not – is another factor changing the banking landscape. In spite of the time that consumers –especially Gen Y – spend online, the Fiserv study found that the influence of online communities/social networks on financial decisions lags well behind the influence of friends and family and banks' own websites. Nonetheless, especially with the rise of Gen Y, social networks need to be

monitored and experimented with in terms of their potential to assist in marketing to and potentially having community members help one another to solve problems or address questions (i.e., servicing customers).

Social networks have also given rise to new competitors. New “social banking” entities like Prosper (with almost 1 million members and loans of \$197 million to date), Lending Club and Virgin Money are borrowing from social networking concepts and applying them to banking. While the direct threat of these social banking competitors may not be particularly immediate or significant, their approach warrants monitoring.

Customer and Channel Implications and Questions to Consider

These marketplace changes have significant implications for banks. Reduced customer wealth, less income/money available to invest in financial assets, decreased borrowing due to deleveraging and increased regulation of consumer banking fees all point to a smaller and, at least in the near term, a potentially less-profitable banking and wealth management landscape. As a result, banks will need to look who they serve/target, with what cost structures/network costs and what products (e.g., can free checking survive). Given the need for new revenue, tapping in to current customer relationships represents a likely growth path for most banks, given the reduced marketing expenses associated with those customers and, hopefully, their favorable experiences with the bank.

At the same time, changes in demographics, the rise of technologies and social norms surrounding those technologies, and the continuing preference of customers to use multiple channels – combined with the cost and earnings imperatives noted above – all raise the prospect that banks need to rationalize, and change the focus of and/or make significant new investments in their various channels.

In light of these changes in marketplace context, banks need to consider some critical questions concerning how they will move forward in the near and intermediate-term regarding customers and channels.

Some of the key questions to address include:

- How is the economic crisis and changing demographics impacting the bank’s base of customers and prospects (and the revenue and profitability related to those customers and prospects)?
- What are the implications for the bank’s overall customer strategies (segmentation, target markets, value propositions and positioning, customer experience, etc.)?

Given these customer-related questions – and the changed market context – banks also need to consider a range of strategic questions related to channels, including:

- Given those customer strategies, how should we rethink channel strategies to deliver both cost reductions and new sources of earnings, while delivering the desired customer experience?
- What channels should we invest in to serve both current and the next generation of target customers, and what should be the relative priority?
- How can different channels and customer “touch points” be used to influence the financial choices and decisions of these customers?
 - How can channel be better utilized to provide targeted customer experience while simultaneously addressing the need to reduce costs given a smaller financial services marketplace?
 - What should be the role of social networks in the role of the customer experience, if any?
- How can online and mobile channels be better integrated with other channels?
- Given expectations for reduced revenue and earnings, how should we optimize and rationalize our channels, both to meet the needs of – and create the desired experiences for – target customers while simultaneously addressing the need to reduce costs and generate new revenue streams?
 - How can we avoid or minimize the “cost-on-cost” implications of serving customers across an ever-expanding set of channels?
 - In particular, how can expensive branches be rationalized and optimized?

In Summary

The combination of the recent economic crisis, increased bank regulation, changing consumer profiles, and evolving channels and channel preferences requires that banks fundamentally re-assess their business. Given this changed environment, questions about customers and channels all need to be looked at in a new (or at least updated) light.

* * *

John Hansen is a Director in the Financial Services Practice at Hitachi Consulting; he can be reached at (510) 290-4131 or JLHansen@hitachiconsulting.com.

Hitachi Consulting, a global consulting company with operations in the United States, Europe and Asia, is a recognized leader in delivering proven business and IT strategies and solutions to Global 2000 companies across many industries. With a balanced view of strategy, people, process, and technology, we work with companies to understand their unique business needs, and to develop and implement practical business and technology solutions.

Our Financial Services practice is the product of significant investments the firm has made in this space over the past few years. In August 2005, Hitachi Consulting acquired Dove Consulting, a Boston-based strategy and organization consulting firm specializing in payments strategy and research. In March 2008,

Hitachi Consulting acquired JMN Associates, a leading provider of consulting services to the financial services, real estate and insurance industries based in San Francisco. Together, our team brings valuable expertise and practical, proven solutions to clients in the areas of business and technology strategy, process improvement, market research, project management, and industry and regulatory compliance.

More information on the firm is available at www.hitachiconsulting.com.