Retail Banking

Anna Omarini

Business Transformation and Competitive Strategies for the Future



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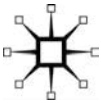
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To my daughter Sara, who always gives me the strength to face new challenges

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Preface

The main idea of this book is that enriching the perspectives through which we look at things makes each of us more aware of our decision-making processes and the choices we make. It is my belief that a multi-disciplinary approach is the way to add new perspectives. It is useful in reframing contemporary issues surrounding retail banking and developing a true customer-oriented business, and it is the approach that I have followed in this book. Fusing together elements of banking theory with theories from marketing and management, I have aimed to show that the only relevant strategic vision today is centered on rebuilding trust between banks and their customers. The basic tenet of the book is to be customer-centric.

New trends are constantly appearing in the market; some of them can be good for banks, while others may not be so good. In this new emerging context, there are many dynamic changes to look at and be ready to face, and a strategic plan is fundamental to getting ahead. It is my belief that in a broad sense retail banks have some important assets they need to protect and on which they need to build their particular version of the future. In their strategic management process they need to make a selection, according to different criteria such as consistency, effectiveness, personal connection, convenience, and so on.

In every strategy, the ultimate objective is to do what the market needs. The future opportunities for retail banks lie in the needs of their customers. Sometimes banks have seemed schizophrenic. They have not always operated in the market with a clear strategy that is a synthesis of their internal and external vision, while consistency and order are both a prerequisite for good functioning. The danger is that certain strategies in some ways lag behind the present, leaving the market without adequate leadership.

The main difficulty in writing this book has been that at the end of the day one needs to select the topics and the best perspectives that best match the needs of the businesses and organizations that will execute their strategies. Over the last decades, we have seen dramatic changes in many industries. New ones have emerged and older ones have declined, or at the very least, changed substantially. Among the successful ones are those that can face up to change and adapt themselves to the changing situation.

It is time to wake up. Retail banking is becoming a battleground where competition is getting more and more multifaceted. As it remains of utmost importance and utility to individual customers and to businesses, I think that the industry should find its own distinctive way of approaching the market, which seems to confine retail banks to the role of mere executors of low value added services and providers of credit. Retail banks should do more than that. Every retail bank has to look inside itself first and try to find its own future. This means that there is no one-size-fits-all solution, as we have being seeing around in the market so far. Each bank needs to look for greater uniqueness following its own recipe.

Among these challenges, retail banks need to figure out what the market looks like, and, given their constraints, what they are good at doing better than others.

Banks need to differentiate themselves, and in doing this they must provide a new concept of customer-focused activity, which other banking and non-banking competitors are unable to emulate, rendering each customer relationship unique, while still maintaining a dominant position in financial services.

There is no reason to presume that banks are less susceptible to change than any other business or institution, or to assume that the banking industry itself will continue into the future as it is now. For a long time, retail banks have been developing new products and services, new channels, and new marketing campaigns, but in doing so they have faced dramatic challenges to their ability to attract and keep satisfied customers. Customer satisfaction is also changing its attributes, and different banking experiences are increasing customer expectations.

In this technology-driven era, customer mobility has increased consistently. Mobility has been an interesting venture for customers. While they are increasingly trying other banking experiences, they still doubt that other banks, and other providers, will be that much different from their existing bank.

In the past, many customers frequently assessed banks on the number and locations of their branches. Recently, however, the selection of a bank seems to have become less influenced by branch numbers and physical access than it was. As the customer-perceived value of bank services slowly decreases, banks have not always recognized some of the structural changes that were taking place in the market. With increasing customer mobility, banks have started to face a change in their customers' mindset: some of them are no longer resigned to the status quo. And even though the percentage of customers leaving a bank for a new banking experience has not so far been very great (it is said

that in some countries this figure is about 2–4 percent of consumers), it is important to understand who migrating customers are.

Banks have come slowly to be less central to their customers' everyday lives, while other businesses are eyeing banking activity with major interest, sizing up any potential gaps in the market for themselves.

The new challenge for retail banks is going to be how to educate customers to assess the bank value offering, and to deliver real wealth-generating services to them. I think that only in doing so can banks gain an advantage and put themselves in a position to build lasting customer relationships. This means recognizing that tailoring services to meet customers' financial needs requires not only incorporating cultural, social, lifestyle, and life events into their value proposition, but also recognizing that more sales do not always lead to better service, but better service almost always leads to more sales. In other words, the bank product is a service and the seeds of the future for retail banking lie in this fact.

For a long time, banking has been considered to be a kind of petrified forest. In the past, customers were aware of the need for banks, but there were not many other possible alternatives. And if we look at the industry from the investor's point of view, the returns on equity employed, in terms of dividend and equity appreciation in general, were sufficiently high that there was no reason for change. Now banks have removed themselves from their customers, sometimes a great distance – so far that they have forgotten that the primary goal is to respond to customers' needs first and investors' desires second.

Why 'another' retail banking book?

I first became interested in retail banking more than 20 years ago, and as my research grew, I worked on many separate pieces of the puzzle. This book is an attempt to put those pieces together to form a holistic vision of the industry as a whole. Since the beginning of my research, it has become more and more evident that this topic requires more than simply translating general management tenets for the industry, and that banking requires new strategies and tactics developed specifically with its features in mind. I became aware that most of the weaknesses in banking have come from the banks' distancing themselves from a knowledge of their specific management needs. Hybridizing business cultures is certainly useful because it can bring a transfusion of new experiences and ideas, but the peculiarities of the banking business

should not be forgotten; even worse, we should not try to impose solutions found elsewhere.

This book can play a small part in explaining these many issues, and, certainly, I hope also to highlight some misunderstandings surrounding the industry.

The framework of the book is managerially focused. I believe that the name 'retail bank' does not adequately describe the business model of a bank and its performance and risks, which can be very different from bank to bank. The main idea, when starting to develop the structure of the book, was to try to look for distinguishing features. These included the following:

1. A section on retail banking recovery that includes a conceptual framework for understanding the topic and of the evolution of the retail banking market;
2. Greater emphasis on the topic of the service dimension as banks are 'still' service companies;
3. A multidisciplinary approach, meaning that no single function in an organizational structure is 'king' but each should collaborate with the others. Sometimes, the emphasis of the book seems to be on marketing discipline, but I use it in the sense of marketing as a company approach, more than an internal function among others. We evoke marketing as how a company should market its services or goods, by continuing to create value for customers in a way that differentiates the 'producer' from competitors and with a view to developing a long-lasting customer relationship. Moreover, the main idea in the book is to develop a non-compartmentalization framework where any issues are capable of increasing value for stakeholders. It is my belief that shareholder value must be regarded as an outcome rather than a purpose.

   The compartmentalization framework may be largely overcome using the service-dominant logic. What has changed today is not that services are overtaking goods in economic activity, but rather that the relative inadequacy of the goods-based classification system of businesses for capturing and informing changes in economic activity is becoming increasingly apparent;
4. Focus on customer expectations and perceptions and what they imply in terms of market strategy;
5. A guest chapter (Chapter 4) that deals with the evolutionary trends in retailing, as a mirroring approach to deal in the banking environment;

6. Key points on the way banks should become customer-focused;
7. Emphasis on a customer-focus strategy that should start with a bank's first customers, its employees (the so-called internal customer);
8. Coverage of some of the false friends in managing new trends in retail banking; and
9. Appendices to provide further detail on some parallel issues relevant to the banking market.

I have synthesized research and conceptual material from many talented academics and practitioners while writing this book. I have relied on the work of many researchers and businesspeople from diverse disciplines such as management, marketing, human resources, organization, and operations. Because the field of retail banking is also becoming international, I have also drawn on work originating from different countries and different institutions.

I think there is space for more opinions and ideas on retail banking, especially if we consider that the crisis that started in 2008 has led to a situation where, while most of the banks that received state aid have agreed to reorient their activities toward a more retail-banking model, the results of a study conducted by the Centre for European Policy Studies (CEPS) and commissioned by the Greens-European Free Alliance Political Group in the European Parliament,[1] do not show that this has taken place substantially. Some retail banks have moved closer to wholesale and investment banking models in recent years, while others are dismissing them.

The structure of the book

There are three parts to this book.

Part I (Chapters 1–3) seeks to describe and understand what retail banking is about. Even those who are familiar with retail banking should browse through it because the purpose of these chapters is to establish a common understanding that goes to the roots of banking as a special industry.

In the introductory chapter, I look at the meaning of banking activity and also try to cover some of the fundamental *raisons d'être* of retail banking. The second chapter discusses some of the lessons learned from our recent experience and shows how retail banking is still a business in transition. The third chapter is centered on the customer-centric perspective to be developed by retail banks, which is the main

consequence of being driven by a service-dominant logic. It is my belief that this is fundamental, because many retail banks seem to have lost their allure and their centrality in the everyday lives of customers. New competitors are threating important parts of the retail banking business, such as managing transactions, savings, and lending. Most of them are looking to 'control' consumption and consumers, and in doing so they have realized that facilitating purchase of their products and services can be as or more profitable than their direct line of business.

Retail banks should strive in the market to protect their strategic assets and their traditional competencies while at the same time developing old and new ones so to keep up customer trust and preferences; develop new opportunities to enhance customer relationships; and, of course, to look for new and more stable revenue opportunities.

Part II (Chapters 4 & 5) concentrates on getting insights from both inside and outside the banking industry, looking for a way to develop a new course for the next phase of retail banking. As the modern customer is becoming more and more demanding, everyone has to become aware of the business as a whole: why they are in it, and why customers choose to accept their own offering and not that of a neighbor or the one-click-away competitor online.

It is my feeling that a one-strategy-fits-all route will not work, and this is not what I am looking to present here; but I am convinced that every retail bank should choose and develop its own differentiated strategy for engaging customers, both internal (that is the workforce) and external (those buying the offerings).

Chapter 4 – a guest chapter, kindly contributed by Martin Butler – looks at how retailers are developing their strategy in the war for the modern customer. He argues that it is fundamental to realize that people do not buy what you sell, they buy what you stand for. This means the most successful customer-facing business models are built to acknowledge the simple truth that now, like never before, people have real choice. This requires every company to be successful in understanding *what* business they are in, by adopting a holistic mind-set of being in the '*business of being chosen.*' They are not simply 'talking' about putting the customer at the center of their orbit but 'doing' it. Building and wrapping their businesses around their customers in a highly emotional, highly differentiated, and forensically smart manner. This is going to be the way to compete in the future retail market arena.

Chapter 5 is dedicated to trying to gain an understanding of some of the issues surrounding customer behavior, attitudes, and requirements, which are more vital than ever for banks' strategic thinking, operational planning, and day-to-day customer treatment. This chapter tries to answer some key questions, which are often remarkably consistent across continents and between countries, and which can be synthesized as a question: 'What steps can banks take to enhance their customer-centricity?'

In Part III (Chapters 6 & 7) the main idea is to look at some challenges banks face, especially when they pass from developing a strategy to executing it. As new trends are appearing in the market, they can be considered both good friends and false friends to retail banks; again, choice is becoming the true issue in the market. But this choice is the choice to build on the assets every banks seek to protect, not to maintain the status quo, but to protect the root, which will make a bank strong and appealing. Sometimes, grave weaknesses appear at the point of execution of a strategy, and for this reason some key themes are outlined concerning both the organizational side of the business and its performance measures in relation to customer-centricity as a goal.

The main thrust of Chapter 6 is not to give answers to any possible questions regarding the process of executing a banking strategy, or outline the organizational problem banks are facing, but instead to highlight the importance of developing business processes that can align a business model in support of a long-term vision of the future and make it a reality through the execution of a strategy. Furthermore, the chapter explains how every retail bank's main issue is to give itself tailored answers to a major question: 'how do we choose our future so that we are chosen?'

In Chapter 7, I draw various conclusions. Banking is becoming more and more an art, and this means that it needs to be perceived and positively assessed by both types of customer (internal and external) in the same way, otherwise they become permeable to any other proposal.

There are eight appendices, developed for those who wish to deepen their knowledge of a number of areas that are not central to this book, but are relevant nonetheless.

The journey to providing effective and consistent retail banking is endless. The true challenge is to build strategies, business models and organizations that are able to stand the test of time. In order to do so, I think every retail bank should start by asking itself some awkward

questions. I hope that by the end of the book, these questions will be easier to answer.

Note

1. CEPS – Centre for European Policy Studies, *Business Models in European Banking – A Pre- and Post-crisis Screening*, 2011.

Acknowledgments

I thank Joe DiVanna and Jonathan Williams, referees who gave permission for their identities to be revealed. They both gave me encouraging and important feedback and strongly believed in this book project. They also both shared with me the conviction that fusing elements of banking theories with theories from management and marketing could be interesting and useful for the task of rebuilding the trust of banking customers as a strategic vision.

The third referee also challenged me on the idea of a 'holistic' approach to retail banking. His or her belief was that this was, and I agree still is, to offer the reader the appropriate key angle. Even though a topic may be inherently interesting, the real challenge, for a writer, is the way you deal with it. This is especially the case when you look around and see that a lot of words have been dedicated to the topic, and you need to engage yourself first then endeavor to involve your reader.

Now that the book is finished, I realize that a lot more could be written about retail banking. My hope is that it will help to reframe the industry's focus both on the soul of banking and then on bank customers (internal and external to the bank). The challenge now is to engage you, my readers. And I would be grateful to those of you who would like to share your ideas and concerns with me.

The production of this book has also relied on the support of Martin Butler, who has given important insights on the way other industries are facing the same main challenge as retail banks, which is to be chosen by their customers.

I would also like to acknowledge the support of Michael Lafferty who granted permission to me to access Lafferty Publications.

I would also like to thank the many senior managers, directors, executives of banks, and my academic colleagues, who have kindly shared their opinions and insights with me over the years. In particular, I would thank those who have been *maestri* for me. They have taught me discern what can be considered the fashions of the moment from the principles and rules that inspire how a company should be managed. Overall, they taught me that there is error in cultivating the discipline furrow by furrow or in laying more emphasis on the single tree than on the forest. A systemic approach is mandatory, especially when you need to manage

discontinuity and changes in the market. This approach is useful everywhere one seeks to achieve the best outcome, to give the right weight to each choice, even if it may appear to be a minor choice – and furthermore – to have a zest for remembering, a passion for knowledge, and to be always researching.

The ideas in this book have also been influenced in no small part by the classes I have had the pleasure to teach both at a graduate and postgraduate level, during which students and executives challenged my thinking with their questions and demanded appropriate answers. These sessions have been extremely relevant in that they gave me an opportunity to think deeply about causes and business relationships.

I would also like to acknowledge the support of my home institutions – the Bocconi University of Milan and the SDA Bocconi Business School of Management – for the opportunities they both gave me in terms of teaching and research. My experience in both these fields has given me the chance to meet and share ideas with a number of extremely engaging and insightful colleagues.

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Finally, I thank my family, my husband, and my daughter for their encouragement and patience over the time while completing this book. Their support is much appreciated. I could not do it without you!

List of Abbreviations

ATMs	Automated Teller Machines
BIS	Bank for International Settlements
Bps	Basis Points
CD	Certificate of Deposit
CDS	Credit Default Swap
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CIR	Cost Income Ratio
CP	Common Principles
CRM	Customer Relationship Management
CRO	Chief Risk Officer
CSR	Corporate Social Responsibility
EBIC	European Banking Industry Committee
EC	European Commission
ECAs	European Competition Authorities
EFT	Electronic Funds Transfer
EMI	Electronic Money Institution
EU	European Union
EU15	The number of member countries in the EU prior to the accession of ten candidate countries on May 1, 2004. The EU15 comprised Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and United Kingdom.
FDIC	Federal Deposit Insurance Corporation
FHCs	Financial Holding Companies
FIG	Financial-Industrial Group
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSF	Financial-Services Firm
G-20	Group of 20
GDP	Gross Domestic Product
GP	Gross Profit
IBG	Integrated Business Group
ICB	Independent Commission on Banking
IC Banking	Integrated Consumer Banking

ICT	Information Communication Technology
IDV	Interactive Data Visualization
IE	Interest Expense
IFA	Independent Financial Adviser
ILR	Interest-sensitive leverage ratio
IN	Interest Income
ISE	Interest Sensitive Equity
IT	Information Technology
KPIs	Key Performance Indicators
KYU	know your customer
LGD	Loss Given Default
LLR	Loan Loss Reserve
M&As	Mergers and Acquisitions
MBS	Mortgage Backed Securities
MFIs	Monetary Financial Institutions
MNOs	Mobile Network Operators
MS	Member State
NAICS	North American Industrial Classification System
NCAs	National Competition Authorities
NII	Net Interest Income
NIM	Net Interest Margin
NIS	Net Interest Spread
NMSs	New Member States
NPL	Non-Performing Loan
OBS	Off-Balance-Sheet
OFT	Office of Fair Trading
OPEX	Operating Expenses
OTV	Over-The-Counter
PBT	Profit before Tax
PCA	Personal Current Account
PD	Probability of Default
PFM	Personal Financial Management
POS	Point of Sale
PSD	Payment Service Directive
RBS	Royal Bank of Scotland
ROE	Return on Equity
RWA	Risk-Weighted-Asset
SBU	Strategic Business Unit
SEPA	Single European Payment Area
SIBs	Systemically Important Banks
SIC	Standard Industrial Classification

SIVs	Structured Investment Vehicles
SMEs	Small- and Medium-Sized Enterprises
SWOT	Strengths, Weaknesses, Opportunities, and Threats
UI	Underlying Income
UPBT	Underlying Profit before Tax
VINC	Vertically Integrated National Companies

Part I

Setting the Scene: Using Past Experience to Inform the Future of Retail Banking

Introduction

The convergence of markets, evolving technology, and important changes in social and customer behavior have all contributed to a present that is markedly different for both banks and non-banks from even the recent past. But while this may be true, it is equally important to go a little further back in time to trace a number of evolutionary steps that have inspired economic and managerial thinking for a long time, and which also have had an impact on the present situation. It is for this reason, that in this part of the book, we want to look back to learn from and leverage the experiences of the past, in order to prepare retail banks for the future.

1
Introduction: From Banking to Retail Banking

1.1 What you will find in this chapter

The term 'bank' can be applied to a wide range of financial institutions. The objective of this chapter is to provide a brief overview of banking and the role played by banks in an increasingly complex financial world. It begins with a review of the meanings of banking and bank so as to come to a definition of the term 'retail bank.'

1.2 Where we are now depends on how we got here

In recent years, the conceptualization of the banking business has radically changed. The largest banks in many countries have transformed themselves, typically via mergers and acquisitions (M&A), into multi-product financial service conglomerates with offerings including retail banking, asset management, brokerage, insurance, investment banking, and wealth management. These major developments on the product side have been matched by the emergence of a diverse array of new funding sources. Driven by securitization, particularly of residential mortgages, banks have become less constrained by their deposit bases for lending. On-balance-sheet assets have increasingly been bundled and sold into the market to release capital to finance expansion. Off-balance-sheet vehicles (such as structured investment vehicles, SIVs) have been created to enable banks to collateralize assets funded by the issue of short-term paper, not only generating profits, but also enabling them to raise resources to finance growing funding gaps (loans minus deposits). Small and medium-sized institutions have also actively participated in diversifying their product and funding features. While banks have been undergoing these changes, a big question has arisen: Do we still think

banks occupy a dominant position in financial services? This is because, after many years of focusing activities to increase shareholder value, banks seem to have lost their way. This has led to a commoditization of some banking products and activities to the point where there is little perceived difference between financial service providers within local, regional, and national markets and other non-financial providers eager to enter the banking market.

For some customers and products, a clear demarcation line between these suppliers does not presently exist, whereas for other banking products there is a very clear distinction, as demonstrated by the availability of transnational banking products such as foreign exchange, international cash management, and other services that facilitate cross-border banking and commerce services. Given this, a large number of customers have now become shoppers, and they view banking services as single commoditized products, rather than as a mechanism to facilitate a total relationship of services.[1] If this is the situation, looking backward can be useful to learn from and leverage past experience, starting with the origins of banks.

1.3 A preliminary issue: what is a bank?

This may seem like an elementary question, but it is important to start from the beginning.

The word 'bank' evokes different mental pictures for different individuals. Some will think of the quintessential bank building with neoclassical columns and a large vault. Others will envision a balance sheet showing the bank's assets, liabilities, and capital. Still others will fall back on the regulatory definition of a bank, which is, generally, an organization that accepts deposits, makes loans, and invests in securities. For our purposes, however, a bank is both a financial intermediary and a corporate entity. It is a financial intermediary, because it:

- Serves as a financial go-between, taking in deposits from those who save and making loans with those deposits to qualified borrowers;
- Fosters economic development; and
- Acts as a community's economic engine.

A bank is a corporate entity because it is:

- Formed by shareholders;
- Governed by a banking charter, articles of association, by-laws or similar documents; and

- Governed by a board of directors, elected by shareholders to protect their interests, who are ultimately responsible for the conduct of the bank's affairs.

And a bank is also a service provider for many different customers. It sells services that are intangible, and this poses a challenge to bankers.

This being the case, banks have played a critical role in every country, facilitating commerce from a macroeconomic standpoint: they operate the payment system, are the major source of credit for large swathes of the economy, and (usually) act as a safe haven for depositors' funds. The banking system aids in allocating resources from those with a surplus (depositors) to those in deficit (borrowers) by transforming relatively small liquid deposits into larger illiquid loans. In addition to these on-balance-sheet activities, banking organizations have long engaged in traditional off-balance-sheet operations, providing loan commitments, letters of credit, and other guarantees that help counterparties plan for future investments and in some cases gain access to alternative sources of external finance, such as the commercial paper market. In the long term, they also provided a wide range of derivate contracts that allow counterparties to hedge their market risks.

However, one might view banks from a different standpoint and look at the business of banking, at banking economics and management. This is the aspect of banking that we have chosen to focus on in this book.

1.4 We aim to start from the origins of banking

The roots of banking can be traced to the earliest civilizations. The Egyptians and early societies of the Middle East developed the prototype upon which modern banking is based. Agricultural commodities were stored in granaries operated by the government, and records of deposits and withdrawals were maintained. Ancient civilization introduced money changers, who would exchange currency from different countries so that merchants, pilgrims, and other travelers could pay taxes or make religious offerings. In the Renaissance era, Italian city-states were home to the first banks, which financed trade, the state, and the church. The name 'bank' comes from the Italian word *banco,* a table covered with a green cloth where moneylenders completed their transactions in the marketplace. These are pretty humble beginnings for what is now a major industry. The successes of the Italian bankers induced the spread of banking across the continent. In England, goldsmiths were responsible not only for storing gold and issuing receipts,

but also for developing what is now termed fractional reserve banking. By issuing more receipts than there was gold on deposit, the goldsmiths increased the profit potential of the banking industry. The United States saw an expansion of banking activity to finance the growth of the young republic, from the time of the American Revolution to the Civil War. Modern banking (see Box 1.1) in the United States traces its origins to the National Bank Act of 1863, which gave the government a means to finance the Civil War.

Box 1.1 A focus on modern banking

Modern banking may have had its origin with the establishment of the Bank of England (1694), and the Bank of Scotland (1695). Before that date, the banks, such as Banco di Venezia (Italy, 1191–1797), Banco di Genova (Italy, 1407–1797), Bank of Hamburg (1619), Bank of Stockholm (1668–1754), and the Bank of Amsterdam (1609–1790) were banks of deposit. Payments in business transactions during the medieval period were made by means of coins. However, the inconvenience of handling and storing a large number of coins, and the risk of theft, led to the establishment of these banks of deposit. Here, the coins were valued, and were then locked up in the bank vaults and never withdrawn, but the title to them was transferred onto the books of the banks. The banks of deposit made no loans, but their income was derived from a charge that was made for each transfer of funds on the books of the Bank. Modern banks are banks of discount as opposed to banks of deposit, and they have given an enormous impetus to commerce. They create credit that circulates in the same way as money and in a far more convenient, safe, and economical form.

At the beginning, the presence or absence of banking facilities was of little or no importance to the working class; and they were utilized by the merchant or trading class. The merchant was able to purchase goods from the producers in an amount far exceeding his capital because he could give to the bank a note payable three or four months later, and receive bank notes for the amount of his note less interest. These bank notes circulated the same as coins. They paid for goods and discharged all kinds of financial obligations in the same way as gold, and were far more convenient to handle. They were redeemable in coin on demand, but the bank maintained only a small reserve in gold for redemption purposes. This led to a suspension of specie payments by the Bank of England twice in its existence, the most important one continuing for 25 years (1797–1822) but the business of England, and of the bank, continued just the same. Private banks were established, but could loan only their own or customers' capital. They could not loan their credit like the Bank of England, which had a monopoly on the issue of bank notes.

Source: H.R. Howe (1915) *The Evolution of Banking*, Charles H. Kerr & Company-Co-Operative, Chicago, pp.19–21.

In every country, banks played an important role in providing their customers with payment services to facilitate trade. Over time, this set of services became more and more diversified, from checks to bank transfers, from debit cards to credit cards to digital wallets. With multiple means of access to stored wealth, consumers are able to make purchases more often and in more places. This allows businesses to employ more land, labor, and capital, which in turn results in a fully employed economy. In doing so, banks have become a system that brings together savers and borrowers.

For a long time, financial intermediaries were often non-banking entities that satisfied a need in the exchange of goods, services, and value. An example is the Florentine merchant banks of the early 14th century, and the Belgian inns that operated in the later part of the same century. They were appreciated because they were useful in the development of the local economy, which, during the Middle Ages, was based upon a family business structure. These formal and sometimes informal organizations acted in direct response to a specific market opportunity, and their actions offer lessons that are still important for today's global banking environment. In fact, during the Middle Ages, the interactions of retail customers, such as paying bills or saving money, and mercantile transactions, commonly labeled 'accounts receivable and payable' were at the heart of regional, local commerce.

In many countries, the evolution of trade brought about a change in the historical banking value proposition. (see Figure 1.1).

During the 18th and 19th centuries, mercantile activity around Europe increased, and the Dutch and the British were particularly energetic. It was inevitable that it was easy for them to shift their accumulated

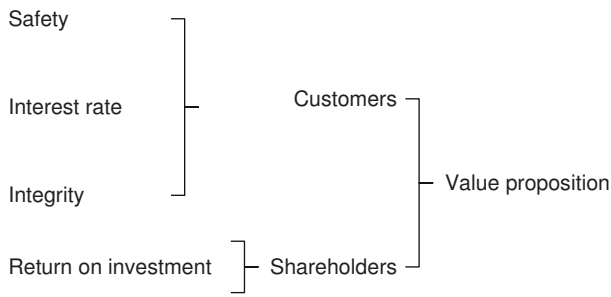


Figure 1.1 Historical banking value equation

Source: Adapted from J.A. DiVanna (2004) *The Future of Retail Banking*, Palgrave Macmillan, Basingstoke, p.15.

capital into financial dealings. As a consequence of this, in Amsterdam, for example, merchants became expert in various financial techniques and developments which, in the course of the 19th century, became identified with the emergent profession of merchant banker. At that time, much of the trade to and from Amsterdam was conducted by commission merchants, who acted as agents, seeking out customers but not owning the commodities in which they traded. This enabled them to trade on less capital, and by degrees, shipping agents and acceptance credit appeared, which can be considered a most important development in the history of international trade.[2]

In the meantime, new trading organizations were born, and the wholesale warehouse appeared, serving the exporter. As a consequence of this, a number of the well-known accepting houses were founded on fortunes made in the textile trade, the leading international trade activity. These houses were prepared to advance up to two-thirds of the invoice to recognized clients for limited periods, three–four months for sales in North America, and up to 12 months for oriental markets. The period from about 1825 saw the rapid rise of the accepting houses, where eminent merchants took on the financial risk of exporting. At this point, financial support was fundamental if the economy and society at large was to grow, and many well-known names, such as Rothschild, Barings, and Morgan, came to the fore.

In its early days, merchant banking was strictly linked to developing local economies, thanks to the activities of the accepting houses and also to developing transactions, which linked customers to merchants on the payment side. When merchants went international, these institutions helped them to develop from the original family business structure toward more sophisticated organizations. This brought about a need for more capital, and as a consequence, a complex partnership arose, which evolved into the business of merchant and investment banking. This evolution shows that, as often happens in modern times, banks expanded and extended themselves beyond their core competencies, and in doing so, the organization become more bureaucratic and less agile in the face of change.

J.A. DiVanna, in his book *The Future of Retail Banking*, puts it this way:

> When the combination of adverse conditions occurred, it caused the infrastructure of organizations to implode, crippling their ability to function profitably. An oversimplification of the state of medieval banks during the 1340s is that they lost sight of their core competency, banking, which is the fundamental management of the gap

> between deposits from their merchant activities and partners and loans extended to external entities, making them rely heavily on fee income. The lesson for modern retail banks is that the medieval super-companies, with their vast reserves and a workforce greater than most medieval governments, fell victim to their own greed. The underlying bureaucratic infrastructure could not sustain operations in the face of the rapidly changing business environment.[3]

This is a useful lesson we can learn from the past, and it shows us that the most damaging competitor for a bank can be its own organization when it starts growing and defocusing.

A final note might be useful on how banking began in America, which is a very different story.

In around 1780, the bulk of the banking business in Europe and Great Britain was in the hands of individuals, families, and partnerships.[4] In America, during the early 18th century, banks were fairly rare in comparison to Europe. Real banks appeared only later, under specific government sanction, with a prodigious assembly of capital, and in a blaze of controversy. It began with incorporation, and with important exceptions incorporation remained the main rule, both in the US and in Canada. America was not, like Europe, an ancient and mature economy with accumulations of monetary capital accessible in many money markets. It had no money or other free capital; for capital, as fast as it was accumulated, became fixed in land, buildings, and tools. This explains the rule of aggregation. But there is another important aspect regarding the development of the American banking system, and this was based on the need for a medium of exchange. At the time, Americans were without specie to serve as a medium of exchange and legal tender, and it was necessary to provide it. Colonial and revolutionary paper currencies were the products of wars, administrative need, and business interest. And in this case too, payment issues were the main reason Americans were asking for banks. Although banks owed their growth mainly to business enterprise and its need of credit for monetary use, they also owed much of it to government and its need for credit. For governments always have been borrowers, and repeatedly their dependence upon banks has been critical, especially in wartime. Since it is a function of banks to create money, and since it is a characteristic of war to cost money, the evolution of banking in the United States has received some of its most powerful impulses from wars.

It is evident that the relationship between banks and their markets is changing, but it is interesting to keep in mind the relevance of banks in the everyday life of the past.

Customers have moved from the industrial age of 'make and sell' to the information age of 'sense and respond,' and if banks do not become once again relevant to them, they will lose their market position. Relevance is important because it affects the conversion rate, because people are more likely to buy something that is of interest to them and relevant to their needs, and finally because it affects customer goodwill.

This is a second useful lesson we can learn from past: that banking is not in search of relevance but banks are.

1.4.1 When regulators started reshaping the market

Up to this point, we have explained why banks came into the market, and how they served the needs of payers, savers, and borrowers. A number of external forces have also exerted an influence on the sector, including socio-economic, regulatory, and technological factors. Socio-economic factors such as distribution of income and wealth, and patterns of consumption have played an important part in determining the demand for financial services and its evolution. However, perhaps more important were changes in the regulatory environment, in the form of financial services legislation, which was made necessary after a wave of bank failures, where savers lost their deposits and borrowers found it difficult to raise funds. Undoubtedly, legislation to regulate financial services had the greatest impact in shaping the behavior of suppliers and offering protection to customers. This happened especially during the 1930s, when laws and regulations built barriers that protected the services offered by each type of institution from competition. As a main consequence, commercial banks, which before 1933 were securities market financial institutions as well as depositary institutions, saw the scope of permissible activities limited.[5] In particular, some of them, besides providing services, such as accepting deposits, giving business, auto and home loans, and offering basic investment products like savings accounts and certificates of deposit, also underwrote corporate securities, selling good-quality issues to the public and placing poor-quality issues in trust accounts for individuals or pensions in its care. These banks earned investment banking fees for riskier activities, the risk being borne in part by their depositors. It is for this reason that regulators decided to separate commercial from investment banking in order to reduce conflicts of interest. In particular, commercial banks were prohibited from underwriting corporate securities and broker/dealer activities, and the investment banks were prohibited from all deposit-taking activities (checking and savings accounts).

Outside the United States, banks were performing different services in each economy, due to different regulations. However, the worldwide

trends of competition among financial intermediaries and changing regulation were shaping the banking industry in other countries in ways that were similar to those in the US. In practice, this trend has protected the investment banking industry from competition, enabling it to earn profits that are higher than those in the commercial banking industry.[6]

1.5 Toward a definition of retail banking

It is possible to describe the modern evolution of retail banking as a series of stages. The main idea is to give the reader the framework within which the industry developed and also pinpoint the moment it shifted away from its origins.

The old or first retail banking revolution is a term coined by Frazer and Vittas (1982) to describe the changes that began in the 1950s in European countries like Germany, Sweden, and the Netherlands. This 'revolution' was about the changing attitudes of the commercial banks toward the personal banking sector. The increased prosperity of the post-1945 period and the large numbers of new entrants into the financial system resulted in the personal sector becoming the dominant supplier of surplus funds in the economy.[7] As a main consequence, retail banking started to be offered by a wide range of providers. These ranged from small banks, which supplied only retail services, to medium-sized or very large national and international commercial banks, which may have been operating across a range of banking activities (such as private or corporate banking). But there were also large savings banks, cooperative banks, and a growing array of other financial and non-financial institutions. Two of the main players were commercial banks and savings banks, which are the main actors in the US dual banking system. (See Box 1.2)

Box 1.2 The US dual banking system in brief

The United Stated has a dual banking system. Commercial banks are chartered and examined both by the federal government and by the state authorities. Regulatory agencies that are responsible for commercial bank regulation include the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency, the Federal Reserve System, and state banking authorities. Savings and loan associations generally are insured by the FDIC and regulated by the Office of Thrift Supervision. Mutual savings banks are also insured by the FDIC but regulated by state authorities. Credit unions generally are insured by the national Credit Union Share Insurance Fund and regulated by the National Credit Union Administration.

The differences in the origins and initial customer segments of the commercial banks and savings banks have gradually disappeared because commercial banks entered the traditional marketplace (the retail sector) of the savings banks. Similarly, savings banks moved strongly into traditional commercial bank activities.

The growing attractiveness of the retail sector reflected the availability of a pool of relatively cheap and more stable funds for banks. In countries like Germany, Sweden, and the Netherlands, the commercial banks began to enter this market segment and to compete with other financial institutions such as savings banks and postal organizations that had traditionally dominated this market. Similar developments took place in other continental European countries, especially in northern and central Europe. In the United Kingdom, commercial banks traditionally enjoyed a dominant retail market presence because of their tight control over the payments system.[8]

At the beginning, retail banking was supply led. In the 1950s, this changed. Banks became more customer-driven, and banking strategies followed this trend.

As competition for retail deposits increased from the 1950s onward, marketing evolved as an important strategic and organizational response by banks. This development marked another important stage in the retail banking revolution. Retail banks started to target specific customer groups and differentiate their products in order to meet the demands of various customer segments.

From the early 1960s onward, retail banking in many European countries demonstrated an almost revolutionary capacity for change. Many different external causes, such as regulation, competition, and technology[9] (see Box 1.3), have been generally seen by bankers as important external drivers for changing bank strategies and their strategy focus. The impact and respective adjustment paths (in terms of strategic reactions to the external drivers) may also differ to varying degrees from one banking system to another, depending on factors like the historical evolution and existing institutional structure of each system, together with its present development level and capacity for change.

Gardener *et al.* (1999) outlined the same three main factors[10] – socio-economic advancement, technological developments, and financial liberalization – as those encouraging retail banks to broaden their range of products and services, sometimes even beyond their historic core businesses, to improve quality, extend their customer base and increase the number of delivery channels through which financial services can be offered. This has occurred in many ways and in several stages. The application of technology has disrupted the industry's delivery paradigms and the traditional channels of service distribution.

Box 1.3 Deregulation and technology as principal causes of change and effects in retail banking

Principal causes	Principal effects
Socio-Economic Advancement	Change in the nature of the banking relationship
	Increase in marketing orientation
	Increase in emphasis on customer price sensitivities
	Change in the nature of customer attitude and behavior
Technology	Emergence as a delivery channel
	Threat to comprehensive branch networks
	Change in the nature of the banking relationship
	Change in the cost structure of retail banking
Deregulation	Increase in levels of competition
	Increase in marketing orientation
	Increase in emphasis on profitability
	Increase in emphasis on quality

Within this changing environment, Clarke *et al.* (1988) outlined two main types of structural diffusion:

- The first one is in connection with an institutional structural reform (financial institutions diversifying their product range and new players entering those product market segments).
- The second one refers to market structural reform (where barriers between traditionally separated market segments are eroded or eliminated via *de jure* and/or *de facto* deregulation).[11]

During the early 1980s, the retail banking concept of broadening product bases began to acquire a new dimension. Retail banks developed allfinanz or bancassurance strategies in which retail banks and insurance companies joined together in order to provide customers with a full range of financial services.[12]

Allfinanz was a strategic attempt by banks (and insurers) to capture and sustain a greater market share of increasingly financially more sophisticated customers. The emergence of allfinanz as an attempt to develop a retail banking strategy was determined by various factors, including shifting demographic patterns, changing customer needs, changing savings trends, and increased competition.

This new phenomenon was galvanized by the globalization process and liberalization of financial markets through which new forms of financial integration and/or financial convergence appeared in the market. (See Box 1.4)

Box 1.4 A brief note on financial convergence

'Financial convergence,' as the process of wiping out borders between different parts of the financial system, concerns all types of assimilation or diffusion between financial services suppliers and integrated demand on these services. The mainstream economics literature has evolved an analysis of financial convergence and its different institutional forms – bankassurance, assurfinance, and allfinanz – (Van den Berghe & Verweire, 1998). Institutionally, financial convergence led to the relatively new form of international financial business organization, termed 'financial conglomerate' and defined as a group of companies under unique control. The exclusive activities of the financial conglomerate are linked to the provision of financial services in at least one of three main sectors – banking, insurance, and investment – taking place through a process of homogenization (Skipper, 1982). In this case, a firm traditionally acting in one sector starts to mix products from different sectors. The combination of bank, insurance, and investment activities leads to cross-selling, packaged products sales, modular sales, and hence to the fully integrated solution. Annuities, unit-linked, catastrophe options, bonds, equity puts; standby letters of credit proposing different finite risk transfer mechanisms, are combined with bank and insurance services and securities trading (Van den Berghe & Verweire, 1998). The growth of the financial conglomerate diversification strategy in the USA was studied by Saunders and Walter (1994), and similar strategies in Belgium and the Netherlands were analyzed by Verweire (1999). The term 'diversification' topped the chart of economic research after Rumelt's (1974) paper and that of his successors, Ramanujam and Varadarajan (1989). A large number of papers were dedicated to the state regulation of financial convergence, particularly in the insurance industry, including Atamtchuk (2001) and Klein (1991).

The European Union (EU) Single Market system facilitated the idea of a universal banking model (see Box 1.5) within which allfinanz became an important strategic feature of European retail banking.

Box 1.5 Focus on the universal banking model

Under a universal banking model, the services of both commercial and investment banks are provided under one roof. Universal banks provide traditional deposit-taking, lending, and payment services, as well as asset management, brokerage, insurance, non-financial business (commerce), and securities underwriting services. This means that a universal bank can underwrite securities, and hence can offer their client firms access to a broader range of sources of funds than can specialist commercial or investment banks. Universal banking has been operating in Germany for many years, but was generally restricted in the US until Congress passed the 1999 Gramm–Leach–Bliley Act. This Act came in response to an increasing commercial need for universal banking that

had already been recognized by the Federal Reserve Board's 1998 approval of the merger of Citicorp and Travelers. The same pressure was apparent in Europe where, in the absence of legislation on the separation between bank activities, financial conglomeration had been taking place for at least a decade. Thus, universal banks may dominate some economies but may be uncommon in others.

Potential conflicts of interest, such as the cross-selling of inappropriate in-house insurance and investment services to bank customers, or the mispricing of internal capital transfers between different parts of financial service groups and so on, are key issues for the universal banking model, which present significant challenges for regulation and for the wider health of the financial system.

In the 1990s, most of the major western countries started to develop new institutional forms of financial-industrial integration that were hitherto unknown. These institutions were named financial-industrial groups (FIGs) and were later termed vertically-integrated national companies (VINCs) or integrated business groups (IBGs).[13]

A report from Lafferty (1991) identified the main forms of allfinanz-type integrations as follows[14]:

– Banks establishing life insurance subsidiaries;
– Banks acquiring life insurers;
– Joint ventures; insurers establishing, and/or acquiring banks;
– Distribution agreements; and
– Banks acting as independent intermediaries.

Similar changes also occurred in the US market, after a period of relaxation before the introduction of the Glass-Steagall restrictions on bank holding companies, which permitted banks to merge across product lines. Bank holding companies were increasingly purchasing mutual fund companies, brokerage houses, and insurance firms in order to offer a full spectrum of financial products to their customers. These cross-industry acquisitions were aimed at stemming the continued erosion of market share by rapid consolidation as well as expansion into non-traditional banking products and services. The driving force in every bank was 'share of wallet,' the desire to attract and retain more and more of a consumer's financial business.[15]

During this period, the strategic focus of retail banking shifted away from a (pre-deregulation) form of collusion and regulatory capture toward more open competition. New competitors and new forms of competition appeared. In this period, around the end of 1990s, the influence of

technology was also ubiquitous, strong and ever-growing. But also, the movement toward the EU single currency heralded yet another stage, in particular within Europe, in which regulation again assumed center stage within the strategic thinking of European retail bankers.

1.5.1 Phases in the evolution of retail banking

A number of stages can be discerned in the evolution of retail banking with regard to the relationship between the banks and their consumer-customers. Most of them lasted about a decade, and they started some years before the 1960s to the present.

The early stage, up to the early 1960s, can be characterized as a production stage. At this time, banks had a predominantly inward focus; the emphasis was on producing and selling. From around the early 1960s to the early 1970s, the emphasis shifted toward product quality and the effects of competition. There was increasing recognition among the banks of the need to identify customers and to advertise. At the same time, the potential of marketing was increasingly being recognized. The concept of selling and developing a sales culture became more strongly emphasized; promotion was given a higher strategic priority.

During the 1980s, the market-oriented stage intensified with the growing competitive threat of the building societies and other financial services firms (FSFs) from both the financial and non-financial sectors. Marketing grew in strategic importance at all levels within the organization. In some European banking systems (especially highly developed and deregulated systems like the UK), retail banks began to approach the final stage, called the 'market control era.'[16] From a strategic point of view, this 'ultimate state' is when marketing concerns drive the whole organization; marketing considerations dominate all other strategic considerations. In this world, banks increasingly attempt to be proactive in meeting customer needs; customer service and quality are dominant strategic concerns.[17]

This shift in bank focus can be characterized as the movement from a bank-oriented financial system (where the traditional retail banks dominate as suppliers) to a strongly market-oriented system (where all markets are deregulated and highly contestable so that new competitors can easily enter and compete, eroding any excess profit).

In this situation, intensifying and new forms of competition become the order of the day. At the same time, the overall performance of banks becomes increasingly subject to external market tests of efficiency at all levels; banks increasingly need to adapt to a more shareholder value-oriented culture. As a result, banks have to be more efficient (reducing their

cost/income ratios as one key dimension of this productive efficiency trend) and more risk and return efficient (ensuring that their internal capital resources are allocated in a way that achieves the maximum return for each quantum of underlying risk). As a result, banks started competing through a policy of cutting costs and striving to be more efficient.

Since then, retail banking has developed in different ways and at varying speeds in different European banking systems with a declared common strategic theme emphasizing the evolution of a more market-oriented system and strategy.[18] But the true challenge has been the implementation of this approach in an effective manner. An example of the way retail banks started developing this approach was that of promoting packages or bundling products for customers (see Appendix 1), and in doing so they were driven by a more function orientation.

This evolutionary stage is interesting in that it provides another important lesson from the past retail banking experience, and this is that the execution of a real market-oriented strategy was, and still is, a weakness in retail banking. There are many reasons to explain the situation; we just need to consider that over the past two decades the banking industry has been undergoing profound regulatory and structural changes that are making conventional definitions of retail banks obsolete. These changes have particularly affected the business environment, the internal organization of bank holding companies, and the design of bank services and their delivery. Therefore, banks have organized their retail activities along three principal dimensions: the customers served; the products and services offered; and the delivery channels that link customers to products and services.

1.5.2 Defining retail banking in terms of the selling proposition

The main purpose of this paragraph is to give the reader a bigger picture about the many different definitions of retail banking that are present around the market and which have been proposed by different stakeholders (such as practitioners, academics, and regulatory authorities). I intend to give a cross-sectional perspective so as to assess whether the differences between the definitions might lead to different strategic and organizational choices as well as differences in their implementation from country to country.

Most bankers look surprised if ever asked to explain what they understand the term retail banking to mean (see Appendix 2). They will tell you that it means doing bank business with individuals – and some might further add that they mean individuals from the lower and middle strata,

contrasting it with private banking, which is used to denote the provision of banking services for affluent and upper affluent customers.

When asked to be more specific about their banking activities, bankers enumerate instruments such as savings accounts, payment facilities, loans, mortgages, current accounts, checking accounts, cash supply, currency exchange, insurance services, and security deposits, and others. They give the impression that the sum total of the soul of banking lies in the financial products they provide.

As far as products and services are concerned, deposit-taking is the core retail banking activity on the liability side. Deposit-taking includes transaction deposits and non-transaction deposits, such as savings accounts and time deposits (certificate of deposits, CDs). These products are interesting for banks because they are important generators of fee income, and they can also be viewed as pivotal because they serve as the anchor tying customers to the bank and offering cross-selling opportunities.

On the asset side of the balance sheet, the key retail banking products are consumer credit and small business loans. Consumer credit includes credit cards, mortgages, home equity lending, auto loans, education loans, and other personal loans.

Although loans and deposits are the primary products, retail banking units provide a range of other financial services to consumers and small businesses. For individual consumers, these services include sales of investment products (such as mutual funds and annuities), insurance brokerage, and financial and retirement planning. For small businesses, they include merchant and payments services, cash handling, insurance brokerage, and payroll and employee benefits services.

Moving on to other definitions, we find a distinction between wholesale and retail business, which is not straightforward. It can be said that wholesale banking has become essentially global in nature while retail banking seems to have remained at a national or even local level.[19]

An interesting contribution is from the regulatory authorities, which in this case is from the Financial Service Authority (FSA), which suggests an alternative split between counterparties: market professionals, expert end-users, and retail investors. Nevertheless, in general, a distinction needs to be made between retail and wholesale finance. The case for regulation and supervision of retail financial services is more firmly based than for wholesale business, and this can be summarized in the following:

– There is a standard problem associated with the absence of repeat orders; the small-volume retail customer does not make frequent

repeat orders of financial contracts. Two problems arise with this: the consumer has little opportunity to learn from experience, and there may be less incentive for firms to offer quality products; problems of asymmetric information are greater at the retail level than in professional wholesale markets; more generally, the suppliers and demanders of financial contracts are considerably less equal in the retail sector than in professional wholesale markets.

- Because of the nature of the contracts involved, it is necessary for financial firms to be continuously monitored. However, individuals are not in a position to monitor the behavior of suppliers of financial contracts.
- A retail consumer may be less able to ascertain the value of a contract at the point of purchase.
- The individual consumer has limited ability and opportunity to acquire the necessary skills to enter into complex financial contracts.
- The purchase of retail financial contracts is often based on advice given by professional advisers, which raises potential principal-agent problems.
- Retail consumers are rarely in a position to judge the safety and soundness of financial institutions.

In effect, market imperfections are more pervasive in the retail than in the wholesale sector, and as the ultimate rationale for regulation centers on questions of market imperfections, it is appropriate for retail financial services to be regulated more explicitly than wholesale business.[20]

According both to practitioners and academics, another definition of retail banking makes a distinction between retail and corporate banking markets, which is of great importance in banking organizations. The two markets differ with respect to concentration, the importance of informational asymmetries, and the extent of customer mobility.

In retail banking almost everything starts with a current account. Arguably, current accounts play a pivotal role in the relationship between a bank and its retail customers. A current account offers access to deposit-holding services, money transmission through checks and debit facilities, and potentially acts as a vehicle for credit through overdrafts. It may also serve as a gateway through which banks attempt to cross-sell other banking services, such as savings accounts.

Essentially, individuals use retail banks for three primary functions:

1. To make payments;
2. To save for the future; and
3. To insure themselves against life's vicissitudes.

In general, people contact a retail bank while searching for a solution to some monetary dilemma. As a result of this, the principal product of retail banks is 'a solution that fulfills an individual's need or, more precisely, a set of integrated solutions that support the individual's lifestyle and financial responsibilities.'[21]

If this argument works in general, it must also be said that social trends shape and reshape customer attitudes and, at the same time, retail banks' products are cyclical in nature, changing as a result of modifications in social attitudes and lifestyle that evolve to represent specific economic conditions of the people within a banking area.[22] These observations allow banks to develop a wide range of products based on information about various activities and transactions effected by previous generations of banking customers. Banks have also realized they need to follow technological developments and model products and services of higher quality in order to respond to new demands from their customer base.

Most of the services a bank offers (such as savings and checking accounts, mortgages, personal loans, debit cards, credit cards) are built on the main relationship between the bank and its customers, which has to do with a set of reciprocal duties,[23] such as the following[24]:

- To honor a customer's checks to the value of the credit balance on the account or to the agreed overdraft limit;
- To receive a customer's money and checks for collection and to credit his or her account with them;
- To repay credit balances on a current account on demand, made in accordance with agreed requirements;
- To be consistent and follow the usual course of business;
- To give reasonable notice to a customer when closing an account in credit;
- To provide a statement of account within a reasonable time and a statement of the balance on request;
- To maintain strict secrecy about a customer's affairs subject to certain exceptions;
- To exercise proper care and diligence when giving advice, especially with regard to the payment and the collection of checks; and
- To advise the customer immediately if and when a forgery is brought to the bank's attention.

On the other side, the customer has the duty to respect the following requirements[25]:

- To take reasonable care when writing checks and when using a check card or cash card in order to prevent fraud and forgery, and to not mislead the bank;
- To demand repayment of a credit balance according to the specified procedure;
- To advise the bank immediately if she or he discovers that checks are being forged;
- To ensure the sufficiency of the available funds on the account or of the leeway in the overdraft limit before signing a check;
- To repay an overdraft on demand; to pay reasonable interest and commission; and
- To reimburse the bank for any costs or losses from operating the account.

However, it is not just that a bank respects its duties that motivates a customer to choose a bank and subsequently remain loyal to it. Many banks offer exactly the same services, and the performance of the bank is assessed by customers mainly based on their cognitive perceptions of the overall experience. This observation highlights that the overall experience is becoming increasingly important as a key differentiator.

In the past, banks used to differentiate themselves with low prices and innovative products, but they are quickly losing their ability to provide an edge. Furthermore, banks can no longer reduce prices in a competitive manner due to increased competition, new regulations, and heightened capital standards, all of which are putting retail banking margins under enormous pressure. At the same time, some financial products have been largely commoditized, limiting the impact of product innovation.[26]

1.5.3 Other features of retail banks

In addition to what has been written so far, there are some other interesting features to outline in retail banks and they are:

1. The distribution model;
2. The cooperation in the sector;
3. The banks' practice of product tying;
4. The practice of multi-banking by customers;
5. The multi-market contacts; and
6. The elastic or inelastic customer price sensitivities.

1. The distribution channels of banks tend to vary between countries. However, the branch network seems to remain the primary

channel, although it is increasingly complemented or substituted by other channels, including internet, telephone and mobile, as will be seen later in this book.

Distribution models also vary according to the product or products being sold. For example, when banks go cross-border they usually enter specific product markets, such as credit cards and deposit accounts, and this approach can eliminate the need for a branch network while enabling all operations to be carried out via internet or phone, significantly reducing costs. However, for 'full service' retail banking, a branch network remains vital, since customers typically want and need face-to-face contact with bank staff to discuss their finances. It also remains a critical factor if a bank wishes to expand and accrue significant market share in full service retail banking.

2. Cooperation frequently occurs with respect to the ownership and management of payments systems or credit registers as well as the development of codes of conduct and other forms of self-regulation. Usually, cooperation takes place at the level of banking associations, but it can also go wider; for instance, when nationwide payment systems or credit registers require cooperation between specific associations. Cooperation among banks may go beyond the joint operation of platforms and concern wider areas such as common guarantee schemes, joint marketing and business strategies, or regional market sharing. This is particularly the case for savings and cooperative banks which, due to their origins, tend to have closer ties than other banks. These specific types of banks or sub-sectors make up a significant proportion of retail banking activities, particularly in Europe, and play an important role in several EU member states, such as Germany, France, Italy, Spain, and Austria.
3. Banks' practice of product tying and bundling accrue when the customer is effectively forced to buy extra products in order to secure the single product he or she wanted.

   Bundling and tying are practices that often have no anticompetitive consequences, enabling banks to offer a range of products that are better suited to customer needs, while generating savings in production, distribution and transaction costs, which can be passed on to the customer in the form of lower prices. In some cases, bundling might reduce price transparency. Since it offers a way to differentiate otherwise identical individual services (it is more difficult for other service providers to copy a bundle), bundling may

also make it difficult for the customer to compare the prices of its current bank with those of competitors. For this reason, prices might be kept at a higher level than otherwise. When purchasing additional services, the customer becomes more familiar with the products and processes of the service provider, while the information asymmetry remains with respect to competitors. In addition to potential problems of price transparency, the more services sold to the customer, the more their switching costs increase, making it more difficult to change service provider. In imperfect markets, market power might be leveraged to other markets.[27] If the service provider bundles the product with (monopolist) market power to a competitive product, or ties the latter to it, the effect might be the foreclosure of the other service providers on the competitive market. A decisive element in determining the consumer harm that may be caused by bundling would be a bank's dominance in the market for a given service to which additional services are attached.

Bundling and tying may not only be used to extend market power, but also to protect it by deterring entry. Many competitors might be interested to enter only some part of the market and sell products or services individually. Bundling and tying practices make it difficult for a single product service provider to compete with a multi-product competitor.[28]

4. Another interesting feature of the retail banking sector is the practice of multi-banking, in which customers have accounts with several banks at one time.

   Multi-banking was for a long time a growing trend, but it has recently shown a decline due to a reduction in consumers' expenditures. The choice of customers to maintain more than one current account was influenced by the cost structure set by banks in the market. The type of price structure clearly raises the cost of multi-banking by customers and reduces the number of accounts held by them. According to an EU Report (2007)[29] between 5.4 and 6.6 percent of current account customers in the EU will change provider each year. However, industry surveys suggest that the proportion of unsatisfied customers is typically much higher. Even though these percentages might seem to be small, it would be interesting to know the real number of people, who these people are (above all), and what the banks earn from them. If it is true that numbers are important, their quality also matters and sometimes can be even more important.
5. Another interesting aspect of contemporary retail banking regards its offering. Banks normally provide customers with a wide range of

products, so that the industry is not only characterized by networks and cooperation, but also by multi-market contacts of suppliers. This occurs when banks meet the same rivals in multiple markets. Multi-market contact gives a bank the opportunity to respond to actions or attacks by a rival not only in the market being challenged, but also in other markets where they both compete. This can be also explained when some suppliers are specialized and only offer one product or a very limited range of products (such as mortgages or online current account services) while the major players normally offer the full range of retail products. In theory, multi-market contacts may induce collusion behavior because retaliation against cheating firms can take place on all shared markets. This situation may also facilitate coordinated behavior in retail banking markets, which can only be established on a case-by-case basis.

6. One last feature to outline is customer price sensitivities. It is said that retail banking is characterized by demand that is rather price inelastic, at least with respect to certain core retail banking products, such as current accounts, as the low mobility of consumers suggests.[30] Alternatively, inelastic demand could also be explained by a lack of price transparency for some products and high switching costs. As someone once said, consumers are more willing to change their spouse than their bank. However, it seems that this situation may soon become a thing of the past. As will be discussed later in this book, both regulatory and legislative authorities are willing to increase customer mobility, while easing the switching process and costs.[31]

However, as for other market features, inelastic demand does not seem to apply to all products in the same way. For instance, consumers seem to be well informed and more willing to invest time in market research regarding mortgages than current accounts, but this could also change over time. The described situation might be explainable by greater price transparency and by a higher cost proportion of mortgages in relation to the consumers' budget,[32] as well as different entry barriers in this market.

2
The History Lesson and the Need to Turnaround

2.1 What you will find in this chapter

Retail banking and retail banks have both faced enormous changes in the last two decades. Retail banking has changed noticeably from an apparently mature market with benign competition into a growing market with aggressive competition, which is as yet not entirely understood.

Before looking at the new challenges and opportunities facing retail banking, it is worth getting a more in-depth picture of past experiences with regard to managerial choices and reactions to the financial crisis.

2.2 From past to present: retail banks need change

People, processes, and technology are drivers of paramount importance for banks, and the way they are combined affect a bank's strategy in its chosen markets and running costs. Future success will depend increasingly on the priority system and the proportions in which people, processes, and technology, as well as other factors, will take on their role within banking strategies. It is my belief that banks will still play an important role in economies around the world, and I am convinced that retail banks need to regain their popularity. This can be done if they set out their capabilities to help customers meet their life events and opportunities, rather than just supplying the many components for them to build solutions. I am not thinking that a retail bank should necessarily be customer driven, but that it should look at its customers more carefully than before and act accordingly and consistently with its market position and proposition.

It should be possible to take advantage of the many changes that are taking place in the market, even as competition is heating up. Change

and innovation need not be disruptive, and retail banks need to take advantage of both, focusing their organization on a new vision centered on what banks are good at and were born for.

Retail banking needs to be reinvented around usage and customer experience, and to introduce a metaphor, it is as if software wins over hardware. In this case, software is the way a bank is positioned in the market. Because the environment is changing, the software needs to be updated frequently. But the hardware does not need to be revised so urgently.

There is another important point to be considered in respect to retail banking, and that is that banks are doing business in services. This feature requires banks to build repeat business, increasing customer experience and developing true customer loyalty. As a result, retail banking success will come from recreating value with the customer by enhancing support.

Many lessons can be learned from the past, but we want to remind the reader of just three of them. As mentioned in Chapter 1, the most damaging competitor to any bank can be itself when it starts to grow and defocus over time. Under these circumstances, a bank becomes fragile and less agile in the face of changes. This kind of lesson is useful both to bankers and regulators when they encourage banks to become bigger as they face and develop competition. The mergers and acquisitions solution may in the long run reveal weaknesses under certain conditions, and this highlights the need to look for the appropriate dimensions for each entity.

As previously noted, the second lesson is that banking is not in search of relevance in the economy, as banks already play an important role in it (such as granting payments, lending, and supplying other financial services), but they need to regain their centrality in their customers' lives.

A third lesson looks at the implementation of strategies within banks. This is becoming more and more relevant as customers' expectations are changing and increasing in number and quality. This is not because of banks themselves but because of the appearance of companies such as Amazon and others, which are disrupting many industries around the world.

2.3 Retail banks and the financial crisis at the turning point

The financial crisis, which started as the US sub-prime crisis in 2007, escalated into a full-blown economic crisis and raised significant political challenges in Europe. Although not the only source of problems,

Table 2.1 Size of EU, US, and Japanese banking sectors (2010)

	EU	USA	Japan
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

Source: Adapted from European Banking Federation (2012).

the banking sector has been at the heart of this crisis, and from that moment onward, the time for changes was accelerated.

An important sign of the worsening situation was that in the years prior to the crisis, the banking sector grew significantly. For example, the EU Monetary Financial Institutions (MFIs) reached a total value of €43 trillion by 2008 or more than 350 percent of EU Gross Domestic Product (GDP). In the US, banking sector assets made up only 80 percent of US GDP, because the US economy is much more market intermediated, and mortgages are largely held on the balance sheets of government-sponsored entities.[1] It is for this reason that a comparison is inappropriate, but nonetheless, the differences in the size of the EU banking sector partly reflect the greater dependence on bank intermediation in the EU economy, with bank credit being the main source of finance for the EU private sector (see Table 2.1).

This outbreak situation was possible because of the sharp rise in the pace of financial innovation and especially in the use of credit derivatives designed to shift credit risk away from loan originators. A major feature of the pre-crisis period was a massive rise in the volume of trading in complex, and sometimes opaque, derivatives contracts. The Bank for International Settlements (BIS) has estimated that the notional amounts outstanding of over-the-counter (OTC) credit default swap (CDS) contracts rose to around $60 trillion by December 2007. One of the factors precipitating the crisis was the exposure of banks to large holdings of securities that were hard to value given the absence of liquid markets. In fact, many credit derivatives were hardly ever traded on any significant scale. Under these circumstances, banks became exposed to capital markets and securities trading risks that they did not themselves manage or sometimes did not truly understand. In addition, over time, banks' holdings of liquid assets fell, and their reliance on wholesale markets for liquidity and funding requirements increased. Another related feature was the more market-centric structure of financial systems, which implied a rise in the role of financial markets relative

to institutions in the financial intermediation process. Furthermore, banks and markets became increasingly integrated. One of the many implications of this trend was that losses incurred in markets were at times translated into funding problems for banks. In addition, financial systems became more susceptible to market shocks, particularly in a continuous increase in interconnectedness and network externalities. The interconnectedness was possible because of many channels, including *inter alia,* increased exposures in the inter-bank market, banks buying credit risk-shifting instruments and other derivatives issued by other banks, all banks trading in the same instruments, and the reduced systemic diversity as banks adopted similar business models too.

To complete the picture, largely unregulated 'shadow banks,' such as hedge funds and structured investment vehicles (SIVs) emerged as major new players in the financial intermediation process, with all the risks and new sources of instabilities they could bring in.

'Shadow banking' arose in complex derivatives, increased interconnectedness, lengthened intermediation chains, and increased leverage.[2] Also, the nature of bank risks changed. Securitization and other credit derivatives were designed specifically to shift credit risk, and for some years, they did just that. However, they also changed the nature of risk and, in particular, transformed credit risk into liquidity risk (buyers of the securities issued to purchase securitized assets from banks being unable to trade them), then into a funding risk (the securitizing banks being unable to either sell assets at other than fire-sale prices or roll-over maturing debt), and ultimately into a solvency risk. The latter arose because banks were unable to sell assets to continue funding their securitization programs. As a result of this, several structural features of the global banking environment changed dramatically, producing major mutations in bank business models, which changed in several important ways across Europe and worldwide. Finance in general, and the banking industry in particular, expanded substantially and unsustainably ('excessive financialization'), and the role of banks in the financial system increased. Several factors lay behind the financialization process in the years leading up to the crisis:

– Excess leverage and under-capitalization meant that banks could expand at a faster rate and to a higher level than would have been possible, and they were not be able to maintain a level of capital commensurate with their risks. Overall, banks became highly leveraged with a rise in assets on the balance sheet relative to total capital, and given that, they intensified their mismatches.[3]

- The systematic under-estimation and under-pricing of risks due to the macroeconomic environment and the collective euphoria of the pre-crisis years increased both the demand for loans and the willingness of banks to meet that demand to maintain an upward cycle.
- The high profitability of banks was enhanced not always by superior banking performance, but by banks raising their risk threshold and moving up the risk ladder. This situation produced a vulnerability of bank profits, increasing their dependency by specific factors (such as movements in interest rates), and at the time this meant that the cost of capital was artificially low because it did not reflect the true risks that banks were incurring. This amounted to an effective subsidy. A perceived safety-net for banks also had the effect of lowering banks' cost of funding.
- For the large institutions, the relative weight of banking activities shifted from deposit-taking, lending, securities underwriting, and trust services toward dealer and market-making activities, brokerage services, and own account trading. The corresponding banking sector expansion was financed through short-term wholesale markets and off-balance-sheet vehicles. For various reasons, banks adopted more short-term strategies to maximize the rate of their return on equity.
- Internal reward and bonus structures created a bias toward short-termism and excessive risk-taking.[4]

Each of these factors, both individually but especially in combination, created the conditions for an over-expansion of banking activity and an artificially enhanced role of banks and other non-regulated financial institutions in the intermediation process.

Another important aspect during the crisis was evaporating market trust also in the inter-bank market; as a consequence of this situation, the liquidity for banks disappeared, thus making it impossible for even the biggest and strongest banks to access either short- or long-term funding. Trading and other assets increased substantially, relative to banks' total assets. There was, of course, significant variation between banks because different banks adopted different business models. While all banks were affected by the crisis, given its systemic nature, certain factors made particular banks more vulnerable than others. This vulnerability came from the income model. In particular, some banks, such as Lehman, Northern Rock, Royal Bank of Scotland (RBS) and certain German *Landesbanken,* experienced heavy losses on trading activities and/or on investment portfolios. Other banks took losses also from aggressive expansion of their business (again Lehman and RBS) and/or departing from traditional

function. Some others relied too much on short-term wholesale funding (again Northern Rock and certain public finance banks) or they got bad results from poor lending decisions, including significant exposure to the property and construction sector (Northern Rock, RBS, and Spanish *cajas*). Finally, there were also banks with high leverage (all of the above) and, as in the case of the Spanish *cajas*, there were also some constraints on external capital raising due to legal structure.

During the years of the financial crisis, the retail banking business has proved to be an interesting source of stability for most banks.[5] And what this sector lacks in terms of performances, it makes up by providing a cushion against a sharp downturn. But like all other parts of the financial services industry, it has been strained by the turmoil, losing some positive effects deriving from greater efficiency, in terms of cutting costs and reaching out to customers. With the global economic downturn going on, retail banks have been increasing their exposure to unsustainable levels of consumer and small business debt and leading to a sharp rise in loan loss provisions, along with a string of bank failures. Given this, it is interesting to recall that these aspects were the same that increased the attractiveness of the retail banking sector by providing a pool of relatively cheap and more stable funds for banks and thus becoming the dominant supplier of surplus funds in the economy.[6]

2.3.1 Where do we stand, some years on from the start of the crisis?

During the different waves of the crisis, the banking sector experienced significant losses, which were, and in some respects still are, reflected in banks' share price performance and return on equity. The average cumulative total returns of Euro area, UK, and US financials were very high in the years 2000–2007, but were subsequently fired, in different ways, by the crisis. As regards the book return on equity, following sharp losses for many banks in 2008 and 2009, profitability recovered somewhat in 2010, but it deteriorated again in 2011. What is important is the dispersion in profits, which increased.

For banking industry regulators, the financial crisis was more than just a wake-up call. In fact, given the severity of the crisis, a high level of restructuring in the banking sector in the main economies has been addressed through important regulatory reforms, which are likely to spur further restructuring aimed at improving the resilience of banks in general. Even though some of them still remain highly vulnerable to shocks or are perceived as too big or too systemic to fail (see Box 2.1).

Box 2.1 Some relevant areas still to manage

- Excessive risk-taking fuelled by intra-group subsidies;
- Increased complexity, size, and scope;
- Leverage and limited ability to absorb losses;
- Inadequate supervision and over-reliance on bank management, boards and market discipline;
- Increased interconnectedness, systemic risk and limited resolvability;
- Competitive distortions and implicit public support leading to competitive distortions and negative bank-sovereign feed-back loops; and
- In the case of the EU there has also been a lack of institutional framework governing the single market in financial services.

Source: E. Liikanen (2012) *High-level Expert Group on Reforming the Structure of the EU Banking Sector: Final Report,* Brussels, October, pp.89–91.

The rules that are now being put in place will have a huge impact on almost all areas of banking, including the way banks manage risks. Banks now need to report information that goes beyond historical data and includes risk-based and predictive information. New systemic oversight allows regulators to ask for information on an *ad hoc* basis too. One important fallout from the crisis was the realization that banks had failed to properly understand the forces that affect them. This led to the kind of risky decision-making that drove many banks to insolvency during the financial crisis. In the post-crisis era, banks know they cannot afford to make similar mistakes. Regulatory authorities want banks to provide a comprehensive view of the market forces and risk-return scenarios across business areas and asset classes.

In the meantime, as a result of the financial crisis, some banks have started to retreat to their home markets, and competent authorities have taken measures aimed at safeguarding domestic financial stability. Some of them have also started to de-risk their businesses and to exit non-strategic markets. This includes putting out for sale capital-dilutive businesses that fail to meet rate of return targets. As far as the deleveraging of banks' balance sheets is concerned, banks are increasing equity capital and/or disposing of assets, as well as making changes in funding structures (such as looking for more stable funding sources than customer deposits), and in bank risk management. However, there can be a risk of bank deleveraging being excessive or disorderly, and this may result in reduced lending to the real economy, as banks have tightened their credit conditions from the end of 2011.

2.3.2 A brief overview of the ongoing reforms agenda

In this paragraph, I intend to give a brief overview of the most important measures from the regulatory reform agenda which came into being as a response to the 2008 financial crisis.

The main task has been to work at ensuring stability, safety, and efficiency in the banking sector, and this has been based mostly on adjusting regulation of the current system, both from a structural and a prudential point of view. In particular, the reforms aim to:

- Strengthen banks' ability to become more resilient to bank-specific or systemic shocks arising from certain vulnerable areas such as the trading and derivatives activities, but also real estate lending or short-term funding structures;
- Reduce the likelihood of asset price bubbles and in doing so ask for some restraints on indebtedness at a general level, and in particular in the private sector, so as to reduce procyclicality in the market.

At a national level, the main examples of these reforms are the following:

- The Dodd-Frank Act in the US, which introduced size limits;
- The Volcker Rule, which is part of the Dodd-Frank Act and introduced activity restrictions. It puts restrictions on the proprietary trading and investment activities of deposit-taking institutions, including their participation in hedge funds and private equity business. However, unlike the Glass-Steagall Act, this approach allows retail and commercial banking to be combined with investment banking activities that do not entail proprietary trading. A pending practical question for the Volcker Rule is how to tell the difference between a proprietary trade and a risk-reducing hedging or market-making one – an issue the Dodd-Frank Act leaves to regulators[7]; and
- The Vickers Report, the proposal from the Independent Commission on Banking (ICB) in the UK, which has prescribed structural separation of certain activities via so-called ring fencing and higher loss absorbance for the ring-fenced retail banks.

At the European level, the Liikanen Report makes recommendations on how Europe's banking structure should be reformed and be inspired by some of the ongoing G-20 reforms.

Following the introduction of these structural measures, a large number of further regulatory initiatives have been introduced, also at an international level through G-20, and more measures are still to come.

There has been a series of reforms, among them, those based on prudential reform measures, and they include: the capital requirements of Basel III to improve bank capital levels; the new liquidity standards; the expected bank resolution measures, which will pressure banks to raise cost-effectiveness, perhaps leading to further divestment away from non-core assets, and the regulation of systemically important banks (SIBs).

Notwithstanding the development and deployment of these reforms, it must be kept in mind that all banking activity involves risk-taking on the part of a bank. Banks by their very nature, therefore, must carry and manage risks in order to meet the needs of their customers and the economy. Removing them from banks implies either removing them from the economy or placing them outside the regulated banking sector, as in the example of the shadow banking sector. Risks cannot be eliminated, but they can be reduced, and the debate is between structural and prudential reforms and how they may increase bank resilience for the benefit of the market and customers.

2.4 Is there a way for retail banks to increase control on their profits?

At this point, it is important overall to look at the way a bank's business performs and also note the key areas that impact bank performance.

Besides being concerned with how much a bank earns, one should also look at the quality of bank earnings, as regards the composition, level, trend, and sustainability of bank profits.

For bank directors and managers, earnings quality represents a 'financial report card' on how well the bank is doing. When earnings quality is good, the bank has sufficient profits to support operations, provide for asset growth, and build capital. Moreover, depositors are given an extra margin of protection, and shareholders receive a competitive return on their investment. On the other hand, when earnings quality is poor, the bank may not be able to adequately serve the credit needs of the community, provide for losses, or build capital. Depositors may be at greater risk, and shareholder returns may be inadequate. Knowing this piece of information may help to ascertain the effectiveness of the bank's risk management. It is also useful for:

- Comparing the bank's performance to budgeted goals;
- Understanding why goals are or are not being met;
- Reviewing the consistency of earnings; and

– Determining if bank earnings are from planned strategies or one-time, or extraordinary, transactions.

The level and quality of bank earnings, and therefore profit control, depend upon a host of factors, both external and internal to the bank. External factors relate primarily to the environment in which the bank operates and pertain to conditions that are largely beyond its control. They determine the relative ease or difficulty a bank encounters in turning a profit. Included among external factors affecting bank earnings performance are economic and competitive conditions, laws, regulations, and technological changes. Instances where external factors have influenced profitability are fairly easy to find. For example, in the 1980s, declines in the agriculture, energy, and commercial real estate sectors in various regions across some western economies contributed to high loan losses at many banks, causing earnings to plunge. In the early 1990s, the downward slide in interest rates improved margins at many banks, causing earnings to surge. During the early part of the new millennium, the prolonged drop in interest rates that ended near a 40-year low, and a nearly flat yield curve, pinched earnings. Recent real estate loan losses and turmoil in the financial markets have made the task of earnings growth more challenging.

Despite the importance of external events on bank performance, internal factors often play an even more important role. In fact, while external factors make it more difficult to steer a profitable course, a bank's policies and procedures can have a greater influence on whether it will succeed or fail.[8]

From an internal perspective, bank earnings quality depends heavily upon a number of factors. Important among these are the bank's business strategy, asset and liability mix, asset quality, and operational efficiency. Therefore, all those who have to monitor their bank's performance need to think of how they, along with external factors, have influenced and will continue to influence bank earnings performance.

In summary, an interesting issue is concerned with earnings quality, which refers to the composition, level, trend, and stability of bank earnings.

For a director and bank management, as noted, bank earnings quality is a financial report card, and it also indicates how the bank has managed its risk exposure.

According to an EU Commission working document,[9] indicating for 2004 the proportion of gross income from consumers that banks generated by product line based on a weighted mean of all MSs, mortgages

were clearly the major source of income, generating just over 30 percent of gross retail income from consumers. However, in the New Member States (NMSs) this share was significantly lower. Current accounts generated more than 25 percent of gross income in the EU-25, and more than one-third of income for banks in the NMSs. Across the EU-25, savings accounts and consumer loans both generated between 17 and 18 percent of banks' gross income, respectively, while credit cards generated more than 7 percent of banks' gross income from consumers (see Table 2.2).

Table 2.2 Gross income share by consumer product line, weighted average (2004)

	Current accounts	Deposits and savings	Consumer loans	Mortgages	Credit cards	Total
EU-15 average	26.5%	15.94%	17.05%	32.85%	7.66%	100%
NMS average	34.95%	23.45%	20.85%	15.62%	5.13%	100%
EU-25 average	27.87%	17.16%	17.66%	30.06%	7.25%	100%

Notes: Country-level estimates are gross income weighted averages across banks surveyed in the country. The estimates for EU-15, New Member States and EU-25 are country-level averages weighted by population.

Source: Adapted from European Commission (2007) *Report on the Retail Banking Sector Inquiry Commission*, p.21.

2.4.1 Looking into a retail bank income statement and its traditional metrics[10]

The income statement is the source of information about a bank's revenues and expenses over a specific period. It is well known that a bank's net income is the difference between revenues and expenses, taking into account various gain, losses, and taxes. Bank revenues come from interest and non-interest sources. As expected, interest income from loans and investments makes up the major part of bank revenues. However, non-interest income from such things as fees, service charges, and commissions is an important and growing source of revenue. The sources of non-interest income for a retail bank are:

- Commission income comprising management fees, brokerage and advisory fees, and fees from funds transfer or foreign exchange dealings on behalf of customers; and
- Investment income arising from lending through market investments by being long, for example, corporate credits, sovereigns, covered bonds, mortgage-backed securities (MBS) and equities.

Likewise, bank expenses are comprised of interest and non-interest components. The main sources of expenses are:

- Operating expenses. These are dominated by staff expenses. But there are other sources of operating expenses, including IT costs, which are incurred to support the bank's operations as well as leasing costs for real estate (including branches), computer equipment, software costs, and others; and
- Provisions. These arise as follows: in order to manage the effect of loan losses, banks create a loan loss reserve (LLR) on the asset side of the balance sheet. As its name implies, a LLR is an allowance for loan losses. It is netted against gross loan amounts on the balance sheet and hence serves to absorb expected loan losses. In accounting jargon, LLR, similar to depreciation, is a contra-asset. At the end of each reporting period, (such as a quarter or a year), the LLR rises by positive addition to the loan loss provision in the income statement and falls by the level of net charge-offs.

In order to control profits, a bank needs to represent its profitability, and this is usefully done through a tree diagram. The drivers of underlying profit before tax (UPBT) are now identified and represented diagrammatically in Figure 2.1. This is an example of a tree diagram where the top of the tree (UPBT) is essentially determined by the root variables situated at the end (or bottom) of the tree. It is important to identify root drivers since the retail bank manager will steer his or her business by implementing one or more of these drivers and will create appropriate key performance indicators (KPIs) to increase the probability of their success. For reference, the root drivers are on the right side of the tree diagram.

From this representation, we can make two comments on the entries of the value driver tree presented above, and they are:

1. While underlying income comprises three sources of income, for a retail bank, interest income dominates, and it can be equivalent to almost 90 percent of total underlying income and sometimes even more than that. While for many large bank holding companies[11] this accounts for 50–75 percent of their revenues; and
2. Staff costs are the largest proportion of operating expenses (OPEX) and while the effective management of probability of default (PD) or seeking collateral to improve the recovery rate and hence reduce the loss given default rate (LGD) will likely reduce the provisioning requirement, OPEX has been providing the greatest opportunity for expense reduction, so far.

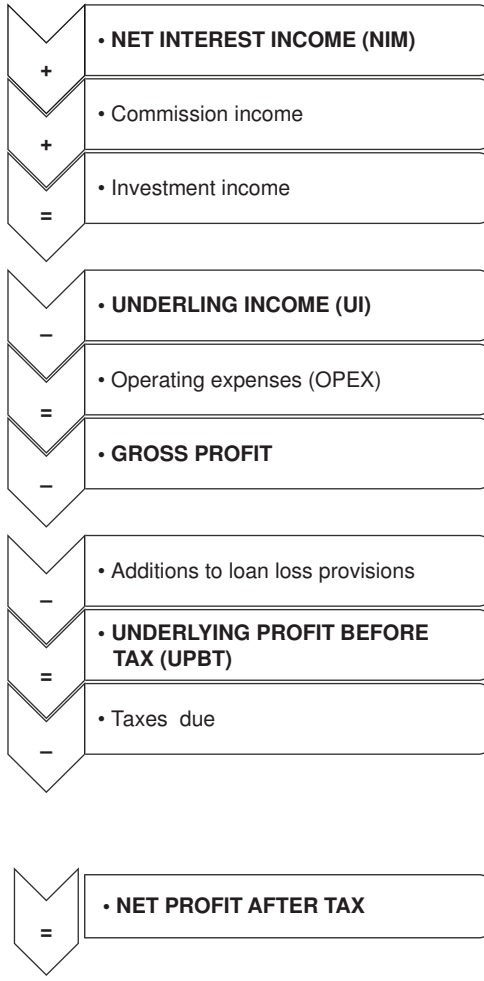


Figure 2.1 Continued

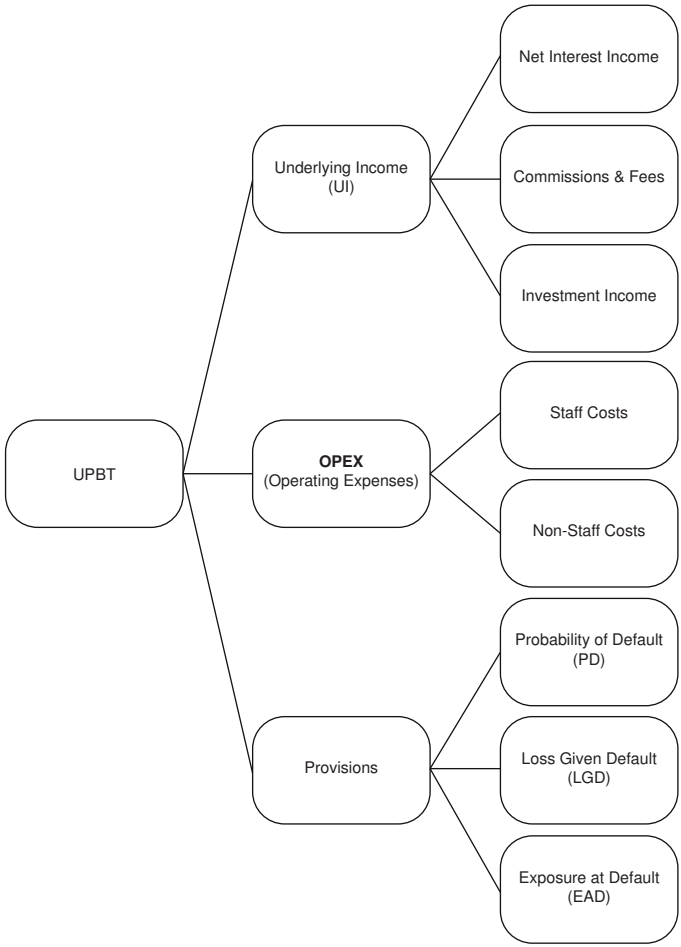


Figure 2.1 How to go through a bank statement representation

Source: A. Rahman (2012) *Operational Leadership in Retail Banking: the Last Frontier for Profits*, Lafferty Group Publication, pp.8–9.

Reducing expenses has become the key driver of bank strategy and management since the financial crisis. At the same time, the Cost Income Ratio (CIR) has emerged as the most popular metric among financial analysts, when the issue is to reach operations efficiency and the goal is to assess banks.

The CIR is based on OPEX and excludes the effect of provisioning. Specifically,

$$CIR = \frac{OPEX}{UI}$$

Since retail banking is a massively competitive industry where margins are razor thin, it is not surprising that bank management spend considerable effort to reduce OPEX in order to reduce CIR. But as the saying goes, cost-cutting is not cost reduction. A laser-like focus on cutting costs has the potential for unpleasant surprises. I would assert that focusing too much on CIR may lead to unintended negative consequences for the bottom line of a retail bank. To further expand this point, I would like to consider some preliminary issues arising from the CIR.

First of all, the fetish with reducing the CIR is understandable. Indeed, there is clearly a negative relationship between CIR and the bank's level of profitability. All else being equal, a reduction in the level of OPEX with no change in the underlying income, will lead to an increase in the level of gross profit. This is seen from the following. Where GP = (UI–OPEX), we derive that

$$GP = UI * \left(1 - \frac{OPEX}{UI}\right) = UI * (1 - CIR)$$

This formula explains why there is so much effort by retail bank managers to reduce the CIR. But in doing so there are also some pitfalls. Let us take a simple example to make an important point that may be discerned by the formula for gross profit (GP) above. The point is this: if both the top-line (such as, underlying income (UI)) and OPEX change in the same direction by X percent, then the CIR will be unchanged because the bottom line GP will also change in the same direction by X percent (see Box 2.2).

Box 2.2 Example 1

At the end of the last period, a retail bank experienced a CIR of 60 percent. For purposes of illustration, assume total UI was €100 and OPEX was €60 leading to GP = €40. Management wants to reduce CIR and implements actions at the start of this period to reduce headcount by 10 percent. But at the end of current period, the income statement reveals that UI also fell by 10 percent. To the surprise of some managers, GP declined by 10 percent. Of course, CIR is unchanged. Simple calculations show the result.

Accordingly, UI = €90 and OPEX = €54.

Of course, CIR = 54/90 = 60 percent (unchanged) and GP = €90–€54 = €36.

This represents a decline of 10 percent in GP from its starting value of €40. Both OPEX and UI decline by 10 percent, and so there is zero percentage change in the CIR; yet GP declined by 10 percent.

Algebraically, this result is seen as follows:

$GP = UI - OPEX.$

Suppose both UI and OPEX change by X%.
*Then ΔUI = X*UI and ΔOPEX = X* OPEX.*
Therefore, ΔGP = X (UI–OPEX) = X* GP. So GP changes by X%.*

The main problem we have with steering the banking business on the basis of the CIR is that it is based on two intermediate drivers, OPEX and UI, which may be correlated – in the same direction. It is a simple management equation. This is because OPEX is necessary for UI. By focusing on the CIR, we could miss the root driver. While UI clearly determines the CIR, we have already noted above that interest income is the dominant component in retail banking. It is therefore plausible that there is a negative relationship between interest income and CIR. This proposed relationship was tested for European banks by Burger and Moorman (2008).[12] They found a statistically significant negative relationship between interest income and CIR for banks in selected European countries between 2002 and 2007. This is interesting in that it is net interest income rather than UI that strongly affects CIR, and moreover, this is a root driver in a conventional retail bank.

2.4.2 The key root value driver for retail banks

The root driver that plays a dominant role in a conventional retail bank is net interest income (NII). The academic literature views net interest margins as the cost of financial intermediation. Net Interest Margins (NIMs) also reflect pure operational efficiencies 'as they drive a wedge between the interest rate received by savers on their deposits and the interest paid by lenders on their loans.'[13]

There is also evidence that tougher competition drives down NIMs, and hence in the developed financial sector (such as in the developed economies), we should see lower NIMs and lower overall profitability unless the credit risk is going to increase. More closely, NII is the difference between interest income (IN) and interest expense (IE). An alternative expression is:

Net Interest Income (NII) = [Y * Interest-earning Assets –
K * Interest-bearing Liabilities]

where Y = rate earned and K = rate paid.

Further analysis shows that net interest income is closely related to NIM. Let us see how this is the case. NIMs is defined as net investment income stated as a percentage of total interest-earning assets. Symbolically:

$$NIM = \frac{NII}{IA} = \frac{Y * IA - K * IL}{IA}$$

where IA = interest-earning assets and IL= interest-bearing liabilities.

This now places the focus on NIM. For a given level of interest-earning assets on the retail bank's balance sheet, growth in NII is equivalent to growth in NIM. A central question now emerges: what are the determinants of growth in NIM? The answer to this question requires a further breakdown of the equation for NIM. After some simple algebra, we can show that

$$NIM = (Y - K) + K * \left(1 - \frac{IL}{IA}\right)$$

The first term in the above formula is the part of NIM that is the difference between the yield on interest-earning assets and the cost of funding by interest-bearing liabilities. It is also called 'net interest spread' (NIS). The second part is the part of NIM that is funded by debt issuance and equity, and is called 'endowment effect.' Typically, the endowment effect is small relative to the NIS. Appendix 6 illustrates the difference between NIM and NIS, and it demonstrates the calculation of each ratio. Here, I would simply like to summarize some key points influencing bank performance. The first point is that a very high percentage increase in interest-sensitive assets is required for even a relatively small increase in NIMs. The second point is that the yield curve matters when it comes to bank NIMs, and because of this, bank managers must be fully aware of the consequences for bank profitability.

Given this, the focus should be on achieving growth in NIM, and retail bankers should adopt a strategy to grow the net interest spread (Y–K) or to grow interest-earning assets at a higher rate than interest-bearing liabilities. But as our case studies have shown (see Appendix 6), margin squeeze arising from rising bank rates (see Appendix 6, Case 2) that tend to flatten or invert the yield curve, or a decision to keep deposit rates below the benchmark rate (see Appendix 6, Case 1), both have potentially significant harmful effects on the bank's profitability. The most annoying issue is that these are all the outcomes of exogenous policy actions over which the bank executive has no influence. This may result in a very pessimistic conclusion. Arguably, the most important driver of profitability is NIMs. But whatever actions bank executives take to enhance the NIMs may be rendered impotent in the presence of a monetary policy that creates yield curve inversion or short-term interest rate increases that lead to margin squeeze. And this uncertainty can only increase as Basel III (see Appendix 7) starts to affect the market.

Although the banking sector is facing many challenges, at present, the underlying profitability of many banks is still solid, due to a mix of stronger growth, wider margins, and in some cases notable innovation in distribution and customer management. But there are also countries where returns are lower, such as in Spain and Italy.

An interesting issue is that the product revenue mix differs significantly at the country level. Using this feature, we can define markets as driven by assets or more by liability and investment products. In the first category are markets such as the UK, Sweden, Russia, and Switzerland, where the main source of retail banking revenue is led by contributions from mortgages, personal loans, cards, and small business lending. In the second category are markets such as Spain, France, Germany, and Italy, where revenues come more from current accounts, deposits, bancassurance, and retail investment products. But there is also another important aspect to consider, which regards the operational model of any bank and the related cost structure. The mix of the two can result in profitability; but we still have to consider that among the main drivers of profitability for retail banks, there are also the non-performing loan (NPL) rates; the asset margins; the liability margins; the cost/revenues ratios and that the situation differs considerably across countries and banks, as well. This is because banks may differ according to their choices, regarding the range of services and market segments; the diversification approach; the customer sales and servicing models, and the business model in general.

2.5 When and how retail banks diversified: a brief review

Up to this point, we have focused on some lessons learned and the ways a retail bank can affect its own performance. In this paragraph, we look at the growing diversification retail banks have experienced over time.

The diversification trend has not been experienced by banks in the same way or at the same intensity, and, indeed, some still continue to focus mainly on their core activities. However, this trend has been visible for some years, and it involves a fairly high number of banks, which have decided to become diversified financial institutions. It is our belief that EU legislation, and legislation in general, has played a significant role in this direction (see Box 2.3).

Box 2.3 A look at some Co-ordination Directives that have widened the bank spectrum

The First Banking Co-ordination Directive in 1977 was consistently directed toward creating an integrated and competitive European banking system by reducing entry barriers and promoting cross-border business. In 1988, the Second Banking Co-ordination Directive sought to enhance competition by establishing EU-wide recognition of single banking licenses ('passports'). Other major EU regulatory developments that have influenced the competitive environment in which EU banks and other financial firms operate include: the 1985 White Paper on the Completion of the Internal Market; the 1986 Single European Act; the 1992 Maastricht Treaty (which consolidated the Single Market program); the introduction of the Euro in 1999; and the adoption of the Financial Services Action Plan (FSAP) between 1999 and 2004. The FSAP aimed to promote a more competitive and dynamic financial services industry with improved regulation. It specified measures to achieve three strategic objectives:

1. Establish a single market in wholesale financial services;
2. Make retail markets more open and secure; and
3. Strengthen the rules on prudential supervision.

A range of other regulatory actions focused on harmonizing the fiscal treatment of financial services. By the end of 2005, 41 of the original 42 measures outlined in the FSAP had been implemented and were incorporated into EU law (European Commission, 2005). One exception was the Capital Requirement Directive, which was passed in 2006 and came into force in 2008. The White Paper on Financial Services Policy replaces the FSAP as a key driver of European financial market integration. Most recently, the EU White Paper on Financial Services Policy (2005–2010) emphasizes that competition is crucial to removing the remaining barriers to a single market in financial services. Financial deregulation prior to the credit crisis of mid-2007 reduced or eliminated many of the lines of demarcation between banks and other financial service providers, and helped facilitate both domestic and cross-border competition.

Source: J. Goddard et al. (2013) 'Do Banks Profits Converge?' *European Financial Management,* Vol.19, pp.345–346.

In fact, the 1988 Directive in particular permitted banks to operate as universal banks, enabling them to engage in activities other than deposit-taking and lending, including insurance, the securities business, factoring, and so on. Within the diversification process, traditional wholesale and retail banking are important divisions, but a wide range of financial services is also on offer. For example, universal banks, even if in a restricted form, offer virtually every other financial service, from core banking to insurance. With a universal bank, customers can access the full range of

services from one bank. This possibility of 'one-stop shopping' is valuable to customers, although these demand-side economies of scope are likely to vary between customers and depend on the combination of banking services sought. However, larger customers tend to maintain relationships with more than one bank anyway, as do some smaller customers.

Non-banking financial services include, among others, unit trusts/mutual funds, stockbroking, insurance, pension funds or asset management, and real estate services. In this way, customers can demand a bundle of services, finding it more convenient to obtain them in this way. For example, buying a basket of financial services from banks helps customers overcome information asymmetries that make it difficult to judge quality. A bank with a good reputation as an intermediary can use it to market other financial services. Thus, some banks may be able to establish a competitive advantage and profit from offering those services.

Most banks are also active in off-balance-sheet (OBS) business to enhance their profitability. OBS instruments generate fee incomes and are therefore typical of financial products and do not appear as assets or liabilities on the traditional bank balance sheet. Some OBS products have been offered by banks for many years. They include, among others, credit cards, letters of credit, acceptance, the issue of securities (bonds, equity), the operation of deposit box facilities, acting as executor of estates, fund management, global custody and sales of foreign exchange. In addition, over the last 20 years, an increasing number of banks have been using or advising on the use of derivatives and securitization. In Europe, the universal banking model has a relatively long history of combining commercial and investment banking under the same roof.

There are different reasons why banks choose to diversify their business model in terms of function and products offered. The main reasons can be summarized as follows:

- Revenue economies of scope. In this case, clients may value the 'one-stop-shopping' experience, and in doing this, a bank can also acquire as much information as possible from its customer base in order to provide other new services, and increase customer loyalty;
- Cost economies of scope. This situation requires a wide range of activities, through which a bank may reduce their operating costs, such as pooling resources across a broader range of activities, as is the case for centralized IT and finance functions. Also there are cost economies of scope in collecting information from customers that can be used for multiple customers and services; and
- Risk diversification. This can be a part of the cost economies of scope and means that a bank provides diversified services, within which there

are less than perfectly correlated income streams. In this case, a bank may be able to diversify the overall risk of their operations and also reduce funding costs. This can be the case with bancassurance, where it may benefit because long-term interest rate risk works in opposite directions when comparing the banking and insurance arms.

If these are the benefits of diversification, there are also some problems associated with it, and they can be summarized as follows:

- Conflict of interest. This may bring about the need to re-regulate the market;
- Increased complexity. This may raise risk management costs, reduce transparency and complicate resolutions;
- Increased risk-taking brought about by diversification into riskier activities (such as trading) and if risk-taking increases, banks may find themselves holding less capital than required;
- Increased systemic risk. This may come about because banks diversify into each other's traditional areas and mostly into the capital market business. In this situation, the entire sector becomes less diverse and potentially more vulnerable to common shocks. This can promote a shift in working at diversity in banking structures rather than making diversified companies.

Some of the problems we have mentioned arose during the financial crisis, especially when banks changed structurally due to a combination of increased diversification and reduced diversity. In many ways, financial firms became less differentiated in that they followed a common policy of diversification, applied new business models, used similar risk analysis models and developed rates of return on equity strategies more forcefully (see Box 2.4).

Moving forward on this issue, I would like to look at the empirical literature on financial firms, which has produced mixed evidence as to whether and how increased diversification may affect bank performance.[14] As a matter of fact, some important evidence from this strategic choice has appeared since the end of the 1990s, when most national banking industries were steadily increasing their reliance on non-traditional business activities that generate fee incomes, trading revenues, and other types of non-interest incomes. While non-interest incomes have always played an important role in banking revenues, in the US banking industry by 2001, they had started showing their growing importance so to account for 43 percent of net operating revenue (NII plus non-interest income), up from only 25 percent in 1984.

Box 2.4 An example of a challenging business model: the 'originate-to-distribute model'

An interesting example arose when banks developed new business models and moved away from their traditional model of 'originate-to-hold,' whereby banks issue loans and hold the risk on their books. The emergence of new business models focused largely, though not entirely, on new credit risk-shifting instruments. Several trends in bank business models emerged in the years leading up to the crisis. Banks increasingly diversified into more lines of business activity, some of which had previously been prohibited by regulation. Securitization of loans became a central business strategy for many banks. Investment and trading activity increased sharply, and the proportion of traded assets in the total balance sheet rose substantially in many cases. Banks reduced their holdings of liquid assets as they developed greater access to wholesale funding markets. The extent of maturity transformation also increased sharply as greater use was made of short-maturity money market funding sources. An increased dependency on wholesale and money market funding developed. A powerful trend emerged toward using credit derivatives as a means of shifting credit risk (a notion that was called into question during the crisis).

This shift toward non-interest incomes has contributed to higher levels of bank revenue in recent years, but there has also been a sense that this could reduce the volatility of bank profit and revenue, and risk. One potential channel is that non-interest income may be less dependent on overall business conditions than traditional interest income, so that an increased reliance on non-interest income reduces the cyclical variation in bank profits and revenues. Alternatively, expanded product lines and cross-selling opportunities associated with growing non-interest incomes may offer traditional diversification benefits for a bank's revenues portfolio. If non-interest incomes and net interest incomes are negatively or only weakly correlated, for example, non-interest incomes may diversify bank revenues and improve the risk/return trade-off.[15] The ability to reduce risk is obviously a topic of considerable importance for individual banks, as well as their regulators and supervisors.[16] This type of correlation should be borne in mind when evaluating different types of non-interest incomes and when choosing the set of diversifications. This is particularly relevant in the medium term for three possible reasons:

1. When planning diversification, managers should try to look for non-correlated and/or anti-cyclical activities in order to stabilize bank revenue.
   In fact, if we consider the volatility of bank revenues due to differentiation, it has been discovered that at the aggregate level, volatility of bank revenue growth declined during the 1990s, but this result was reflecting a lower volatility within NII growth rather than

diversification benefits from increased non-interest income. The growth in non-interest incomes was much more volatile than the growth in net interest during the same period of time, and this was largely due to very volatile trading revenue. At the aggregate level, non-interest income was much more volatile than more traditional net interest income.[17] Although net operating revenue became less volatile in the 1990s as non-interest income grew in importance, this was directly related to the declining volatility of net interest income that more than offset the increased contribution from the growing share of the relatively volatile non-interest income.[18]

In addition, more cross-selling and a greater reliance on loan substitutes such as commitments were two examples, as both strategies expose multiple business segments to the same economic or financial shocks and naturally reduce the potential for diversification benefits. In fact, non-interest income appeared somewhat more cyclical than net interest income. This may suggest that the banking industry should not necessarily be counting on non-interest income to smooth revenue flows or reduce aggregate cyclicality. Bank-level data paint the same picture;[19]

2. Diversification should not cannibalize other services over time; as partially this was the case for the asset management services *versus* the bank activity to collect family savings (in terms of saving deposits). In that case we saw a kind of substitution between these two services in favor of the first one which was, and still is, from an economic point of view, more rewarding to a certain extent for a bank. But, on the other hand, it lacks in terms of bank liquidity; and finally
3. Diversification should be always focused on the customer, and center around building a lasting customer relationship.

Given this, we can learn that diversification is a critical issue for retail banks as the more they become heavily involved in non-traditional activities, the more potential diversification benefits seem to be receding.[20]

2.5.1 Diversification and marketing challenges

As banks started to diversify, they started facing new, parallel challenges, especially from the marketing side. The distance between banks and their customers was increasing, and this brought with it problems in managing the bank-customer relationships.

Most of the time, these problems are a result of inadequate management of service promises because of a lack of information and effective integration.

People at the branches often sell services, particularly new business services, increasing customer expectations that over time would be

disappointed. This, again, was the case of some new financial services such as those from the asset management. When something is new, companies need to sufficiently educate both customers and employees. If customers are unclear about how a service will be provided, what their role in delivery involves, and how to evaluate services they may not have used before (think of a mortgage, a pension fund, mutual fund, and others), they will be disappointed. When disappointed, they will often hold the service company responsible. In most cases, professionals offering high-involvement services often forget that customers are novices who must be educated about each step in the process.[21] But the same employees also have to be trained through internal marketing. In fact, if internal communication is poor, perceived service quality is at risk. In order to deliver excellent customer service, banks must be certain to inform and motivate employees to deliver what their customers expect. Employees' lack knowledge will affect the quality of the service they deliver. A final form of internal coordination central to providing service excellence is consistency in policies and procedures across departments, branches, and new channels, aiming to offer customers similar performance across all of these points of contact.

Over time, we have seen banks increasing their diversification, while others returned to their retail banking roots. Refocusing on retail has become a key area of strategic emphasis in the US banking industry, and as a main consequence, we have seen a large number of bank mergers, such as Bank of America's acquisition of FleetBoston Financial and JPMorgan Chase's acquisition of Bank One, and the mergers of First Union/Wachovia and Citigroup/Golden State, which were all motivated in large part by retail concerns.[22]

This was the case with the agreement between Bank of America and Fleet Boston, for example, which was touted as a return to retail banking roots. One interpretation,[23] albeit speculative, was that US bankers were starting to be aware of the limitations of product line expansion and were retrenching toward core competencies in order to avoid the products that adversely affect the bottom line.

But there are some other arguments against diversification, such as that diversification benefits between financial holding companies (FHCs)[24] are more than offset by increased exposure to non-interest activities, which are quite volatile but not more profitable than lending activities. Within FHCs, marginal increases in revenue diversification are not associated with performance, which may reflect either a change in managerial focus or the endogenous nature of the diversification decision. In contrast, marginal increases in non-interest income are still associated with declines in risk-adjusted profits, suggesting a very robust relationship. This is the dark side

of diversification, as FHCs move into activities that are inherently more volatile, which has implications for a range of FHC stakeholders.

This conclusion introduces the question of why FHCs are moving into these activities. One might initially think that normal competitive forces have simply eliminated profits. While this explains the lack of excess returns for diversified FHCs, it is hard to reconcile with the finding that more diversified FHCs have consistently higher volatility and lower risk-adjusted profits, and suggests that other factors are at work. One explanation is that FHCs may have simply taken the diversification idea in the wrong way. In some situations, a lot of FHCs, for example, have focused on 'cross-selling' as a key strategic means to lower costs, increase income, and diversify revenue. If FHCs were really trying to diversify revenue by selling many products to the same customers, then this might have simply exposed multiple businesses to the same shocks, increased the correlation across revenue streams, and reduced potential diversification benefits as detailed later on in this chapter. Furthermore, FHCs were moving toward certain activities, which were the most volatile, which offset any diversification benefits.[25] Also, traditionally, retail banks have diversified by cross-selling additional products to existing customers, such as current accounts and associated payments services, savings accounts and loans, insurance, and asset management. Cross-selling will typically increase banks' revenue while accruing only limited marginal costs from marketing and distribution. Thus, cross-selling may offer an easier means of increasing profit than acquiring new customers. In addition, by widening the customer relationship, cross-selling increases the customer's reliance on its bank. While cross-selling may suit the interests of banks, customers may also derive some benefits. Certainly, an existing relationship with a bank means that customers can, should they wish, acquire additional services without an extensive search or much paperwork. There may also be an important financial aspect to customers' decisions. Having more information about the customer, the current bank should be able to price new products more accurately and thus, on balance, more cheaply than other banks. Therefore, where customers have a longstanding relationship with their bank and trust it as an institution, cross-selling may be a rational strategy for both banks and customers.[26]

2.5.2 When diversification benefits may be limited

Before dealing with the limitation of diversification benefits, it is useful to classify non-interest incomes as follows:

– Fiduciary incomes are revenues related to the bank's fiduciary operations, for example, administering investments for others;

- Service charges include revenues directly related to current accounts, such automated teller machines fees, check usage fees and any other payment services related to the use of a current account;
- Trading revenues are primarily incomes from trading cash instruments, off-balance-sheet contracts, and market-to-market changes in the carrying value of assets and liabilities; and
- Fees and other non-interest incomes include all other fees, such as loan commitment fees, safe deposit boxes, commissions, land rental fees, bill collection, execution and acceptances and letters of credit, mortgage services fees, and notary, consulting or advisory services, periodic credit card fees, merchant credit card charges, and many others.[27]

Among the previous categories of non-interest incomes may be different levels of correlations; the one related to trading incomes can limit diversification benefits significantly. In particular, they are associated with a decline in profit per unit of risk, while increased fiduciary income is associated with a gain. Clearly, trading income is the most volatile component of bank incomes. Service charges and fees in particular are highly correlated with NIIs, while trading and fiduciary incomes are less so.

Trading activities appear to be the biggest drag on profit per unit of risk and suggest that continued expansion may ultimately lower risk-adjusted returns, while fiduciary incomes are associated with higher profit per risk and more stable net income growth. These results raise doubts that non-interest incomes are able to stabilize revenue and profitability and also reduce risk. Net interest incomes and non-interest incomes growth seem to be positively correlated for the typical bank, and the correlation seems to be rising for both individual banks and at an aggregate level. These results may suggest caution for those believing that the shift toward non-interest incomes offers large diversification benefits, guarantees more stable bank earnings, and lowers the risk as it was analyzed for the US banking industry.[28] Non-interest incomes, particularly trading, are volatile, and the correlation between net interest income and non-interest income can even rise as banks diversify their product lines and start substituting non-traditional sources of incomes for interest incomes. If this is true then the banking industry may not realize the reduction in volatility and risk that some are expecting.

A probable explanation of this situation can be that increasing the focus on 'cross-selling' different products to a core customer base may expose different banks' lines of business to the same shock, such as firm, industry, or lending market troubles. In a nutshell, simply selling more products to the same customers does not grant diversification benefits if a given customer's demands for all products are highly correlated.

This issue is significant and leads to an equally important issue of management that has to do with the way banks segment their customer base. In addition, and similarly to this aspect, the selection of lines of business to develop and the ability to offer bundled strategies is also important; think of the increased use of loan commitments, which may expose both net interest income and fees and other non-interest incomes (where loan commitment fees are booked) to the same fluctuations in loan demand and market conditions.

In all the cases mentioned, if a bank provides both traditional lending and non-traditional fee-based activities to a particular firm, industry or market segment, then several lines of business may suffer simultaneously, if that firm, industry or market segment is facing financial troubles. This would increase the correlation between the two revenue streams and, therefore, reduce diversification benefits.

Although these results may show a limitation in benefits from the diversification, we must also recognize that this does not mean that no institution has benefited from a more diversified revenue stream; it may also be true that the potential diversification benefits can recede as bank revenue streams become more closely linked.

It should also be noted that the choice of diversification for a bank, and any given company, is a long path with different stages of learning how to reap the benefits from broader and more diverse business lines, which have different risks and returns. Further, there is the importance of information about the relative attractiveness of different business lines. It is also important to underline the relevance of the hard-earned experience of managers, development of strong business practices and operating procedures within the institution, and a particular attention to the understanding of market-specific factors.

Therefore, it is important not to misunderstand the business line expansion as the dark side of the search to diversify, the latter being a different strategic choice. Therefore, understanding how and whether banks maximize the gains from a diversified revenue portfolio is a critical also for successful risk management decisions as well as future strategic choices.

More research is needed into new types of non-traditional activities into which retail banks might diversify, and overall reconsidering the importance of segmenting the market properly.

2.6 Can retail banking be considered a business in transition?

For a long time, retail banking has been a kind of oligopoly market and in their article, Gardener, Howcroft, and Williams put it this way:[29]

> [There was] a great deal of similarity between the market players, which resulted in competitors introducing similar, if not identical, competitive strategies. Financial product innovations were also quickly replicated with a corresponding reduction in the initial innovator's reward. These strategic considerations, compounded by a herd mentality, were responsible for the clearing banks duplicating each other's services. An exceedingly wide and diverse range of identical products was offered by each bank with the result that management in retail banking became correspondingly more complicated and less cost-effective.

With this in mind, an industrial approach has been applied to bank strategies and management, while the truth is that banks were, and still are, in the business of services, and thus different from suppliers of physical goods. This difference is underscored by the unique features of services, to which I would add that of being financial services; both of these issues lead to specific behavior on the part of customers, as I will mention later in this book.

If this feature is not effectively managed, some risks can arise and, among others, customers may start moving and shopping around. Such a trend is even more possible because customers are becoming more mobile than in the past, due to 'new' technology that allows them to 'click away.' But there are also a number of other important concerns with regard to customer attitudes and behaviors, which center on a lack of customer loyalty. At the moment, the major reason why they shop around is price, but factors other than price can play an important role too, such as the provider's reputation (or brand), and the customer's past experience. It should also be added that shopping around can be both a customer decision or an output from an FSA strategic aim.[30] The final result might contrast in some ways with marketing objectives according to the benefits coming from a strategy that is truly focused on customer retention. Of course, it must be said that in this respect there are two perspectives to outline: the first one is at a macro level, which intends to encourage competition through customer mobility, and the second is at a micro level, and this is interested in increasing revenues from long lasting relationships.

Another issue, which has weakened retail banks over the past few years, is that in the period leading up to the crisis, from 2001 through 2007, banks settled on a relatively simple growth model. Revenue growth came from acquiring more customers – often through competitively priced products, such as mortgages or free-of-charge checking

accounts – rather than deepening existing relationships. According to a BCG report (2010),[31] 'more than half the banks in the study achieved customer growth at the expense of revenue per customer.'

An interesting example, which paves the way to a critical result concerned with this approach, is from the Italian market where, according to a market research study conducted with retail customers, the average turnover of the customer base in 2011 was 15 percent, which in five years would produce a net effect, between acquisition and abandonments, of a 50 percent turnover in the customer base.[32] Another example comes from the UK market; where rates of switching differ across core and secondary personal retail banking markets. From the available data, it is notable that the annual rate of switching in the Personal Current Account (PCA) market was 9.2 percent in 2009, compared to around 6 percent in 2006. In addition, some 12 percent of consumers in 2010 had switched cash saving account provider in the last year. This compares to a rate of 24 percent of residential mortgage customers switching provider in 2010. While the above switching rates appear low (for example, when compared to other sectors, such as energy in the UK),[33] the low rates are of themselves not necessarily a problem. Switching rates can remain low when a market becomes more competitive if consumers are offered better deals by their existing providers to deter them switching. However, when low switching levels are due to consumers being uncertain whether they will be better off by switching provider or fearful of the switching process itself, this is very likely to reduce the competitiveness of the market and create a barrier to firms being able to attract customers.

Coming back to our issue, which was concerned with the customer approach that banks develop in their strategies and the major attention they pay to customer acquisition driven strategies, it seems that over time the bank marketing behavior also started to a certain degree to look at customer loyalty. Afterwards, banks started moving in another direction, customer retention, but it is my belief that the main weakness still remains, as they should increase customer care in aligning their service models toward customers' true needs.

Staying competitive in the future will depend greatly on the decisions banks make. The events of the past few years have shown the price to pay for poor strategic decisions, where a short-term outlook prevailed over long-term decisions. Given that, at present there is a need to 'return to retail,' which contrasts with the recent past when banks sought to diversify revenues, de-emphasize branch networks, and target financial services to a broader range of clients. An analysis of this strategic shift suggests that interest in retail banking fluctuates in predictable ways

with the performance of non-retail banking and financial market activities.[34] Given that, there is a further aspect to underline, which has to do with today's relatively boundary-less and barrier-free markets: that the traditional approach of building a business around a competitive advantage and then defending it while milking the profits no longer makes sense. And overall, pursuing strategies with a short-term perspective on where banks want to go is no longer sustainable, due to a number of market and regulatory constraints. It is for these reasons I think of retail banking as a transition business, which requires a long-term perspective on where the business and the banks want to go, but it is important to recognize that whatever banking is doing today is not going to drive its future growth.

The roadmap to the future is to gather skills and competences to exploit temporary competitive advantages that, however, will not be sustainable over time. Therefore, banks need to forge both the corporate strategy and the organizational structure around the principle that for a certain time their business will need to be prepared to rely on competitive advantages which should last for a time, but they should be able to develop 'new' ones or revised them if things change.

Therefore, I would like to refer to retail banking as a business in transformation, and this can mean different things to different people. Certainly, I agree that transformation can be a continuous process of aligning a business model in support of a long-term vision of the future and making it a reality through a choice of a given strategy and its execution.

And so, is retail banking really in transition? I believe that there is a revolution afoot, and that afterwards retail banking will look very different. It may require significant input of new or additional resources ('energy' and communication) to change. In this regard, the words of JPMorgan's chief executive are significant (see Box 2.5).

2.6.1 Poor differentiation should pave the way to a more customer-driven approach

Many retail banks offer the same services, and customers assess their overall experience, through their cognitive perceptions. This means that customers' overall experiences with a particular bank are becoming more important as a key differentiator.[35]

In the past, banks have differentiated themselves by lowering prices and developing innovative products, but they are quickly losing their ability to provide an edge. Banks are no longer able to reduce prices in a competitive manner due to increased competition, new regulations, and heightened capital standards, all of which are putting retail banking margins under enormous pressure.

Box 2.5 JPMorgan's chief executive sees Facebook and Google as potential challenger banks

Jamie Dimon, CEO of JPMorgan Chase, has said that he sees competition coming from the likes of Facebook and Google as both technology companies further expand their financial service offerings. Speaking at the Euromoney Saudi Arabia conference in Riyadh, Dimon said: 'We move $10 trillion a day. We're one of the largest payments systems in the world. We're going to have competition from Google and Facebook and somebody else.' Last month, Facebook was reported as being 'only weeks away' from gaining an Electronic Money Institution (EMI) license in Ireland, according to the *Financial Times*. EMIs in Europe can also avail themselves of 'passporting,' a process that allows firms to issue, redeem, and distribute e-money or to provide payment services in other European Union countries under the terms of the EU's Payment Services Directive. The FT cited 'three people involved in the discussions' to report that Facebook has also been in discussions with potential partners in London – TransferWise, Moni Technologies, and Azimo – that offer international money transfer services online and through smartphone platforms. Meanwhile, Google is integrating Google Wallet into Gmail, its online email service, so that users can send payments as a mail attachment, even if the recipient doesn't have a Gmail address. Senders composing an email will have to hover over the attachment paperclip, click a '$' icon to attach money to the message, enter the amount, and send the mail. The recipient will receive an email confirmation that the money was transferred successfully immediately after. At the conference, Dimon also expressed his belief that now is the time for regulators to decide how to handle financial services offered by technology companies, commenting that 'there's no way that Google wants to be a regulated bank.'

Source: Lafferty Retail Banking Insights (7 May) from http://www.lafferty.com/Retail-Banking-Insights/News

At the same time, some financial products have been largely commoditized, and this has set a limit on the impact of product innovation. In some cases, banks innovated by differentiating their product ranges, but in doing so, they made choosing among the available products more difficult from a customer perspective. The cost of producing a differentiated financial product is fairly low, compared to other goods and services, and as a result there are thousands of unit trusts and mortgages available around the world. And this further increases the costs of searching the market to find out what is on offer and which product best fits the customer's needs.

2.6.2 When non-bank competition enters the retail banking market

From the 1990s onward, the strategic focus of retail banks shifted away from (pre-deregulation) collusion and regulatory capture toward more

open competition. New competitors and new forms of competition appeared. Around the end of the 1990s the influence of technology was also ubiquitous, strong, and ever-growing. The movement toward the EU single currency heralded another era, in particular within Europe, where regulation again assumed center stage within the strategic thinking of European retail bankers.

In this situation, new, intensifying forms of competition become the order of the day. At the same time, the overall performance of banks becomes increasingly subject to external market tests of efficiency at all levels and banks must increasingly adapt toward a more shareholder value-oriented culture. As a result, banks had to be more productively efficient (reducing their cost/income ratios as one key dimension of this productive efficiency trend) and more risk and return efficient (ensuring that their internal capital resources were allocated in order to achieve the maximum return for each quantum of underlying risk).

Potential entrants can now choose to enter the sector through a number of routes, and as retail banking covers a number of different services, competition may be different among them. And so the banks' market-share can be eroded over time.

An interesting picture of the many ways to enter retail banking is that proposed by the UK Office of Fair Trading (OFT), which has categorized retail banking services into three broad areas (see Figure 2.2). It is not necessary for a retail banking provider to supply both core and secondary banking services to personal and SME customers. Indeed, many providers have entered retail banking and concentrated on only a sub-set of services (for example, specialist credit card issuers or specialist mortgage providers) while others have focused on niche products or market segments.

Another interesting issue concerning the entry barriers new entrants may face is that barriers to entry, expansion, or exit may differ between core and secondary banking sectors and by the method of entry or expansion.[36] Having access to a branch can be – or it was – an important factor for choosing a bank and therefore investing in a significant branch network was found to be a structural barrier to entry for PCA and SME banking services providers. Also, a successful brand, as deposit-takers, can be an important issue for non-traditional providers who need to gain customers' trust and build a reputation for providing safe and high quality services. In fact, building brand recognition and reputation may be found to constitute an entry barrier in the PCA and SMEs banking services markets, due to the lower propensity of customers to switch providers, and building a sufficient customer base is an important issue for new entrants to both markets. Another issue may be access

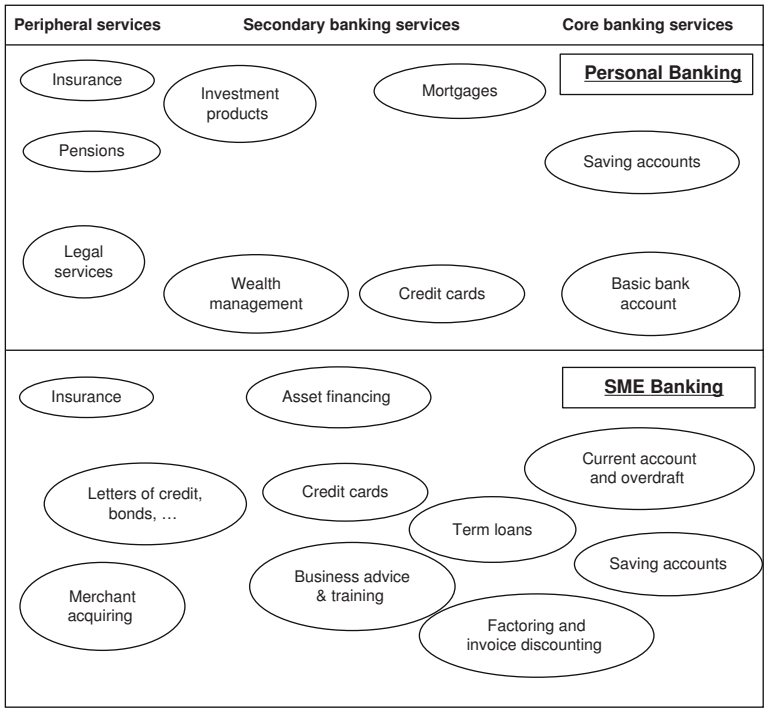


Figure 2.2 The retail banking space

Source: Adapted from the Office of Fair Trading (2010), Review of barriers to entry, expansion and exit in retail banking, November, p.26.

to information regarding customers' credit risk; if entrants cannot get access to accurate information on risk profiles they will be unable to offer appropriate financial products and therefore find it difficult to build up their customer base while at the same time managing the related risks. This issue may not be a barrier in the PCAs market, but it could be a concern when financial services are marketed for small SMEs. Also, access to payment networks, such as money transmission, may represent a core activity of the banking sector, and this is of crucial importance for new entrants. As firms wishing to offer most retail banking products are subject to a range of regulations, many of which are specific to the activities they undertake, regulatory requirements may also be a barrier to entry, or may delay entry and make it more costly.

These and other related aspects may affect firms' expected profits and influence their market dynamism, or even delay or induce a decision not to enter the market, and in this last situation, there is a reduction in pressure of actual or potential competition. This can lower the

incumbents' incentives to keep prices down and innovate. In addition, incumbents may also benefit from low levels of switching and as a result, new entrants may find it more difficult to attract customers away from incumbents, even if they offer better value-for-money. If potential entrants do not believe they can attract sufficient numbers of customers to recover their costs, they may be deterred from entering in the first place.

The new wave of competition, which is facilitated by the explosive changes in IT, is going to fuel the need for banks to innovate in products, services, and delivery channels but most of all in their approach to their customer.

There are many ways new providers may enter the retail banking space. In some cases, these new competitors choose to supply only a limited set of products, often aimed at a particular customer segment, while in other cases, non-banking providers seek to offer a complete suite of retail banking products for personal and SME customers. Despite this diversity, the major incumbents continue to enjoy the largest market shares across many different product markets. New competition can be useful to customers if it means they are offered better deals, and this can incentivize incumbents to react in certain ways.

Firms supplying retail banking products use a number of different business models too. Among others, there are those through which non-traditional financial institutions offering retail banking products enter into an agreement with an established retail banking provider to provide banking services, for example, through a joint venture or a white label arrangement. On the other hand, mono-line providers (such as Capital One as a mono-line provider of credit cards) are focused on a single product or product line. From this position, it is possible to move toward offering a much wider portfolio of products (as is expected in the case of Virgin Money and the Tesco Bank), or to expand from just offering products to individuals to catering for SMEs as well. There are also facilitators, which have been developing in the market due to web platforms, and which may offer services matching lenders with borrowers, and so many others.

There is another interesting peculiarity to highlight in the market, and this regards the choice of distribution channels, which varies between business models. Channels include the use of a branch network, the internet, telephone, mobile phone, post and intermediaries, and other third parties. Some business models will lend themselves better to using online distribution channels (for example, peer-to-peer lending); others may be more suitable for distribution through intermediaries (for

example, mono-line providers of mortgages); while others may require a physical presence.

The new retail banking service providers have been developing non-conventional business models and they compete on a number of dimensions, especially in the savings market, and they are contributing to the transformation of the business in dramatic ways. So far, the key factor has been the rate of interest offered, including how and when it is paid. They can rapidly build up their brand profile by offering high rates of return and achieving 'best buy' status. Other dimensions of competition include, but are not limited to, distribution channels, conditions around withdrawal of funds, quality of service, and security of the provider.

In the credit card market, there is also competition on interest-free periods, rewards, annual fees, and ancillary charges. If a kind of rule has to be found, then we can say they look at where bank-customer satisfaction may be lacking and then position themselves with a clear value proposition.

2.6.3 A renewed interest in retail banking activities

As previously mentioned in this chapter, since 2003 and 2004 retail banking activities have become once more of interest because they are stable businesses.

If this is the main feature of interest, how can it be characterized? First, many banking services related to retail banking are recurring customer buys. A second element is that retail banking is fundamentally a consumer-based business. The resilience of the consumer sector in recent years has almost certainly contributed to the stability of retail banking. Related to this observation is an important corollary, that retail banking will likely be a stable and growing business only as long as the consumer sector remains strong and stable. In addition, retail banking serves a large number of small customers. It is the granular nature of the customer base, which also offers stability and which can be managed in terms of portfolio in search of true diversification across customers.

A recurring revenue business is one that generates income from its customers on a regular basis without having to continually sell and push products or services. The attractive feature of recurring revenue business models is that they simply create an annuity stream for the owner of the business. Several businesses could fall into this category, and we think that some retail banking activities and related services can be termed recurring, for example, payment services and insurance. When an insurance agent sells an insurance policy to a client, the client pays premiums either monthly or annually. When the client pays his/her premiums, the insurance company receives a portion and the insurance agent gets

his/her own part. This creates a recurring revenue stream for both the company and the agent.

The mobile phone industry is another example of a recurring revenue business model. With mobile phones, users get a certain number of minutes or service per month. They pay the mobile phone provider a certain amount of money each month to keep their phones. Many providers require their customers to sign service contracts that last one or two years. This guarantees the income for the provider for a certain amount of time. These examples may be useful in understanding why some telecom providers are also in search of delivering payment services as well as other value-added services. They need to develop traffic on their 'highways,' and they look for valuable content to deliver customers and keep them paying. According to them, banking is just pure content, initially; while for banks this content is their core business. Now if we take a customer perspective, then the content becomes a solution to his or her problem or set of problems, and the key to a long lasting customer relationship is to solve customers' problems more effectively.

Now, if we agree that in the market there is an interest to 'return to retail,' this time the game will need different ideas and rules. As usually happens, there can be many different ways to reach the goal (there are those growing their retail activities again through mergers and acquisitions, while others are focusing on *de novo* expansion, and others are more keen to develop network strategies (for non-traditional players).

At this point, it is not clear which strategy, if any, is going to dominate, and we will have to wait for new research over the next retail cycle. But what is important, at present, is that if banks want to 'return to retail' they need to leverage their experience, so as not to make the same mistakes they did in the past. The industrial approach has to be transformed into something significantly different.

Retail banking, as a set of different activities, should no longer to be considered an asset in a portfolio management strategy. It is because of this that retail banks lost their customer-centricity, and the often-used counter-strategy of increasing price competition, proved to be unsustainable in the short to medium term. In particular, the new retail banking cycle is driven by many actors in the market, starting with the largest banking firms, but also including retailers and others, who are developing unconventional competitive approaches to retail banking (low cost that is not low price, and new value propositions before, during and after the sale), as we are going to see in this book.

3
The Customer-Centric Perspective and How to Get It

3.1 What you will find in this chapter

At present, one of the biggest problems facing retail banks is their inability to stand out in an increasingly commoditized and competitive marketplace. As their value proposition is at the nexus of technologically based products and service innovations, they are at a crossroads, and some are hesitating, uncertain whether they wish to be forced into becoming a utility-like provider. Others are trying to develop their presence in the market by leveraging on existing strengths and so become part of their customers' (both individuals' and businesses') everyday life.

More than ever, retail banks have to work on their customers' experiences and understand how to drive a positive outcome. The more costumers vary in their expectations, the more banks will need to study them carefully and lay down standards of service and goals for their organizations.

Even though retail banks belong to the pure service company category of businesses, during the last 15 years, they have been acting as industrial companies. They have lost parts of their traditional service culture and in doing so have entered on the path to commoditization.

The objective of this chapter is to reinforce a service dominant perspective for retail banks to grasp and highlight some reasons why and how a retail bank should seek to look more like a service company. Given this, retail banks have to consider and manage their services more broadly than they have done so far. And this is urgent, as they have to react to new market conditions, which are threatening banks in most of their business.

In this regard, both the terms 'products' and 'services' will be used interchangeably to describe the offering of a financial institution, and the intention is to describe what a service company should consider best in its strategy.

3.2 Some definitions about services, main features, and managerial implications

Services represent a wide range of intangible product offerings that customers value and pay for in the marketplace. It is not that they have suddenly sprung to importance, but that they are becoming more apparent in the economy as specialization increases, and as less of what is exchanged fits the dominant manufactured output classification system of economic activity. As the world's major economies have matured, they have become dominated by many service-focused businesses, and in many countries, 70 percent of GDP is now generated by services. This growth is projected to continue unabated for many countries and probably for many years. But even though services are going to represent a growing percentage of the world economy, some customer satisfaction indices are still showing consistently lower scores for them, and this could open the way to greater opportunities to come.[1]

In this chapter, we will rely on the simple, broad definition of services as all economic activities that are essentially intangible concerns of the purchaser and whose output is not a physical product or construction, but regards something that is generally consumed at the time it is produced, and provides added value in forms such as convenience, timeliness, protection, and so on. However, we think it is useful to add some further detail to this description of services. Usually, a set of four distinct aspects is delineated, and they are:[2]

1. Service industries and companies; they include those industries and companies typically classified within the service sector whose core product is a service. All of the following companies can be considered pure service companies: Accor (hotels such as Novotel and Ibis), Lufthansa (transportation), and HSBC (banking). The total services sector comprises a wide range of service organizations that provide or sell services as their core offering;
2. Service products: which are the output that can be sold by service companies and by non-service businesses, such as manufacturers and technology companies. For example, IBM and Hewlett-Packard offer information technology consulting services to the marketplace, competing with firms such as Accenture and other consulting companies, which are pure services firms in the traditional sense. Other industry examples include retailers, like Tesco, which sell services such as insurance and photograph processing;

3. Customer service is also a critical aspect of what we mean by 'service.' Customer service is the service provided in support of a company's core products. Companies typically do not charge for customer service. This can occur on-site (as when a retail employee helps a customer find a desired item or answers a question), or it can occur over the telephone or via the Internet, or any other device or platform. Many companies operate customer service call centers or helplines, often staffed around the clock. Quality customer service is essential to building customer relationships. In this category, we can also put retailers that have started selling financial services to facilitate customers to purchase their goods or services, such as the case of small consumer debts. This category should not, however, be confused with the services provided for sale by the company; and finally
4. There are also derived services. Physical goods are valued and considered for the service they can provide. For example, a pharmaceutical provides medical services.[3]

We can observe that:

- Many businesses that were once viewed as manufacturing giants, are shifting their focus to services. Just think of personal computers (such as the example of IBM, the Apple Genius Bar), or the increasing customer care in the car industry and car manufacturers' entry into the financial markets through banks, such as Volkswagen Bank, or retailers such as Metro with Metro Bank. This means that services are no longer limited to service industries. The main reason for this shift is that services can be very profitable, and they help to manage the customer relationship and market new business. In this respect, what has changed today is not that services are overtaking goods in economic activity, but rather that the relative inadequacy of the goods-based classification system of businesses for capturing and informing changes in economic activity is becoming increasingly apparent;[4]
- It is clear that the market orientation has shifted from the producer to the consumer, and the academic focus is shifting from the thing exchanged to the process of exchange. And this is also because a service company has to deal with processes;
- If this is going to be the scenario, then retail banks need to react, because their industry offering risks falling into the 'commoditization trap.' This happens when something is perceived to be undifferentiated or too difficult to understand. Both of these make customers start looking at prices as the more rational and shorter way to make their selection;

– As a consequence, in the future, retail banks should think of services more broadly than they currently do, and this is becoming relevant also because of the large number of new competitors entering the retail banking arena. This requires them to start reconsidering their offering and service features, because many financial services they sell today are structured the same way and this means that customers perceive them as being identical. In general, the idea is to offer a certain level of service for a given flat fee, but this does not always meet consumers' expectations. Customer expectations develop over time and they also seem to be more diversified than before.

  Retail banks should start to recognize that some of the changes in customers' expectations may result from their non-banking experiences. On the basis of these, customers might be more likely to perceive poor customer service and decide to switch banks. It may also be true that 'happy customers' do not shop around for a new place to store their cash. Box 3.1 explains how regulation is going to force retail banks to act differently;
– Finally, many companies are undergoing a shift in their focus, and in doing so they have started paying more attention to intangibles, such as skills, information, and knowledge, and this increases the need for more interactivity and connectivity in relation to ongoing relationships. This is already the case in the car industry, where the new set of devices (such as mobile, tablet, and others) is working to make car companies develop important platforms to serve customers rather than ends in themselves.

Box 3.1 Retail financial services and shopping around

The Special Eurobarometer 373 on Retail Financial Services released by the European Commission in March 2012 identified:

> ...a clear need for improving financial literacy amongst EU citizens. Many people who have financial products or services are unaware of the advantages of shopping around for financial products (both within their own country and in other Member States) and similarly seem not to see the potential benefits of switching providers in order to secure a better deal. Many respondents are still dependent on face-to-face purchasing and rely on their providers for recommendations. Encouraging the use of other purchasing channels, such as the internet, or making advice recommendations more readily available to citizens would enable them to compare products in a way which is perhaps more limited currently.

Source: European Commission (2012b) Special Eurobarometer 373, *Retail Financial Services Report*, March, p.119.

If this is the next scenario, in the market there is still a paradox, which may weaken the execution of some new market service-oriented strategies. Most of the tools and techniques that service managers use were designed to tackle the challenges of product companies, and they do not always fit the service context appropriately. Again, this happens because services differ substantially from goods, and this difference is underscored by the unique features of services, which are widely recognized, and include the following:

1. Intangibility; it is the lack of physical form and the resulting inability to be seen, touched, or displayed in advance of the purchase (see Box 3.2, for bank contextualization);

Box 3.2 What does intangibility mean for financial services?

A banking service is intangible in the sense that it has no physical form. It is neither observable nor experienced prior to being acquired. The reason is that the consumer cannot directly assess the quality of a retail bank's service prior to agreeing to take it. For example, the customer cannot assess the quality of customer service before it agrees to make a deposit or take a loan. Only afterward is the customer able to form an opinion. The immediate implication is that the consumer may experience a heightened level of 'purchasing risk.' To reduce this perceived risk, the consumer may rely on a bank's brand image as a signal of service quality and ethical interaction with consumers. Indeed, there is evidence that brand image is a predictor of a consumer's perceived risk at the time of purchase. The more positive the brand image, the lower the level of perceived risk. The potential customer may become actively involved in information search and rely on shared information on the Internet, social networks, and word-of-mouth to assess the reputation of a bank. The bank itself may also be proactive and take steps to help consumers reduce purchasing risk. One of the most effective ways of doing this is to design and implement effective service guarantees. This is especially important for prospects relative to existing customers, as they can rely on accumulated experience with service delivery to make a decision about the quality of the service.

– Inseparability: this term refers to the simultaneous production and consumption of services, which leads to the co-creation of services, because the production of services is performed by the provider and the consumer together (see Box 3.3, for bank contextualization);

Box 3.3 What does inseparability mean for financial services?

Inseparability for financial services refers to the fact that the bank, as provider of a service, cannot be separated from the service. For example, when a customer goes to an ATM to make a bill payment, both the customer as consumer and the bank as provider are involved in completing the transaction. In the most basic terms, the bank teller in the branch is involved in the transaction with the customer. In an important sense, the service provided by a retail bank cannot be distinguished from the person delivering the service or from the person consuming the service. Clearly, if a customer has a negative experience, he or she will automatically blame the provider since there is no separation between the provider and the service. This may not be the case for tangible products where negative consumer experience may be attributed to the quality of the product and not to the professionalism of the provider. Associated with this attribute of inseparability is the notion of simultaneity. For example, the teller produces the service and the customer consumes the service at the same time. The consumption of a bank's service is contemporaneous with the production of the service. The provider of a bank service and the consumer of that service are inseparable, and consumption and production are simultaneous. The implications can be described using the example in the simultaneous consumption and production of a bank loan.

There are two stages in the delivery of a banking service such as a loan. The first stage is the period between the time a customer applies for a loan from a retail bank and the moment the money is deposited into his account. The second stage involves the continuous delivery of the terms and conditions to which each party (bank and customer) have agreed. In this second stage, consumption and production continue simultaneously during the term of the loan. The consumer is obligated to make repayment on a regular basis as the loan is being 'consumed.' The bank's back office collects and records repayments and ensures that the bank's obligations are also met in what may be described as 'continuing production.' As such, a loan is consumed and produced over its lifetime – the term to maturity of the loan. The implication of this long-term relationship is that the consumer may feel that the bank is not living up to the terms and conditions of the agreement (such as timely reporting of the outstanding balance of the principal) or that it is very difficult to establish contact with the right bank employee to resolve problems.

– Lack of storage: this is the inability of service providers to build and maintain a stock, and as this does not apply to services, there is a lack of a physical storage. But while the actual service cannot be stored, the experience that customers acquire during the delivery of the service can be stored in their memory, and this may be of crucial importance to future decision making. This view of customer capital, as equivalent to the stock of customer experiences stored in a mental inventory, is new in the banking literature, and it may show how experience-based decision making is key to understanding retail banking consumers' attitudes and behaviors;[5]

– Heterogeneity: the variation in quality of the service caused by the difference in customers' service needs and in the requirement for the individual interaction between the customers and the producers (see Box 3.4 for bank contextualization).

Box 3.4 What does heterogeneity mean for financial services?

When a banking professional is needed to deliver a given banking service, he or she is an inseparable part of the delivery itself. This being the case, it is only to be expected that as the service is repeated with different customers and different banking professionals, a degree of heterogeneity or service variability will naturally occur. The delivery of a bank service is not done through a statistical process with controlled variability in outcome. One would expect this in mechanical processes guided by automation. For example, the mechanical process of filling a bottle of spring water is subject only to statistical variation. One can see this by casual observation of bottles of spring water on a supermarket shelf. It is not the case that each bottle has exactly the same amount of water. But the variation is relatively small, as would be expected from random processes.

But when people are involved, as in the case of the delivery of banking services, there can be systematic variability in service delivery. By this we mean that the same errors and mistakes can be repeated without any averaging-out of the effects, as in the above example. A person who delivers poor service may do this for a long time until discovered through customer complaints. Training and the optimal matching of a person's ability with the job requirement are ways to reduce systematic variability in service delivery in a retail bank.

Clearly, these features seem, and they are, crucial when starting to work on new service offerings or reshaping some of the old ones; and this may require a focus on:

– How to define quality for intangible services, and identifying and measuring the elements that can be managed in order to create and deliver quality service;
– The importance of people as an element within the service product, both as producers and co-consumers;
– Not over-simplifying the elements of distribution, which are of relevance to intangible services, and so on.

As with any other service company, banks often experience difficulty in setting standards to match or exceed customer expectations. This is partly because doing so requires that the marketing and operations departments within a bank work together, and sometimes this does not happen. Even if it does, it may still be insufficient.

Developing a functional integration is starting to be a useful approach, and it requires banks to define a set of common internal goals, rather

than each functional unit setting and achieving separate goals. Doing so may have an effect on processes and may propel retail banks toward developing a set of customer-defined standards. At this stage, knowing customer's requirements, priorities, and expectation levels turns out to be of crucial importance when managing a bank. Anchoring service standards in customer perceptions can save money by identifying what the customer values and eliminating activities and features that the customer either does not notice or will not pay for (see Figure 3.1).

From a managerial point of view, a service perspective would appear to impact first and foremost the marketing function. While this observation seems self-evident, but in fact, the service perspective should be extended to the whole organizational structure rather than limited to the marketing function. As a consequence of this, the marketing function would seek to become a customer-consulting function and marketers would become a kind of buying agent on a long-term, relational basis, working with other functions to source, evaluate and purchase the skills (either as intangibles or embedded in tangible matter) that the customer needs, wants, or desires.[6]

Clearly, any true service company should focus its attention on serving a specific need (or set of needs), rather than on marketing a specific product/service for that need. As always happens with managerial issues, this is a question of perspectives, but in this case the primary need is to focus on the customer rather than only on the marketplace or the competition.

Identifying a need rather than a product/service allows the retail bank to create an enduring path to follow, and this is because service itself is so important in creating value to customers that it is able to compete on its own terms.

At present, banks compete mostly on other variables, such as price. But value and price are not the same thing; price is part of value but not its equivalent. Value is the total experience. It is value that customers want.

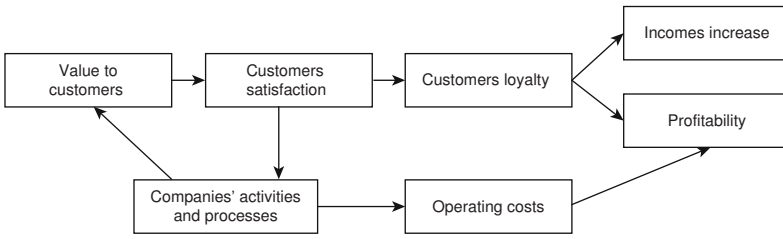


Figure 3.1 The service profit chain

Sometimes, the lack of physical differentiation among competing services encourages managers to overuse price as a marketing tool. When the products themselves can give customers non-price reasons for favoring one brand over another, services managers are limited to nonphysical means of differentiation. Managers frequently use price cutting as a means of differentiation, which may lead to cost-cutting and weaken execution, and this may result in a trap for a service company. In fact, as competition becomes fiercer, then preparing for that situation requires strengthening execution, not weakening it.

Again, many managers seem to prefer price cutting because it can be implemented quickly, and may be deemed more salient to customers. But without differentiation in quality, without superior total experience to offer customers, every company has few, if any, non-pricing options when key competitors cut their prices, as they feel strong because of their core competences. This is far more important today than it was in the past. The key to successful competing is differentiation. Hypercompetition and over-communication are key features in the market at present. What used to be national markets with local companies competing for business has become a global market with everyone competing for everyone's business everywhere. With the increasing competition, markets today are driven by choice, and targeted customers have too many choices, all of which can be fulfilled instantly. Choosing among multiple options is always based on differences, implicit or explicit, so differentiation is needed in order to give the customer a reason to choose a particular service. Thus, differentiation is one of the most important strategic and tactical activities in which companies must constantly engage, and at present, it is not discretionary.

The ability for a service company to add value to its products comes down to the quality of its employees, and the way its processes have been drawn with detailed specifications. This may be true because of the way services can be defined (see Box 3.5).

Each definitions in Box 3.5 seems to underline that major coordination and a more consistent approach in the whole organization is paramount to executing a strategy, especially when this regards services, and in particular financial services, which have more features to consider. In this regard, it is becoming mandatory to invest in employees' success by using strict hiring measures to find employees whose values match those of the company. Any service company also needs to foster attitudes of ownership in their employees. Helping them feel they are part of something bigger, part of the team, and in the loop is essential. The more people know about the organization, and where it is going, the more they will care.

Box 3.5 How a service may be defined?

According to:

- Gummesson (1990, 1995a/b, 2001) differentiates between service and manufacturing processes 'on the basis that customers enter service processes much earlier and are involved in the design of the outcome later statement, which appears to argue for performance over delivery.' And he underlined that 'brain is given more attention than heart in service quality management. We have a fanatic belief in structures, systems, information technology and legal technicalities to solve our problems: we are easily blinded by the tangible outer that may hide the real, abstract nature of inner wisdom and consciousness.' There exists an 'identifiable "service" paradigm, which focuses upon customer relationships and aims to meet market needs directly through actions.' In service industry, 'everyone is a "part time marketer" in that their actions have much more direct effect on the output received by customers.'
- Grönroos (2000, p.48) Services are 'processes consisting of a series of activities where a number of different types of resources are used in direct interaction with a customer, so that a solution is found to a customer's problem.'
- Normann (2001, pp.114–115) 'Services are activities (including the use of hard products) that make new relationships and new configurations of elements possible.' Viewing the economy as a web of activities and actors linked in co-productive value creation gives us another view of the nature of offerings. Normann shifts the focus of the offering 'from firm output to the process of value creation by suggesting that the offering is a reconfiguration of a whole process of value creation, so that the process rather than the physical object is optimized in terms of relevant actors, asset availability, and asset costs.' Lusch & Vargo (2006, p.3) 'Services are the application of specialized competences (knowledge and skills), through deeds, processes, and performances for the benefit of another entity or the entity itself.'

If there is anything a company can do to enhance communication with its employees, it should do it. It is becoming more and more important for service companies to work consistently and continuously on its support processes, because services are produced through them. And making services more like goods may not be correct from a normative management point of view. It is therefore important to start reconsidering the primary nature of a retail bank, the business of which is to sell promises: promises made and promises kept to customers.

Given these observations, we may say that at present retail banks need the appropriate tools to depict its strategic framework, inside and outside its organizational structure. And this can be done using, as a guideline, the services marketing triangle (see Figure 3.2), which shows three

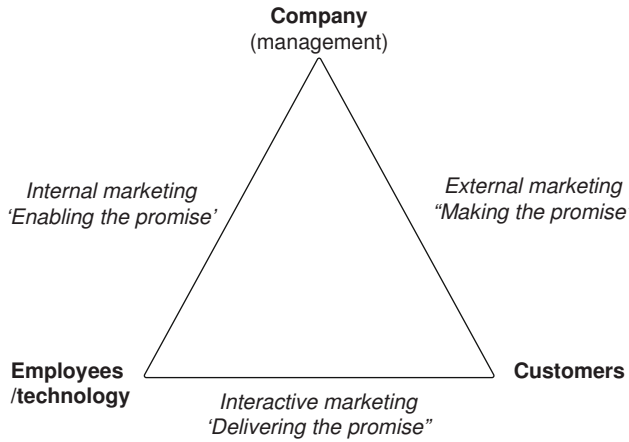


Figure 3.2 The services marketing triangle

Source: Adapted from M.J. Bitner (1995) 'Building service relationships: it's all about promises,' *Journal of the Academy of Marketing Science*, Vol.23, No.4, pp.246–251; C. Grönroos (1990) *Service Management and Marketing*, Lexington Books, Lexington, MA; and P. Kotler (1994), *Marketing Management: Analysis, Planning, Implementation, and Control*, 8th edn, Prentice Hall, Englewood Cliffs, NJ, p.470.

interlinked groups of people who work together to develop, promote, and deliver service promises. The key players are labeled on the points of the triangle, and they are:

- The company, or strategic business unit (SBU), or department or 'management' such as the retail banking section in a universal bank;
- The customers; and
- The employees/technology. This last group can be the firm's employees and subcontractors who deliver the company's services or it can be the technology as well, such as automated teller machines or any other devices that supply the service.

Each actor plays an important role in relation to the others, because they all need to better market the service. All of them are essential to complete the whole, and overall they should be aligned. That is, what is promised through external marketing should be the same as what is delivered; and the enabling activities inside the organization should be aligned with what is expected of service providers and employees. This makes a consistent strategy inside and in favor of the market. The three marketing efforts required are:

- The external marketing efforts that a retail bank may engage in to set up its customers' expectations and make promises to customers regarding what is to be delivered. Anything or anyone that communicates with the customer before service delivery can be viewed as part of this external marketing function. But external marketing is just the beginning for services marketers: promises made must be kept;
- The interactive marketing or real time marketing, which is where promises are kept or broken by the bank's employees, technology, subcontractors, or any agents working on behalf of the bank. If promises are not kept, customers become dissatisfied and eventually leave; and finally
- The internal marketing, which plays a critical role when management engages in these activities to aid the providers in their ability to deliver on the service promise: recruiting, training, motivating, rewarding, providing equipment, and technology. Unless service employees are able and willing to deliver on the promises made, the services triangle will collapse and the retail bank will not be successful.

There is something to add at this point: banks and their customers are bound by a thread, and this is customer confidence. When a service company loses its customers' confidence, it loses almost everything. And this may be even worse if we think of the uniqueness of financial services, as we will discuss later in this chapter.

3.2.1 Beyond the service promise: the service blueprint

Matching customer expectations is becoming more and more important if any company is to compete in the market. One of the keys to matching service specifications to customer expectations is the ability to describe critical service process characteristics objectively and to depict them so that employees, customers, and managers alike know what the service is, can see their role in its delivery, and understand all the steps and flows involved.

Service providers must effectively match customer expectations to new and actual service process designs, and this is not a strategic option anymore, it is becoming a mandatory issue to fulfill as the design and development of a service offering are complex and challenging. But it is also relevant because in the retail banking business, as in any other service business, the presence of people may bring a higher risk that service quality will vary over time. In this regard, overall process design is becoming more and more the responsibility of management, and surviving and prospering in the market means gaining control of the design and management process.

In fact, the way a company delivers the services it offers will impact customer experience and directly influence repeat purchase decisions. Consequently, how services are provided is central to both sales revenue and profit growth.

An effective technique to overcome the challenges of developing a service offering can be the service blueprint, which can offer managers a context within which to deal with the management and control of any process involved.[7] The rationale of this method is that services fail because of many reasons, but in particular they may fail due to a lack of systematic method for design and control, and because there is no way to ensure quality or uniformity in the absence of a detailed design.

Service blueprinting can be a useful approach as it enables developing and improving service processes, especially if we consider that services commonly lack concrete and detailed specifications. It is like designing and building a house without detailed specifications. Often, a service, even a complex one, might be introduced without any formal, objective depiction of the process, and furthermore, services are unusual in that they have impact but no form. Only when managers of a service company are able to go back to the original service idea according to their core business can the company become outstanding. A better service design provides the key to market success, and more important, to growth. With this perspective in mind, the operations side of service management is going to become fundamental but it also requires not forgetting the consumer's relationship to, and interaction with, services.

Even though I am not going into this method in depth, I want to outline just a few aspects of it. The service blueprint method has been suggested for developing new services (or simply developing a service innovation process), but the same principles can be applied to test the quality of services for which we contract.

A service blueprint is a picture or a map that accurately portrays the service system so that the different people involved in providing it can understand and deal with it objectively, regardless of their roles or their individual points of view.

A service blueprint depicts the service visually, usually through a flow chart, by simultaneously describing the delivery process, the points of customer contact, the roles of customers and employees, and the visible elements of the services. It is useful because it breaks a service down into its logical components and defines the steps or tasks in the process, the means by which the tasks are executed, and the evidence of service as the customer experiences it. The main rationale for using this tool in

services is that services are 'experiences' rather than objects that can be assessed.

The process of designing a blueprint involves several issues, including the following:

1. The identification of the service process to be blueprinted. Defining the process does not mean mechanizing all procedures. But identifying the components of a step or action reveals the inputs needed and steps covered, and permits analysis, control, and improvement. It is important to watch out for parts of the service that the consumer does not see. While they may be invisible to the customer they may still be important because changing them may alter the way consumers perceive the service. If, for example, a bank decides to redesign a computer program so that it produces a different account statement for its customers, it may affect its image or other consumer perceptions of value. These sub-processes must be considered integral to the success of the service. As a result of this phase, it is possible to picture the service from the customer's perspective;
2. The identification of the customer segment or the customers who are supposed to experience the service, so as to identify the attributes and values they may require;
3. The identification of the possible fail points along with the service process, which may involve both employees (onstage, which are the visible contact employees, and backstage, the invisible contact employees) and/or technology in use for delivering the service. This step is important to show where the service may experience quality or consistency problems. Telephone communication, for instance, is a component that is not only critical and difficult to control but also one of the most powerful influencers of customer perception, since it provides the only personal contact. In this regard, an example would be to suggest producing scripts, for various situations.

It must be added that for each customer action, and every moment of truth, the physical evidence with which customers come into contact is described at the very top of the service blueprint. These are all the tangibles that customers are exposed to and they can influence their perceptions of quality. They become a set of designed attributes of a specific service and their qualities can be translated into a process which may detail any necessary specifications. These aspects may matter to customers because intangibility and inseparability make services low in search qualities (tangible attributes) and high in experience qualities (see Box 3.6), which can only

be assessed after consumption. In this regard, customers are motivated to look for signals of quality, such as place, people, communication, and price, and this subsequently forces service providers to make their offerings tangible in some way and give them visible signals.

Box 3.6 From the properties of consumer products to consumer behavior

There are three main categories of properties regarding consumer products, and they are relevant because they drive customer behavior:[8]

1. Search qualities: a set of attributes that a consumer can determine before purchasing a product (examples: color, style, price, fit, feel, durability, and smell);
2. Experience qualities: a set of attributes that can be discerned only after purchase or during consumption (examples: taste and wearability); and
3. Credence qualities: includes characteristics that the consumer may find impossible to evaluate even after purchase and consumption (examples: legal services, auto repair, medical diagnosis).

According to these classifications, it can be said that:

– Products high in search qualities are the easiest to evaluate;
– Products high in experience qualities are more difficult to evaluate because they must be purchased and consumed before assessment is possible; and
– Products high in credence qualities are the most difficult to evaluate because the consumer may be unaware of, or may lack, sufficient knowledge to appraise whether the offerings satisfy given wants or needs even after consumption. In this regard, most services are credence-qualities based. And again this feature make services difficult to evaluate.

The broad category of financial services (from payments to personal finance, mortgages, and others) fall prevalently into the third category. As a consequence, bank customers face difficulty when they try to ascertain the quality of the service on offer, hence value for money and the appropriateness of the product or service being purchased, and in its extreme form, bank services might never be fully open to objective evaluation.

Given these observations, the quality in service is the output of a set of activities developed by many actors involved (the customer first and then the entire organization involved in the delivery). They are all linked in a process within the framework of a customer's perception space (see Figure 3.3).

Some interesting benefits arise as a consequence of using the service blueprint:

1. It provides an overview so employees can relate what they do to the service viewed as an integrated whole, thus reinforcing a customer oriented focus among employees;



Figure 3.3 The customer's perception space

2. Identifies fail points, that is, weak links of the chain of the service activities, and in this way it can be the target of continuous quality improvement;
3. It provides the line interaction between external customers and employees so as to outline the customer's role and show where the customer's experience of quality may come from, thus contributing to informed service design;
4. It may increase a conscious decision about the line of visibility on what customers should see and which employees should get in touch with them, thus facilitating rational service design;
5. It highlights the line of internal interactions so as to capture interfaces across departmental lines, and in this way a virtuous circle can be developed in terms of continuous quality improvement;
6. It can develop an interesting strategic discussion which can outline some of the relevant elements and connections that constitute the service thanks to the integrated view of the service it provides;
7. It can be a useful tool for identifying and assessing cost, revenue, and capital invested in each element of the service;
8. It is relevant as it can help managers deploy both external and internal marketing more effectively;
9. It can facilitate a top-down, bottom-up approach to quality improvement both from the front-line and support teams of employees.

From these observations, we can learn that delivering a service requires recruitment, training, and also general management, all of which are people-based activities. Nevertheless, it is also true that some services can be rendered mechanically, as banks have demonstrated with automatic tellers, and some can be performed by customers themselves. As implementation constantly evolves, alternative means of execution must be weighed during the design and management of services, but the basic idea regarding the need to sell services to customers should not be missed, and in this sense the productivity and profit margin increases

must be weighed against customers' perception of lower quality. This may become a trap if cost efficiency constraints are going to drive the entire organizational structure. And this is the case, when retail banks are driven by ratios such as the cost/income ratio (where the numerator is the operating expenses and the denominator is the underlying income). In order to reduce the cost/income ratio, and to receive a favorable assessment from financial advisers, many banks are concentrating on reducing operating expenses rather than trying to increase new sources of revenues and develop a more stable profit base.

If we go back to the topic of the paragraph, then, we can say that the blueprint is more than a tool for designing and managing the quality of service delivery. In fact, it should become a tangible method of managing what the customer values in a banking service and therefore encouraging a long lasting bank-customer relationship. This is, among others, the major factor influencing bank profits, in the long term; otherwise banks start looking for new sources of revenues so as to reach an appropriate level in terms of return on equity (ROE). In this regard, the service blueprint may also be useful for the pricing department, because it provides a basis for a thorough cost analysis; while for distribution, it functions as a map that can be duplicated; and in the case of promotion, it may provide tangible evidence for the management and control of interesting results. Last but not least, from an organizational perspective, it can be useful in increasing employee engagement, and this is seems to be relevant as retail banking becomes more and more a people business.

Another lesson we can learn with a view to improving the management of retail banks is that although superficially aspects of services may seem the same, the design particulars involve so many alternatives and choices that no two services will have exactly the same design. Services differ from competitor to competitor in the sum of their particulars, and the same can be said of banking services as well. Individual aspects may allow consumers to discriminate between companies offering services that are only superficially similar.

Finally, we also want to underline that developing a blueprint approach is not only a matter of redefining services and seeing them from a customer perspective; activities render services, things render services. Again, the shift in focus is from the means and the producer perspective to the utilization and the customer perspective.

3.2.2 Reconsidering the unique features of financial services

For those retail banks that seek to provide, engage, excite, and delight their customers, a broad strategy of customer-centricity should be the

goal. Success in customer-centricity is two-fold because it requires deep knowledge of individuals to enhance the customer experience. But it also requires banks to figure out an organization capable of facing and managing the changing environment.

When developing a new approach, therefore, a retail bank should ask the following question: how does a customer want to use his/her bank, rather than how should a bank market its services better. In fact, the way a customer wants to use his or her bank is very pertinent to the way banks should be organized.

As the customer is the main actor in the service process, then it is interesting to dip into his or her point of view when he or she asks for a banking service. For this reason, in this paragraph it would be interesting to outline some of the unique features of financial services, and look in addition at those mostly related to the intrinsic nature of services:

1. The service provider has an implicit fiduciary responsibility to manage with prudence the client's investment or savings, and it may be a long time (if at all) before the consumer is aware of the value and faults of a financial contract. Customers entrust their financial well-being to the organizations and rely on financial advice given. This may limit the power of reputation as an assurance of good services. The development of trust and confidence takes place only after experience, and it is crucial in maintaining the long-term relationship as it can create inertia;
2. Financial services are rarely one-off purchases and are developed more efficiently as a result of the interaction between the customer and the service provider. This two-way information flow enables banks to collect useful customer information needed to enhance the organization's relationship-building capabilities. This information is relevant when it becomes part of the bank's knowledge of the customer and is managed accordingly, allowing banks to develop their activities and cut across departmental boundaries;[9]
3. The need for a transparency of performance, which refers to the availability of information presented by the bank, and the consumers' ability to make evaluations based on that information, can both result in a lack of intrinsic appeal[10] for some financial services. This may happen, in particular, because these elements may discourage consumers from becoming actively involved in problem recognition, unless there is an urgent need. But this is an important step in the consumer decision-making process. Sometimes it becomes difficult for customers to verify the claims being made by the seller.

Some customers engage in a search for information in order to assess the alternatives, and in this case they gather relevant information either from their own experiences or from an external source. But as financial services are low in search qualities and high in experience and credence qualities[11] (see Box 3.4), then consumers are mostly comfortable to rely on their own prior experience of the product;

4. Poor comparability caused by the scarce number of identifiable attributes may be increased when banks sell bundles of products;[12]
5. The long-term maturity of some services, which deliver the value of the purchase to customers over a long period of time or only after a considerable lapse of time. This situation makes it difficult to have a personal experience of the specific product offered. This also has a double effect: the first is that there is a customer tendency to rely heavily on the experience of others expressed in the form of word-of-mouth recommendations, and also on the credibility of the organization as a whole. And the second effect is that many financial products fall into a public policy intervention with regulation and supervision, that in retail banking is mostly focused on consumer protection.[13]

The list of specific features for financial services could be longer (see Box 3.7).

Box 3.7 An extract of the more specific features in financial services

- Financial services are often not purchased frequently and hence the consumer has little experience or ability to learn from experience[14] and the consumer often lacks confidence while purchasing these contracts;
- There is no guarantee or warranty attached;
- The consumer's future welfare is often dependent on the performance of the contract: a faulty product can be replaced, while a bad financial contract cannot be surrendered other than at (sometimes substantial) cost. Faults cannot be always rectified;
- If the firm becomes insolvent during the maturity of the contract its value may be lost, which is not the case with most other goods and services;
- Value is not immediately clear at the point of purchase: the consumer cannot know if a bad product is being purchased;
- Value is often critically determined by the personal circumstances of the purchaser;
- The value of contracts is determined by the behavior of suppliers after purchases have been made; this creates the potential for opportunistic behavior and gives rise to a need for monitoring. No amount of information available at the point of purchase can guard against this potential hazard;
- The consumer frequently requires advice when purchasing financial products; this gives rise to principal-agent problems;

– It is often easy for a financial salesperson to conceal relevant information and/or mislead the consumer;
– It is usually difficult to detect misrepresentation at the time of purchase;
– The full cost of the product may not be known at the point of purchase and it can sometimes be concealed from the consumer.

Source: D.T. Llewellyn (1999) 'The Economic Rationale for Financial Regulation,' Financial Services Authority, Occasional Paper Series No.1, p.37.

In addition to previous observations, a crucial point to underline is the personal interaction between the sales staff and the customers during the purchase stage. They indicate that face-to-face interaction remains important even with recent developments related to Internet, ATMs, telephone, and mobile sales. In fact, post-purchase behavior is dependent on the evaluation of the personal experience of the customer and on the level of cognitive dissonance generated. It is important to note is that the establishment of a high degree of trust between the buyer and the seller can create a high degree of inertia while the recognition of a high level of institutional reliability is likely to decrease the rate of customer defection.[15]

Finally, it is important to recognize that financial products may combine all or a large number of the characteristics mentioned, and they also present some information asymmetry problems, which will be presented in Appendix 7.

Finally, even though I am not going to deal with this issue in this book, it is worth mentioning that particular attention must be paid to the recognition and analysis of consumers' actions and decisions at each stage in the decision-making process (see Figure 3.4).

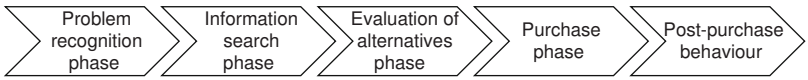


Figure 3.4 An exemplification of the decision-making process

3.3 Why do banks need to shift their mindset from offering products to servicing customers?

On repeated occasions, questions are asked about whether banks should improve their resilience in the market, especially now that the financial crisis has brought about important changes in the industry. But when referring to the resilience of a bank, the discussion moves immediately to prudential regulation, which is focused on increasing the solvency of the banking sector as a whole, and of any bank taken individually.

It is usually understood, however, that tighter regulation also leads to more concentration and higher spreads. And in this regard, prudential measures are seen as implying a trade-off between solvency and competition. But resilience is not about buying protective measures to reduce risk or actuarial insurance to displace it. Investing in resilience enhances the competitive fitness of any organizational structure.[16] And this requires a change in the strategic perspective, which is the one I am seeking to develop in this book.

Under these circumstances, resilience worth the name will need specific measures to grow rather than decay in the face of the even greater strategic challenges that lie ahead.

Consequently, this means recognizing that resilience is a combination of profitability and growth[17] in an uncertain world, where a consistent strategic management approach is needed. Accounting standards should incorporate better measures of value,[18] and a new framework has to be developed to reconcile competitiveness and cooperativeness, working on 'shared value.'[19] We need to research better the value of every business-specific resilience and try to take advantage from any possible transformation.

A retail bank should spring forward, innovating appropriately through learning from a past overtaken by events and exploration of the uncertainties ahead. And the way this can be done may be through re-assessing the service dominant approach.

What is changing today is not the sudden emergence of services but, rather, the combination of an increasing ability to separate, transport, and exchange information, apart from its embodiment in goods and people; and increasing specialization (what Normann (2001) calls 'liquification' and 'unbundling' respectively), allowing increased outsourcing.

These changes might create new opportunities for service provision but they do not change the nature of what is being exchanged (applied knowledge and skills).

The reason why I want to highlight the service dominant approach within the retail banking industry is to make a distinction that is critical in terms of innovation opportunities, their impacts and possible evolutions from banks.

When it is clear that service is the fundamental basis of exchange, then innovation is not defined by what firms produce as output, but how firms can better serve. Again, it is a different perspective, which makes a distinction between competing with services versus competing through service. The last statement is about more than adding value to 'products.' It has to do with the entire organization viewing and approaching

both itself and the market with a service dominant logic. And this is based on the understanding of the interwoven fabric of individuals and organizations, which are brought together into networks and societies, specializing in and exchanging their applied competences.[20]

The logic is grounded in a commitment to collaborative processes with customers, partners, and employees.

The more service-centered a bank becomes, the more it has to be customer-centric and relational. It may be argued that at least some banks and customers seek single transactions rather than relationships. If relationship is understood in the limited sense of multiple transactions over an extended period of time, this argument might appear persuasive. However, this is also true if we think of a service transaction, that is a promise with an exchange relationship that will yield valuable service provision, often for very extended periods of time. These contracts are at least partially represented by the brand of the offering firm. Consequently, part of the compensation for the service provision is the creation and accumulation of brand equity.

We think it is time for retail banks to start developing a new picture, which is going to make them better at:

- Joining in with the real needs and wants of their customers;
- Facing all different forms of non-traditional competition;
- Protecting their core products and services by widening their scope of activities with broader functions and services; and finally
- Exploiting the opportunities that have arisen through changes in society, such as mutations in the welfare state and other social changes, which can be treated as both a challenge and an opportunity.

In this regard, there are three fundamental aspects a retail bank has to manage consistently; and they are:

1. The offering and funding mechanism;
2. The employee system; and
3. The customer system.

What is clear, is that there is no right way to combine these elements, but it has been amply demonstrated[21] that it is important to develop an appropriate design for each one, remembering its relationship with the others.

When we look at service businesses that have grown and prospered (companies like Walmart in retail; Commerce Bank in banking, and

others), it is their effective integration of these elements that stands out more than the ability of any element, taken individually.

3.3.1 We need to start from the core business and its representation in bank reports

When developing a new perspective, we must start by recognizing that many strategists often agree that in most markets – and the financial services is one of them – the definition of the core business has traditionally focused on the kind of products offered. Typically, this is reflected in the words used to denominate the different types of financial institutions: life insurance companies, mortgage companies, pension funds, car insurance companies, and others. In the present situation, both product and geographic boundaries are disappearing, and the traditional technical and product-oriented definition of the core business in the retail bank market might not work well anymore.

Given this, it is fundamental to gain a deep understanding of what the core business for a retail bank is, and then try to reframe it, both considering consumers' and banks' perspectives, compared to more traditional views.

For many years, retail banks have been product driven and this meant that they developed new products and packages and took them to their customers telling them 'you need this.' This worked much of the time, but this situation does not last forever. In particular, this is due to a change in bank–customer relationships because many customers have taken advantage of new technology to interact with their bank, and they have started doing their banking differently from the past. It is also important to highlight that many of these situations have been developed in the market without a clear idea of the standpoint of the customer. The situation lacks direction, which could have provided the customer with a clear script on how to manage his or her bank–customer relationship more effectively. A possible consequence of this situation is that a sort of self-sufficiency of the consumer is created, with a clear index of dissatisfied customers. And if we go to a European level, some data show that consumers shopping online across the EU have up to 16 times more products from which to choose, but that 60 percent of consumers do not yet use this retail channel. As a result of this reluctance, they do not fully benefit from the variety of choice and price differences available in the single market at present.

The smart examples are instead those that have picked up on this change and they are listening to their customers, and in doing so they are increasing their resilience. Improving consumer confidence in

shopping online could provide a major boost to every bank–customer relationship, and this is a strategic choice and not a result of appropriate policy action developed to boost the situation.

Competition, mostly brought about by the appearance of 'new' banks and non-financial competitors, means finding and developing different ways to address customers' problems and identifying new needs, in a way that customers can clearly perceive as different from their past banking experience.

All this leads to unfamiliar scenarios for regulators,[22] which should start looking also at some other issues in the market, such as how to protect bank–customer relationships. This is something that must go beyond consumer protection, which still remains a major issue in national and international financial legislation. The main idea of regulators is that financial services have a very significant impact on consumer' lives, and it is therefore important that consumers make well-informed decisions and feel confident that they are adequately protected if something goes wrong. On the other hand, financial institutions are well aware that a reputation for honesty and good customer service are among the most effective marketing tools in an increasingly competitive market. But there is still some evidence that nowadays, consumers in the retail banking sector are not in a position to choose the optimal product for their needs. Persistent problems regarding the level of information available on bank fees and the way in which this is presented by banks, such as is the case in the EU, has hindered the ability of consumers to comprehend how much they are being asked to pay.

And for this reason, empowering consumers[23] has become a major issue in the retail banking sector, according to regulatory authorities (see Box 3.8).

Box 3.8 Consumer protection regulation

Consumer protection legislation may cover many issues but it is unavoidable that they adopt a comprehensive approach covering some pillars – such as access to a basic bank account; switching, and fees transparency and comparison – since too many interlinks exist among them.

It is recognized that a trustworthy financial services industry has to be maintained, and all legislation should contribute to this goal. In particular, and for the case of the EU, I would like to present a brief overview of the issues, as they were outlined by John Mogg, Director-General of DG XV44 in his Green Paper (May 1996):

– Consumer information: financial services directives contain a number of provisions requiring financial institutions to provide their clients with appropriate information. For banking, this may include information on credit limits, termination procedures, and so on. For insurance, the policy-holder must be informed about the duration, right of cancellation, applicable law, and so on. For the securities and stock exchange, directives seek to ensure investor protection by means of maximum transparency.

In the banking industry, the management of information asymmetry is crucial because it helps to determine the optimal contract, which governs the relationship between the principal and the agent, and reduce the possibility of moral hazard and adverse selection phenomena. Information asymmetry, in particular with regard to the savings market, means that depositors cannot assess individual banks' capital strength and the probability that a bank will go bankrupt. Under perfect information, market forces would enforce 'good' banking practice because they maximize profits and so banks would choose strategies with zero probability of bankruptcy.[24]

– Legal protection: certain provisions in a number of directives strengthen the consumer's position vis-à-vis the financial institution and protect the consumers' legal interests should something go wrong.
– Systems of redress: both in banking as well as in insurance, the existing union law has addressed some aspects that indirectly affect consumer protection. For example, in banking, Member States must ensure that the depositor's rights to compensation may be subject of an action by the depositor against the deposit-guarantee scheme. In legal expenses insurance, the policy-holder must be explicitly informed in the event of a conflict of interest with the insurer, about his or her rights to have the free choice of a lawyer, and to have recourse, if necessary, to an arbitration procedure; and
– Pricing of financial services: we indicated that deregulation and financial convergence has led to lowered costs and increased efficiency. It remains to be seen whether this also implies lower prices. The financial services directives do not seek to interfere with the free determination of prices.

These objectives are also in the later European Consumer Agenda, which aims 'at increasing confidence by: reinforcing consumer safety; enhancing knowledge; stepping up enforcement and securing redress; aligning consumer rights and policies to changes in society and in the economy.'[25]

The EC is committed to ensuring a high degree of consumer protection as an essential feature of a smoothly functioning EU market for financial services, and in particular the Health and Consumers Directorate General's work focuses on consumer credit, the distance marketing of financial services, and ensuring that consumer interests are considered in other EU financial legislation. The EC has adopted a strategic vision for EU consumer policy with the aim of maximizing consumer participation and trust in the market.

This is about considering bank business models beyond their revenue model, because income characteristics may serve as a poor indicator for assessing them.[26] Saying this does not mean we are asking regulators to become strategists but encompass this only apparently 'soft information' differently from the past.

It may sound simplistic, but the way banks listen to customers and understand their problems in detail, may prove to be the most important strategic activity. Certainly, regulators should have a different perspective from strategists, but this issue should also matter to them.[27]

Many regulatory demands interfere with bank strategic plans in a significant way, and they do not always have a complete disclosure about the main consequences and impacts these measures have on banks' business and their operating structures. Disclosure practices show heterogeneity, both across banks and countries. While some banks report more than others, there appear to be discrepancies, even for a given bank over time; in other cases, many banks do very poorly. And this happens most likely in response to calls from their shareholders who tend to be more disclosure-demanding. Apart from a handful of general terms, such as total assets, a comparison across banks is rendered extremely hard due to a general lack of standards on the reported items [28] and features.

If we go back to the core business, the challenge for bank service management begins with its design, and the awareness that for both product companies and service businesses, the way an offering is delivered to the market cannot last long if the offering itself is not appropriate for the market. But this does not always mean that the customer's needs have changed. The service must only effectively fit the needs and desires of an attractive group of customers.

When thinking about the design of a service, managers must undergo an important shift in their perspective. Whereas product designers focus on the characteristics buyers will value, which still remain important but not as much as before, service design has to do with the way customers use their bank/s.

If banks change their mindset they may provide different frameworks and new logics, and they may re-assess implications on the operational side that regard how to exchange processes, markets, and customers. In particular, a service-centered view starts identifying or developing core competences, which are the fundamental knowledge and skills of any economic entity, as they continue to represent a potential competitive advantage. In fact, in a service, what is exchanged is a mix of competencies spread around the entire organizational structure.

Core competencies are not physical assets but intangible processes; they can be 'bundles of skills and technologies'[29] and may often be

routines, actions, or operations that are tacit, causally ambiguous, and idiosyncratic.[30] Core competencies can also be higher-order resources,[31] because they are bundles of basic resources. According to another perspective, core competencies stem 'from dynamic capabilities rooted in high performance routines operating inside the firm, embedded in the firm's processes, and conditioned by its history.'[32] From another point of view ('competition for competence'), core competences are competitive advantage resulting from competence making a 'disproportionate contribution to customer-perceived value.'[33] A recent contribution suggests instead that 'core competence is communication, involvement, and a deep commitment to working across organizational boundaries.'[34]

Being service-centered is more than simply being customer-centric; it means collaborating with and learning from consumers and being adaptive to their individual and dynamic needs. A service-centered dominant logic implies that a bank's value is defined by and co-created with the consumer rather than embedded in output.

Some successful firms[35] have moved from a 'make-and-sell' strategy to a 'sense-and-respond' strategy. In Table 3.1, I outline some differences between a traditional product-centered dominant retail bank logic and the service-centered dominant retail bank logic.

According to this perspective, the common denominator is the application of specialized knowledge, mental skills, and, to a lesser extent, physical labor (physical skills) to own the customer relationship. This approach can be useful both to provide benefits to customers and also satisfaction of higher-order needs.

New competitors are looking for services, and among others financial services are of great interest to increase their offering through

Table 3.1 A shift from a product-centered to a service-centered logic

	A product-centered dominant retail bank logic	**A service-centered dominant retail bank logic**
Primary unit of exchange	Bank exchanges product	Bank exchanges knowledge, skills and competences spread throughout the organization
Role of customer	Product taker and transaction developer	Service developer and relationship developer
Determination and meaning of value	Value is embedded in the product offering	Value is embedded in the use process
Source of economic growth	Wealth comes from owning and/or controlling the process	Wealth comes from the customer relationship ownership

different selling platforms. It is in this regard that a retail bank needs to protect its business, competences and renew its customer knowledge to ensure higher fees. This looks like a new wave of differentiation in bank strategy; where differentiation could be based more effectively on the idea of developing different levels of services, as a reaction against the threat of the commoditization trend.

The core business for a retail bank will have to pass through the opportunity of considering bank customers from their consumers' usability point of view, and so identify the processes that are best requested, so as to develop a set of options available to them. In this way, banks are shifting their focus from offering products to servicing customers. What is important in this strategy is to discover what is expedient for customers and develop the offering strategy according to that.

This situation mirrors the options in shipping businesses such as FedEx and others, but also in hotels, travel, healthcare, and many other services, where consumers may pay differently according to their need. If they want to send a non-urgent package, they can send it overland and pay the minimum amount. Alternatively, they pay more to have the package arrive the next day. And of course, those who wish to have their package delivered by 10:00 am the next morning can use the most expensive premium overnight service.

3.4 It is time for banks to start considering themselves as special intermediaries

According to the theoretical literature on the existence of banking firms, there are two parts to this issue.[36] One part takes the existence of banks for granted and focuses on certain aspects of their operations. The other part primarily deals with the reasons why banks exist, or more abstractly, the conditions under which intermediation is viable.

In the latter category of studies, usually referred to as 'financial intermediation theories,' transaction costs and problems of imperfect information, market signaling and so forth are of critical importance to explain the role of banks in the market and some of their special features.[37]

In this paragraph, I want to outline three main reasons why banks can be considered to be different from other financial institutions and therefore regarded as special intermediaries.[38]

First, they supply services that are generally thought to be vital for the functioning of modern society: they are information specialists, which enables them to intermediate between borrowers and lenders; they transform and accept risks; they provide liquidity and thereby facilitate all

sorts of transactions, and many others. Second, in contemporary financial systems, banks tend to have widespread and substantial positions with each other, known as the 'interbank market.' As a consequence, one major bank failure may ruin a whole series of (intrinsically safe) banks and, hence, disrupt the entire economy. Third, since banks are the foremost transmitters of monetary policy, their behavior is crucial for the central bank's ability to influence the real sector of the economy, and also because the process of lending creates money. In other words, banks are special because they:

- Offer transaction accounts;
- Are the backup source of liquidity for all other institutions;
- Are the transmission belt for monetary policy.

Given this, we can agree that overall these features are concerned with the payment/transaction function and the lending capabilities; both have been developed and carried out by banks for a long time, and a great deal of business is transacted around them.

The first function developed mainly through the core account, which has been a cornerstone of any retail bank's relationships with its customers. It offers a direct contribution to income such as account fees or interest income from deposits as well as indirect sources of value, such as the basis for cross-selling, and valuable insights into customer behavior, as seen in Figure 3.5.

Today, the banks' position in providing the transaction function, and all the related services, is under threat, primarily from two sources: regulation and competition (see Table 3.2).

If we combine all the threats with the yet-to-be-explored rise of 'all things digital,' then the challenge to the core of retail banking is not just coming from the cards business, and its impact on bank revenues is of great importance. According to a recent report,[39] it has been estimated that 32 percent of banking revenues will be at risk by the year 2020 as a consequence of new digital competitors, which are contesting specific business areas:

- Deposit and current accounts (17.4 percent of banking revenues). Online banking, alternative deposit products, and mobile money accounts compete for market share and also compress bank margins;
- Payments and credit cards (6 percent of bank revenues). Due to a shift in the payments' market share to alternative providers and merchants, with interchange fee reduction;

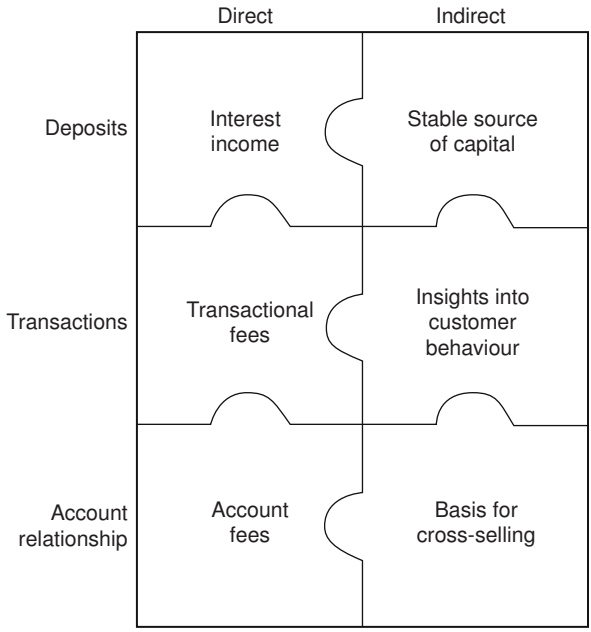


Figure 3.5 Value of the core accounts to banks

Source: Z. Bareisis (2013) *The Rise of the New Bank Account? The Quest for Transactional Account Primacy*, Celent, London, p.4.

Table 3.2 Selected examples of threats to banks

	Cards business	**Core bank account**
Regulation	• Pressure on interchange	• Account switching mandates (in countries such as UK, Italy, and others)
Competition	• New players building alternative payment propositions (in particular digital wallets)	• General purpose reloadable prepaid cards • 'Digitally native' players

Source: Z. Bareisis (2013) *The Rise of the New Bank Account? The Quest for Transactional Account Primacy*, Celent, London, p.6.

– Lending (4.9 percent of bank revenues). Competition is from direct peer-to-peer mortgage providers and asset owners; and
– Asset management/bancassurance (3.4 percent of bank revenues). This decrease is from direct competition due to price comparison portals and fee reduction from direct trades.

In detail, most of these threats come from a common theme among the new entrants, which is how to improve customer experience and reinvent banking concepts, especially around the current account bank product. In fact, the new picture of a bank account is a wallet capable of holding all of the customers' value, both real (money) and virtual (coupons, miles, etc.); and also allowing customers to aggregate their loyalty programs in a single place and view, transact, or exchange points.[40] Some explanatory examples look like a new generation of 'old bank services,' and they are:

- Consumer account propositions: prepaid card-based account propositions, such as Bluebird from Walmart, GoBank and Banking Up. Offerings from 'native digital' players such as Moven, Simple, and Fidor. These providers look more and more like checking accounts;
- New business account propositions from players such as Holvi and Cashflows, which are players from outside the banking industry deriving value differently, such as charging merchants for promotion services rather than payments.

All of the players involved are radically changing customer expectations in regard to the transactional account by developing innovations such as: enhanced information services; next-generation personal financial management (PFM) tools; control tools; user-friendly money management advice; engagement tools and integration with social media; innovative approaches to account pricing. While on the other hand, regulators are still demanding more from banks, such as easy account switching and all the implications related to the consumer protection wave of regulations.

Given these observations, we may argue that the transactional function among non-bank competitors is gathering primacy in the market. And given that, questions may arise, which are: why and how should retail banks restart competing to protect their core product?

There are a number of good reasons, both offensive and defensive, why banks should consider competing to protect and develop especially account capabilities, including the following:

- Keeping up customer trust and preferences, as customers still trust their banks;
- Developing new opportunities to protect and enhance customer relationships; and of course
- Revenues opportunities, useful to stabilize bank profits over time.

With this in mind, retail banks should try to fill in their scope of activities with broader functions and services. This has already begun to happen in the market. Some examples:[41]

- Rethinking how a current account is sold (Barclays);
- Taking mobile banking to the next level (Banco Sabadell, La Caixa, and PostFinance);
- Protecting card-based payments through value-added services (Bank of America and The Clearing House); and
- Enabling more payments directly from the bank account (IKO and Zapp).

If competitors are interested in current accounts, they are also paying attention to another valuable service to customers, and this is the PFM, which may be all about helping customers now, as they shop and make financial decisions. When bank customers act as consumers, they are looking for more than just viewing balances; and they are looking for a way to manage money and make financial decisions in real time, on the go. If this is a customer's requirement, than PFM should no longer be a single product. Again, the technology is changing the way a PFM is working, by shortening customers' time-horizon for immediate consumption (see Box 3.9).

Box 3.9 A brief overview on the future of PFM

PFM can be described as a product that bolts onto an account, but the consumer does not see it in this way. And this is because things like paying bills and shopping all tie together and integrate like threads in a tapestry. It's not a shrink-wrapped box anymore. Instead, PFM is – or should be – about short-term, real time decisions, and it can answer some interesting questions customers have, such as:

- Which card gives the best reward?
- What is the right decision regarding debt payment?
- How long should I wait before buying a certain good? And so on.

In this regard, a PFM is moving beyond a transactional machine toward helping customers by not just giving them a plan for a vacation, but also for figuring out whether or not to buy a 'pair of shoes' while they are in the store looking at them. Help of this kind, providing decision-making tools and predicting what the customer needs, deepens the relationship with the customer.

But on the other hand, this kind of PFM sounds a lot like some of the benefits promised by mobile wallets. And in fact mobile technology is changing PFM, and it seems to be changing the market for PFM as well. The truth is that some of the (desired) features are not all banking related, as they leverage the power of the smartphone: alerts, reward reminders, and price-change reminders. But in this way, the smartphone helps the bank to retain customers by deepening relationships, stickiness, and cross-selling.

The idea that banks should return to and reinforce their central function in payments is not new. Here, we just need to remember that payment services are the engine that facilitates commerce between consumers and business. Nobody knows exactly what the future holds. However, I strongly believe that retail banks have to protect their competencies and go back to seeing themselves as special intermediaries, according to some of the reasons above. But in order to regain ground in the marketplace, it is not enough to react, they need to think strategically with a long-term perspective, which requires them to compete with skills and competencies, investments, innovation attitudes, flexible organizations, and renewed business processes.

But there is one more answer we may give and this is that payment services may seem to look like a Trojan horse. Metaphorically, a 'Trojan horse' has come to mean any trick or stratagem that causes a target to allow a foe into a securely protected bastion or space.

A historical view of banks can offer timeless lessons that can help to shape their future, as the value proposition of incumbent retail banks is a pretty low performing asset, at present. This is because the lines of competition are converging, and this makes many industries look the same way in customers' eyes.

The retail industry is looking to increase its control both on consumption and consumers; competitors such as grocery stores, retail shops, and a host of new market entrants have realized that facilitating the purchase of their products can be as profitable or more profitable than their direct line of business.

The future of money is a complex subject, but retail banks should not lose the game, and this is because the history about how money is changing represents a snapshot reflecting the attitude and behaviors of a society, and how value is exchanged. Money follows changes in society, and it still continues to be something for storing people's wealth. This has been and still is a critical issue, because the minting of any representation of value (digital or otherwise) is backed by the full faith and credit of the issuer, whoever that may be. And this is because the rate of acceptance follows recognizable patterns of behavior,[42] which is fundamental for any monetary substitute to be accepted and circulate freely in the market, over a stable long-term period.

Retail banks need to develop consumer and business services to facilitate the wave of new exchanges of value in whatever form it takes. Without question, the ability for the world to pay its bills is the foundation of all international economies. Facilitating the exchange of value between trading partners, consumers, governments, and markets is made

possible by each nation's banking infrastructure. Here is another important strength for banks: they are already part of a network economy, which enables them to exchange payment instruments and make them circulate and be accepted in the market, while others do not always have the same reach.

Along with this idea, there is another part of the payment industry, which has been a bank dominant landscape, and that is payment processing, which could be under pressure. This is a core component of any transaction service provided by banks. Banks have always played a dominant role in this activity, ensuring that funds are safely and promptly transferred from payer to beneficiary. Increasing use of electronic money and electronic transfers is already opening up the retail banking scene to a new type of competition. Computer, telecommunications, and encryption specialists are playing increasingly important roles in the development of retail banking. Suddenly, banks face a situation where the core expertise of back office and delivery functions are no longer their proprietary right. Instead, they are increasingly dependent on telecommunications, information technology, and data processing expertise. In effect, these key players can slice off a considerable part of the added value that used to belong to the retail banks. Payment processing techniques have shifted gradually from manual to automated procedures. In order to avoid cannibalizing existing platforms, banks have applied incremental innovation strategies and over time, have developed extremely complex and inflexible payment processing systems that rely heavily on archaic standards and technologies. For many reasons, the legacy payment systems, which enable money transfer among the different actors involved in a payment, have become very burdensome and costly to upgrade due to a multitude of incremental investments performed on them over time. Incremental investments, such as applying upgrades to pre-existing platforms, were developed only when strictly necessary to satisfy temporary needs time after time, but banks seem to have generally lacked long-term development strategies for their payment processing systems.

As a result the legacy payment platforms are composed of fragmented silo structures that still rely on systems developed during the advent of computing technologies and seem to be highly inflexible. These systems pose a big burden on banks by inhibiting them from making the most of the boom in non-cash payment instrument demand. Banks are at a turning point and must decide whether offering payment services is strategic in terms of reaching their profitability goals, by evaluating the importance they give to payments related to other services offered. While the market potential for payment services is booming, regulatory

and competitive pressure again is greatly increasing the risk for banks of seeing profit margins from payments fall dramatically if no action is taken. Banks that intend to take transaction services seriously need to make significant investments to radically transform their payment processing systems in order to make the most of current technologies and be ready for further evolutions. Also in this case, non-bank players are entering the market thanks to regulations such as the PSD in Europe, and these new players have the advantage of being able to invest in modern systems, without the need to cannibalize existing assets. Banks have not given enough attention to payments as a strategic revenue source, despite the sustained growth in demand for these services at a global level, which has also been surprisingly resilient to the economic downturn following the 2008 financial crisis. According to a study presented by The Boston Consulting Group[43] in October 2012, payments represented 13.5 percent of bank revenues from transaction banking in 2011, which in turn represented 47 percent of total bank revenues in the Americas, 38 percent in Asia-Pacific, and 32 percent in Europe.

Whether or not retail banks will decide to strongly compete in the arena of the evolving global trade corridors, which result in large amounts of payments flowing to new destinations, the payment hub (see Box 3.10) may seem an opportunity for banks to assess, and try to lead the market.

Box 3.10 What is a payment hub?

The payment hub model is an emerging concept that is gaining consensus among the most prominent consulting companies and software vendors. It carries the promise of radically improving banks' payment processing capabilities, as well as ensuring compliance to ever-more stringent regulations. A payment hub is a centralized structure capable of handling a wide range of payment services systematically, ensuring end-to-end payment processing in a highly automated way. The development of a payment hub is occurring due to the inability of current bank payment processing platforms to meet the growing needs of the payments market. Transaction volumes are growing rapidly across the globe and consumers and businesses alike are requesting more reliable and advanced services. A payment hub must enable payments origination from a large number of channels by implementing effective integration interfaces. Internal bank systems as well as external systems that generate payment instructions, must be seamlessly linked to the payment hub. Once a canonical payment object is generated a payment hub processes the payment through procedures that rely on inputs provided by systems in other departments of the bank, and it is crucial that they are linked efficiently by interfaces built according to modern criteria.

It is evident that technology enables the streamlining of the process of payments both foreign and domestic, providing a reduction in both cost and time in the facilitation of global business. What remains to be seen is the role that traditional retail banks will play in these intermediary services. It could be argued that unless retail banking institutions develop a value proposition that clearly demonstrates an added value in facilitating transactions, they will slowly be driven out of one of their most traditional services.[44] The mindset regarding this function needs to be changed from being ancillary to the other roles a retail bank plays such as credit delivery and risk management. Payments are not the Cinderella in retail banks, they must become an asset to develop and this is because the transaction is reflected on the customer statement and sometimes customers (both individuals and businesses) may manage their finances by exception not by the individual details. And this may pave the way to how a bank can manage this situation as the customers want advice on how to reduce expense and optimize cash flow. I believe this is a bank competency, which can be applied to every customer, according to each specific profile.

Another piece of retail bank business that is under threat is lending, with the incoming phenomenon of peer-to-peer lending. This is a practice of lending money to unrelated individuals, or 'peers,' without any financial intermediary. This lending takes place online in the related peer-to-peer lending companies' websites using various different platforms and checking tools; it is important to add that in most situations they are unsecured personal loans.

It is not a topic I am going to deal with in this text, but it is important to introduce the issue, as another form of bank disintermediation. The growth of the online peer-to-peer lending industry will have strong implications for the incumbent players in the financial industry. At the moment, the phenomenon is too young and small to represent a real threat or a real opportunity, but given the potential for positive feedback and given the easy selling points embedded in the peer-to-peer lending phenomenon (social endeavors, no banks, and so on), players in the traditional financial industry could witness a fast emergence of a new player. There are some elements that can make banks stronger than any other competitors, including their competence in assessing credit risks and the long lasting contact history they usually have with their customers (both individuals and businesses).

We are aware that banks should consider this, and look for opportunities to leverage their core competencies such as those related to some of the situations described below:

- In order to service a loan, this lending platform requires that lenders and borrowers transfer money to a specific account with can be held virtually at the lending platform. In reality, this account is usually not managed by the platform itself but this service is usually outsourced to a bank;
- In the same way as deposits, the transactions of payments from lenders to borrowers (beginning of loan) and from borrowers to lenders (on a monthly basis) are usually managed by banks which, with their IT systems, ensure correct and timely execution of the payment;
- There is also a need for secondary markets (which supply liquidity to the borrower): in order to set up secondary markets, legal requirements demand that lending companies create agreements with a bank. This institution indeed issues notes (backed by the loan itself) that are then traded on the secondary market.

If banks start looking for new market opportunities, then peer-to-peer lending platforms may represent an additional source of income to banks. There are probably more lucrative ways for them to benefit by this phenomenon, but the question is always how to react and leverage their own competencies, and re-assess the idea that banks have to start engaging consumers so that they adopt banking channels as the preferred and most reliable mechanism to support their lifestyle.

Retail banks have an extremely urgent opportunity to grasp, and this is to redefine the relationship between them, customers, and money. Retail banks have to come back to and be central in payments. And this can only be done if they include this issue in their strategic goals and develop it in more consistent strategic visions and plans. Otherwise, they are going to be disintermediated by losing customers to new market entrants that offer banking products at lower prices and with a higher value customer experience. In addition, banks will reduce their customer knowledge due to a reduced volume of interactions.

3.5 A roadmap to future customer-centric retail banking

A roadmap is something that details roads and transport links, and it helps travelers to end up where they want to be.

Retail banks have spent much of the time during the last decade squeezing costs out of banking more or less successfully. But now, it is

time to make order and get started on a development plan. This may require asking themselves what they want to invest in. And according to a given retail bank, here are some possibilities:

- Product and prices;
- Brand, service, fitness-for-purpose, price;
- Disruption and innovation;
- Risk management;
- Market awareness;
- Staff issues (recruiting, skills, competencies, rewards schemes, and so on);
- The service's consumer management (needs, acquisition versus retention, caring, loyalty, true relationships, word-of-mouth sales, service levels, market segmentation, process and components of relationship development, consumer empowerment, and so on);
- Strategy versus tactics;
- Investors;
- Payment infrastructure;
- Technological developments and game-changing technologies;
- Reframing financial product concepts;
- Multichannel versus omnichannel strategy;
- Customer information and knowledge management;
- Business process reengineering; and
- Outsourcing.

Whether it seems that each one is worth investing in, the thing is to focus just on a few of them; this means making one's own list and thinking about which goals are the most important to the bank and by when the bank wants to reach them (see Box 3.11).

Box 3.11 Where to start developing your roadmap?

What do you want to save or invest for?	By when?
1.	
2.	
3.	

Then you need to figure out the financial situation; to know what you own and what you owe, and these are your assets and liabilities. On top of this, bank managers need to summarize the strengths, the weaknesses, the opportunities and threats (SWOT), and its possible representation may look like the one presented in Table 3.3.

Given this picture, the major threat for a retail bank is to face a situation where there are important structural changes in the market; competition seems to call for it to reduce its cost structure, and it has to figure out the demands of new regulation.

If a short-term perspective is going to prevail in the market, then a major risk is that some of the retail banks may also neglect their institutional stature,[45] which is one of the vital ingredients of their corporate identity. And it is also their most valuable and strategic intangible asset for the future.

The term 'institutional stature' seems to be a little contradictory and this is because it is associated with customers' trust and banks' esteem. For generations, banks have skillfully commercialized trust by differentiating themselves through their institutional stature. On the other hand, it could also be a burden for banks, as they are not necessarily considered good enough at retail marketing and their attitudes and

Table 3.3 A SWOT summary example

Strengths	**Weaknesses**
Product range; ancillary services; price; IT; staff; flexibility; simple organization structure; design; brand; and others	Investments; market awareness; marketing costs; staff rewards schemes; legacy IT; flexibility; complex organization structure; organizational glue; don't understand customers; lack of flair; and others
Opportunities	**Threats**
Value awareness; true relationships; flexibility; whole relationships; developing bank specific methods; institutional stature; connectivity and convergence; and so on	Competitor fees; commoditization; short time to improve; staff issues; regulations; disruptions; connectivity and convergence; failure of model; time to profitability; can't compete on price; copying existing bank methods; and so on

organizations may not be capable of meeting the challenges of rapidly changing markets.[46]

I think these issues may change over time, when the consumer-centric perspective drives banks' strategic plans, and retail banks begin once more to increase their degree of engagement in their markets.

Especially on the local community level, retail banks have experienced some disengagement trends; and this might have happened as banks rationalized their branch networks to improve their cost effectiveness, and in the meantime there was an increasing supply of retail banking services through various options, such as front-line providers, channel providers, and gateways providers.[47]

This situation shows a potential vulnerability because a retail bank is a service organization, and it can undergo the dynamic changes in IT, which have increased competitiveness and the proliferation of new competitors.

Just think of connectivity and convergence, which are two of the most important trends in the market, impacting many businesses, including retail banking. There are many forms of convergence in the market: convergence of products – computer + phone = smartphone; convergence of technology – building technologies + automation = intelligent home automation; convergence of industries – space + energy = space-based solar power.[48]

All this is useful to outline another important issue, and that is that the value proposition of retail banks is at the nexus of technologically based products and service innovations. If this is true, then both corporate strategy and organizational structure have to be informed by the idea that the business is going to be dynamic and demanding as it evolves over time.

Even though technology is very important to banks, it is not a guarantee of success. In this situation not only a shift in the strategic focus seems to be relevant, but also a re-assessment of the role of business models, which are to be backed up with good offerings and clear positionings.

This means that there is an interesting correlation between battles and business models.[49] In this regard, technology is an accelerator, enabling the growth and development of new and innovative business models, which look similar because they need to offer value to many people as a consequence of their being technology

driven. Technology, in fact, enables banks to reach a large number of customers, with relatively minimal costs if well supported by large volumes[50] or small groups of customers with high trading-up value services.

Retail banks need to avoid undermining themselves[51] because otherwise they erode their institutional stature. This happens when banks underestimate the importance of their own institutional stature, which relies on the unique features of financial services – and this means the devaluing of value-added service – and on being considered as special intermediaries.

Self-undermining is an internal process; it may be a slow process, but it has the potential to creep up on retail banks without them always fully realizing it themselves. But banks also have the greatest potential to reverse the situation.

This situation may happen also because of some conventional measures, which can hide the true picture of the stability of a bank's customer base, above which the profitability of a business should be developed. An example may be that of the customer loyalty issue, which can be misinterpreted if it is measured in terms of the defection rate. A low defection rate may mask the fact that many retail customers leave behind dormant accounts when they switch to new banks. With this in mind, it might be better to study the 'share of wallet' indicator than the defection rate.

The erosion of a bank's institutional stature might come from structural changes accruing in the market, and it is worth recognizing these.

Such structural changes are a mix of mergers and acquisitions, and again technological changes; both can be considered as external processes, in which the banks have only a limited ability to intervene.

Finally, these trends are leading to an increased fragmentation both on the bank–customer relationship side and on the market offerings, where the choice is as bewildering to the service provider as it is for the customer (see Figure 3.6).

3.5.1 The starting point

If, as previously mentioned, a roadmap is something that details roads and transport links, and if banks have to grasp their opportunities, there are some roads they should follow:

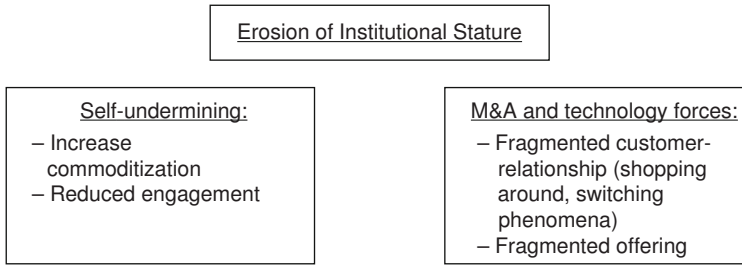


Figure 3.6 How retail banks may erode their institutional stature?

– Cultivate and develop, according to the present market situation, their institutional stature;
– Differentiate themselves more clearly from the influx of new providers, also because if they all follow the same track, then the growing similarity in business models may increase the vulnerability of the banking sector as a whole;
– Select their own strategy; and
– Develop their own business model as long as they are consistent in their design and implementation processes. This is relevant because business models reveal the story behind the balance sheet, which need to work on the quality of their earnings.

And regarding the transport links, the most critical are the followings:

– Figuring out a new organizational structure that is reactive, flat, and flexible;
– Positioning both the bank and the offerings consistently with the market vision and mission;
– Increasing employees' engagement; and
– Developing a review process about the effectiveness of some key performance indicators in use.

It would be a surprise if anybody were to 'discover' an overlooked factor (or, indeed, more than one) with massive potential that banks were not already aware of. Nobody will, and nothing written in this book is new to bank management. However, my intention is to set out to look for a broader picture of the market and the bank so as to step improvements that should be pervasive, benefiting both banks and customers.

'Pervasive' is an operative word since this involves all aspects of the bank and its customer relationships (both with individuals and businesses). And this brings us back to a consideration and assessment of bank processes as a crucial point of departure for increasing competitiveness in the market.

Part II

Controlling Consumption and Engaging Customers Seems to be the Issue for Every Retail Business

Introduction

Increased competition has been an issue in banking for years. As a consequence, bankers all over the world have focused strongly on attempts to improve their cost/income ratios. They not only experienced competition from industry peers, but they also faced increasing competition from unregulated 'non-banks.' For example, many large corporations are increasingly carrying out their banking business 'in-house.' In the UK: Sainsbury's, Marks & Spencer, and Tesco are all now taking deposits as well as making loans to their retail customers. Specialized companies are also targeting the markets for credit cards, mortgages, and the leasing of certain kinds of equipment.

The central point is that the fixed costs of entering these markets have come down with advances in technology and many financial services can now be produced by specialized providers very efficiently and at low cost. These companies have also extremely well-known brand names, and this gives them a further competitive advantage. There are also non-financial firms that control communications networks, and the gateways to them, which could act as 'brokers' for customers, directing them to the most suitable product for them. In this situation, the role of broker rather than the ultimate producer of the product, which can also be a bank, is increasing its reputation. At the very least, this process will squeeze the margins of traditional financial service providers, reinforcing the loop toward the commoditization process. The more these non-financial firms develop transactions and relationships with their

customers, the more they could use all this to design new services themselves so as to compete in the market. Given this, the war for customers is going to be for serving them better and gaining their trust. Moreover, in this contest where much is going to be digital, and everything seems to reach crystal clear transparency, there is a new modern customer growing up. Thus, retail banks should start looking to develop their own customer-centricity, through which to not only engage the final customer but also to enroll its workforce in this process. If this is the scenario, then the possession of a brand name to inspire confidence will become ever more important as a marketing tool for retail banks too. This is a form of competition now being developed by many retailers who have realized the business they are in, is that of 'being chosen by customers.' And that is what this part of the book seeks to outline. Retail banks should start managing their customers' expectations, and in doing so they should understand that they have to change; but if change is good, to be different in their market is going to be better.

4

Winning the War for the Modern Customer

*A guest chapter by Martin Butler**

Fundamentally, people don't buy what you sell; they buy what you stand for.

This is because whatever you sell these days can, broadly speaking, be bought elsewhere. And even if it can't be bought elsewhere at the moment, it won't be long before it can. This means the most successful customer-facing business models are now built to acknowledge the simple truth that now, as never before, people have real choice.

So, to attract more of the world's increasingly discerning customers and incidentally, more of the world's increasingly important talent, the world's most successful companies understand *what* business they are in. Adopting the holistic mindset of being in the 'business of being chosen.'

To understand how to be chosen by more customers, more often, the world's most successful organizations know precisely *why* they exist (their purpose) and diligently celebrate this fact at every opportunity. Indeed, it helps them recognize what a good decision looks like when presented with options or the need to find solutions to challenges. These days it is with this scrupulous attention to purpose that the more progressive, more successful businesses view shareholder value as an outcome, *not* a purpose.

Interestingly, the truly successful modern businesses are now focusing increasing levels of energy shifting their emotional center of gravity to

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customer contact points (which importantly includes multi-channel). *How* they do this differs company by company, but one thing remains constant. They are not simply talking about putting the customer at the center of their orbit but doing it. Building and wrapping their businesses around their customers in a highly emotional, highly differentiated, and forensically smart manner.

Based on personal research and observations, this guest chapter, with the aid of two case studies,[1] will take a brief look at *What, Why,* and *How* the world's top performing retailers are winning the war for the modern customer.

Interestingly, the reader may find themselves asking the same question I have been asked many times. 'Why didn't one of the major retail banks feature in the book?' And if I may, I will make a simple and respectful response, please read this chapter.

4.1 What

So what business are you in?

Whether it be at a business school, conference, or corporate mindset workshop, I often start the sessions by asking my audience to stand up, and to only remain standing if what they sell can't fundamentally be bought elsewhere. After a few seconds and a bit of shuffling around, deep thinking, or peer pressure, the audience starts to sit down. I then help any remaining people to sit down by reminding them a little black dress with a *unique* bow, a washing machine with an *exclusive* wash cycle or an accountant with a *proprietary* accounting process is not selling anything fundamentally different. From a customer's point of view, they are selling a solution to something they want or may want, with the inconvenient truth to the seller that there are many other places the customer can go to broadly satisfy that need or be inspired to buy something very similar, if not identical.

A little black dress is a little black dress, and there are lots of different ones 'to die for.' A mortgage is a mortgage; a tomato is a tomato. Indeed, the really inconvenient truth is if what you're selling *is* truly unique, you can be sure it won't be long before it's copied in some guise or another.

So, I then challenge my audiences to embrace the concept that success in business comes from adopting the holistic mindset of being in a permanent state of 'being in the business of being chosen,' in fact, *embracing* the idea that they are in the business of being chosen, whether their expertise is in fashion, or finance, or food, or whatever.

Human beings

I can't remember where I heard it first (probably Steve Jobs), but I love the whole thought that not enough businesses acknowledge their customers are 100 percent human beings. I think it's why I hate the literal translation of 'consumers' and always implore the people I work with to refer to their target markets with warm, rich definitions, such as customers, or clients, or even 'guests' as the famous Target store group puts it. In the UK, the remarkable Justin King led Sainsbury's miraculous recovery back to supermarket eminence by calling everyone 'colleagues' because they were all in it together.

On the other hand, I remember hearing that one particular financial organization referred to 'revenue earning units' when talking about its customers. I'll leave you to make up your minds about the corporate mindset that thought that was a good idea to use this descriptor in winning the war for the modern customer.

How much better it is to develop a corporate mindset of being in the business of being chosen, famed for a particular expertise, acknowledging that you are dealing with human beings, and acknowledging their attendant feelings and nuances. Quite simply, you have to earn the right to serve customers, and the most successful companies make this apparent in all their thinking and actions.

Being in the business of being chosen is a really simple idea, but it's not simplistic.

Looking backward

I've always been fascinated by success. Lots of people are.

But I remember looking out of my bedroom window above my parents shop as a child and wondering why certain people came in and others didn't. And I also remember wondering why my parents placed so much importance on what they sold last year. *What's that got to do with today or even tomorrow?* I would muse. Why, just because someone bought a liter of white paint on June 7 last year would my parents reasonably expect someone to buy a liter of white paint plus 6 percent this June 7? Or, stranger still, why would someone else be expected to come in and buy that same liter of white paint plus 6 percent this year?

It wasn't until I realized that business is judged by financial experts whose lives are dedicated to looking backward (comparables or like-for-likes or whatever fancy title they decided to give this pastime), that I truly understood just how ridiculously simplistic this thinking is. Life, and in turn success, doesn't work like that. We are dealing with customers who

are 100 percent human beings, and it's the great leaders that appreciate this who are winning the war for the modern customer.

What do great leaders do or think?

In an attempt to answer my boyhood fascination with success and to understand why customers choose to enter any given shop or not, I decided it was time to do some more research.

With the support of the World Retail Congress and a grand ambition to interview the best-of-the-very-best retailers, I decided to poke my nose into 100 of the world's top retail operations. Over two and a half years, I traveled two and a half times around the world, insisting on only speaking, face-to-face, to the boss or founder of these famous retail companies. To ask them what was the key to their success. It was fascinating.

My questions were centered around one simple, yet big question: what single initiative have you been responsible for that has had a profoundly positive effect on your business. I received 100 different answers. Unsurprising, given the world we live in, and 'retail' in particular. It's all about human beings. But I also noticed that each of the 100 answers seemed to cluster around six key centers of gravity. Rightly, many of the answers overlapped at the edges, and certainly none were mutually exclusive. But as an individual never frightened of hyperbole, I decided that in the business of being chosen these six centers of gravity should be called my *Secrets to Retail Success!*

Is there a success gene when you want to be chosen?

I'm often asked if there is a retail gene. A 'success' gene for customer-facing business leaders? And I'm delighted to say, yes. Without fail, all the really successful leaders I've ever interviewed are exactly the same. They all want to be different. They are all driven to deliver sustainable difference as often as possible and with as much impact as possible.

The reality of modern business life and the essential understanding for winning the war for the modern customer is that the really successful leaders not only want to be different, but that they are far more concerned with the careful stewardship of other people's emotions than simply buying and selling stuff. These leaders first and foremost spend their time making sure their workforce get and understand the bigger picture. How the business is going to be chosen and then, and only then (and with the utmost humility) try to understand what might motivate shoppers to choose their business – and, yes, in that order. Internal customers before external customers – *non-negotiable!*

It's simply common sense that if your workforce (or internal customer) doesn't understand why and what they need to do in order to be chosen, you can hardly expect your external customers to 'get it' and choose your company. It's the reason I refer to the internal customer as a business's most important customer ... and this still fits with the often used and seldom executed expression: customer-centricity (a subject I'm currently researching for my next book).

Emotional edge

With the apparent exception of the people responsible for producing a business's financial accounts, complete with year on year expectations and comparisons, we all appreciate that customers need a reason to choose because experience dictates people don't visit a business and buy something each year just because it's there or because they did it last year, especially if what you're selling can fundamentally be bought somewhere else.

So, if you're looking to win the war for modern customers, and what you're selling isn't particularly unique, then the *way you sell it* had better be.

What I learned from the world's great retail leaders was that winning today demands that both sets of customers – internal customers (workforce) and external customers (shoppers) – need to be emotionally and individually engaged, and as I said earlier, with the all-important internal customer engaged before the shopper. In the really successful companies, being chosen is not just a corporate ambition for the external customer but had to be a personal ambition for every single person working for that business (internal customer) because they always needed to be chosen first by the shopper before the business they represented could benefit from the transaction.

My expression of what needs to be offered to external customers to help them choose a particular retailer over another is best summed up by the strange confection of words: *emotional edge* (my laptop always tries to correct this because it's not grammatically correct).

I really like 'emotional edge'

It deals with all the softer things associated with human beings, their emotions and behavior. At the same time, it speaks to all those people who hate what they consider to be the fluffy things in commerce, keeping them happy with a hard, harsh component that feels like you can measure it. (Maybe even year on year ...)

Looking for and finding an emotional edge is never easy. It puts a commercial imperative on the all-important softer things that help customers choose one particular business over another. At the same time, by the very nature of the expression, it means companies understand they must indeed strive to find an 'edge' that embodies emotion if they are to own a competitive position in the hearts and minds (in that order) of customers.

Which neatly brings us back to successful leaders: their need to be different and their obsession with the careful stewardship of other people's emotions. They are all united in looking for *emotional edge*.

Change is good, being different is better!

It's also worth remembering the really successful leaders don't suddenly wake up one morning and start measuring themselves, or their success, against their competition. Most businesses were founded by being different, and the truly successful constantly strive to be more different in every way, every day. I love these companies. And more importantly, so do customers. And remember by that I mean internal as well as external customers. A profitable status quo is no place to hide in the war for winning the modern customer. Or as I love to challenge: *if it ain't broke – break it!*

4.2 Why

The purpose of purpose

In a previous work,[2] I found that the really successful businesses have a well-articulated and almost fanatical understanding of their sense of purpose – often neatly expressed as an authentic reason why the business exists.

It may not be classic business book doctrine and may even be something of a chicken and egg circular argument, but during my research conversations, I felt many of the world's top retail leaders believed first and foremost they were in the 'business of being chosen' and that the purpose of their business was then used to focus and guide strategy. Indeed, using this purpose to answer the age-old question of why the entire business gets out of bed every morning. Or more accurately, defining what the entire business aspires to achieve during its existence; as Steve Jobs famously enjoyed asking, 'What wrong are we trying to right?'

So for most of the businesses I interviewed, there was broad agreement that they were in the business of being chosen, and that they felt they would be chosen by more customers, more often, if the entire business

had a well-articulated and heartfelt purpose. But clearly start-ups or entrepreneurial organizations often do things the other way around, and this has enormous superficial appeal. They start with a massive dream or purpose – it's how most businesses begin. They believe passionately that if they execute their dream well enough, they will be chosen by enough customers to make a success. With each one free to define what success might look like to them.

A useful sense check

I don't claim to understand why more small businesses fail than succeed, but I'm often asked as a former small business owner myself why this might be. And the clue to this became evident to me many years ago whenever I bought or acquired struggling businesses to join my group structure. I always found that the passion and enthusiasm for what was trying to be achieved was not always matched by the cool and clinical mindset of asking why a customer might choose their business. I believe more start-ups would succeed if more used the sense check of being in the business of being chosen, first and foremost, and then overlaid this with their grand dream or purpose!

But for this particular guest chapter, let me straighten the circular argument and concentrate on my findings on the type of businesses I interviewed: existing corporations looking to drive success to the next level. Most of them appreciated they were in the business of being chosen, and most were then looking to reinvigorate and celebrate their authentic purpose. What was interesting was that their purpose often coincided with their business's emotional edge, but not always.

The heretical view of success

A profitable company is a successful one, right? Not necessarily.

Recently, there has been an interesting shift in thinking on the whole subject of profits in the modern era. Several people I interviewed told me that they now believe shareholder value must be regarded as an outcome rather than a purpose. Heresy or not, there's a lot of talk about this. I'm no expert, but there's an emerging argument that if we are looking for direction on the subject of profits, we need to reflect on the wise words of the Dalai Lama to put things into perspective, 'If a company loses money it dies as does a person without food, but does that mean that the purpose of life is eating?'

So, is the reason a company exists simply to make money? There seems to be a stirring deep down in the minds of modern customers that the businesses they do business with need to have some sort of higher

purpose – not the spiritual sort of higher purpose but the holistic sort. And it wouldn't be the most stupid thing in the world to have some form of first-mover advantage just in case these stirrings gain exponential traction. Corporate Social Responsibility is not what I'm talking about. It seems these days to be more about a reason for the business's existence.

Who pulls the plug?

The old adage that it's very difficult to serve two masters seems to shed light on the evolving conundrum. The really successful companies now have an ambition to serve their customers first and investors second. Yes, I hear you say, but only until someone pulls the plug!

True, but it's worth remembering that plug can be pulled by the customer first.

And as the world slowly recovers from the global financial meltdown and a new set of customers takes over from the old, we see huge changes in our customers' mindsets. *You have been warned!* Based on current trends, businesses that are thriving are those who truly, deeply, love, listen to, and understand their customers first and foremost. (And have investors who appreciate this.)

Certainly in the USA, 'Conscious Capitalism' is a movement that is becoming increasingly important to customers and businesses alike, as well as – and importantly – to enlightened investors!

Who are these modern customers?

The Internet has been the death of distance and the birth of crystal clear transparency fueled through accessible information. It has also seen the end of the ill-informed customer and the beginning of customer unions happy to flex their power. And it has changed the lonely shopping mission into a shared experience, especially for the young.

In turn, as online shopping comes of age, it offers untold opportunities to make life easier and faster for customers. The effect has been so profound that many believe the future of retail will be local, with students of the subject agreeing hyper-local will be the way forward. I will touch on this later (emotional precision), but the key issue modern retail must acknowledge is that big is not so beautiful, scale and ubiquity no longer equals success, and the various channels to market in a retail business need to have their silo walls demolished. Building on this point, the remarkable Jon Stine of Cisco insightfully argues they must now be viewed as channels of influence. Whether it's researching online and buying in store or vice versa, or click & collect or show-rooming or

endless aisles and so on, each channel must be used to influence and support the others. With each channel used to influence and close the sale – channels to market are not mutually exclusive.

Astonishing prescience

Massive by anyone's standards, the world of food retailing is undergoing a tectonic shift. This was pioneered by an ex-client of mine and now good friend, David Simons, who was one of the first UK retail bosses to recognize and embrace the idea of proper neighborhood food shopping. Now, 20 years on from his astonishing prescience and aided by online shopping, families are rejecting the notion that fortnightly expeditions to food shops is an efficient and enjoyable way to spend alternate Saturdays. Modern customers prefer to shop online and even pay a small charge to get replenishment items delivered on a specific day, at a guaranteed time. Leaving modern customers free to pick up fresh, inspiring food as suits their mood on the way home from work or from school with the children or whenever. A customer verbatim quote from research I was involved in sums this all up succinctly: 'I don't know what I want for supper on Thursday evening, right now it's Saturday morning!'

There is a new world order, and customers are in the driving seat. And it's not the driving seat of a four door forklift truck in the parking lot of a food hypermarket on a Saturday morning.

What bit of easy don't you like?

So how do you win the modern customer? Let's look at the signals that are already out there and put them under the spotlight. Modern customers want it all. They want outstanding value; they want outstanding product. They want an outstanding and enjoyable experience, all this and online too. But what they really want as the world speeds up is things fast, and when given a choice, they want life to be easy. Really, really easy.

Making something simple is not the same as easy. We must strive to make life easy for our customers (internal and external by the way). And for me, easy is simple with emotion attached. There are plenty of procedures that are simple but not easy – like asking a click & collect customer to simply present a piece of paper in store to the check-out person and to then wait for the pre-ordered product to be found. It sounds simple, but in reality the customer has to stand in line and then wait. How much better it would be to have a unique pick-up number that unlocks a beautiful cabinet with your chosen item inside… that's easy! That's what Amazon is now offering in many markets to make life

as easy as possible for their customers. There will be Amazon pick-up lockers at gas stations, shopping malls, railroad stations, wherever is easy for the customer – you have again been warned. *Do not confuse simple with easy!*

Modern customers also expect the companies they emotionally connect with to have a really compelling emotional edge that is robust enough to flex over time, ensuring the reason for choosing remains compelling and relevant.

Success breeds success

Customers love being associated with success, so they want their favorite and chosen businesses to thrive and be seen to thrive.

But the feedback I get suggests they'd like them to thrive as a result of a real, authentic passion, not a manufactured, superficial presentation. (That's why I have a problem with the expression 'retail theater' – it implies acting. To me it should be called something altogether more authentic and emotive, but this is a huge subject for another time.)

Success for customers means their chosen businesses delivering something better than anyone else. Indeed, doing it so well they are eager to be associated with it. If a customer's favorite business makes lots of profits in the process, all well and good. But modern customers need to feel part of the process; they want conversations, not one-way presentations. They want news not facts (when was the last time your internal customers were given a piece of 'killer' news to really excite external customers?). The really great retail leaders talk about the story their businesses tell and how their point of sale romances the customer. This is why social media –when used properly – becomes such an essential and effective tool.

So, is social media the answer to winning customers? Absolutely not. It's just a mechanism. Just part of the emotional armory in the war for winning the modern customer. But it is certainly becoming an increasingly precise tool for engaging customers both on a qualitative and quantitative level and is paramount if a business is to enjoy success.

And by the way, any business that is interested in its customers and hasn't already totally geared-up for smart phone formats shouldn't have got this far in my chapter!

4.3 How

As special as possible

In order to be chosen by more customers, more often, the key objective is to make those who are choosing a business feel as special as possible.

And here I have found there are two significant parts to delivering emotional edge. There are certainly more, but for the sake of brevity let me just concentrate on the role of *emotional precision* and e*motional parity.*

Emotional precision

The more precise a business becomes in executing its emotional edge, the more competitive it will be.

But first I'll address the question that I'm asked most. What role does price play in the business of being chosen and the ambition to be emotionally precise.

Rightly, there's always a lot of talk about price, and its huge appeal in being chosen. But broadly speaking, unless you're trying to be the cheapest business in the market (usually but not exclusively an online operator due to lower overheads), I have found that most competitive businesses simply try to neutralize price. They do this either with a price promise or alluring discounts. Some even talk about value rather than price and others make high prices a reassuring signal. In many cases, businesses resort to any combination of any of the above.

Often referred to as a hygiene factor, price always needs to be addressed. But I have found that provided a great product is available for sale and price is as neutralized as possible, a well delivered and executed emotional edge will cut through and deliver the best chance of success in the war for the modern customer. I refer to this as offering 'new value.' Rather than the old definition of value: price versus quality. I often hear and agree with the idea of the new value equation: what I get versus what I pay…where what a customer gets (quality, quantity, and experience) and pays (price, time, and emotion) acknowledges the softer more differentiating qualities of the transaction.

New value helps customers give permission to themselves to feel differently about the absolute cost of something.

Walking the talk

The humble pizza: it tailors everything to the individual's tastes. That explains its enduring popularity. The businesses that are really enjoying huge success are those who not only talk about listening to customers but actually act upon what they've heard. These I refer to as *emotionally precise* businesses.

How compelling is the proposition of a retailer who not only sells training shoes but personalizes them by 3D printing insoles from a scan of your feet? And how emotionally attractive to a woman is a pair of

shoes made to her own precise vision from a selection of designs and fabrics and offered at a great price? Beautifully

boxed, and delivered to her home with a no quibble guarantee? That's what a wildly successful Australian online business called 'Shoes of Prey' does.

These examples make a customer feel very, very special indeed, and it's called customization or mass-customization. And we can all agree this type of product offering is near the extreme end of the spectrum when delivering emotional precision. However, not everyone can produce customized products (you'd be surprised what actually can be done these days). But in an attempt to make their customers feel special, there are many retailers around the world who listen deeply to their customers to deliver a form of customized offering (see case studies at the end of this chapter).

Emotional parity

Only two jobs

When interviewing Len Roberts, former boss of the gigantic US retailer Radio Shack, he made a disarmingly simply observation. He said, 'you only have two jobs in my company: one, you either service the customer directly or two, you serve someone who does.'

Whether he was or wasn't the first to utter this succinct piece of thinking matters not.

For me, it was the intensity in Roberts' eyes that made me realize that in these few words could make the difference between success and failure in modern customer-facing businesses (and remember we are talking internal as well as external customers here).

With an increasing need to listen and act on what customers are saying and thinking, the most successful businesses are shifting their emotional center of gravity to the all-important customer contact point – and that includes online. We are not talking about an intention to listen and act, we are talking about embedded imperatives that are designed to make this happen within a business (as in the case studies).

In the business of being chosen, it makes simple common sense to celebrate the vital importance of the contact points a business has with customers. Besides all the free research and feedback that can be gleaned by listening to customers, there must be an acknowledgment that this is how and where a business brings its emotional edge to life. As my colleague and friend Alistair McGeorge argues, 'even if you don't "do" emotion – and you should – please remember there are no tills in a head office!'

Head office closures

As I travel the world, I'm still amazed at how many head offices are still leading the fight to win customers. For me, the more enlightened businesses have all closed their head offices. They have rejected the whole notion of command and control, instead opting for Len Roberts' mantra of having a support structure to support all the points where external customers are served by internal customers: shops, phones, websites, and anywhere else the business touches those who may choose it.

The more successful companies now have support offices (or centers) rather than head offices. The terminology reminds those who are not serving customers directly, that they are there purely to serve those who are! Reminding and nudging them every time they walk through the front door of their office that their sole job is to support the people who are in direct contact with the people who are free to make a choice where to buy.

Equal in endeavor

And for the record, it's OK for a dynamic, experienced, highly-paid, and hugely successful retail boss to faithfully serve a new, 18 year old, part-time Saturday shop assistant. The word 'serve' is there as a powerful reminder, a powerful tool, of how modern business should organize its protocols. Emotional parity must be embedded as a strategic imperative to win the war for modern customers. Remember, even the president of the United States, currently the most powerful man on the planet, appreciates he is there to serve his constituents. So no matter how respected someone is within their own sphere of expertise, the sole purpose of everything that is done in a support office function is to serve someone who is serving an external customer directly. *Full stop*. Gone are the days when a store visit meant someone grandly arriving from head office, standing on a shop floor, enjoying the smell of fresh paint, and expecting the staff to gather around and hang on their every word as if in the presence of greatness. Rather, these days, for successful businesses, a site or store visit is a wonderful opportunity to relate and to learn from those who are respected for their understanding of why another human being is choosing to buy (or not) from their shop or website or whatever. In turn, it is a wonderful opportunity for the frontline workforce to understand and comment on how they are being supported (or not) by the support functions.

The key here is in the appreciation and acknowledgment that those who serve directly, and those who serve them, are both equal in their endeavor to be chosen. I can't emphasize enough the importance of

a true understanding of emotional parity in the business of being chosen.

4.4 Summary

So, is winning the modern customer a war? Absolutely. I may have used gentle words like 'choice' rather than 'kill,' but the effect is exactly the same. No business will survive without a well-articulated and well-understood strategy that's precisely constructed, emotionally differentiating, and relentlessly relevant. It needs to adopt a mindset of being in the business of being chosen and needs to fully understand its purpose. Trading went out when the Internet came in. And the leader of a customer-facing business is now more important than ever. Their enduring and passionate commitment to a corporate mindset of *being chosen* must be permanent, obvious, and a beacon for long-term success, never misunderstood as another short-term initiative. They must love and aspire to being different, love and aspire to emotional warfare, and love and aspire to connect with their customers at every level (and, yes, that means both internal and external customers).

Simply put, leaders these days must love human beings. And you'd be surprised how many leaders don't. There's been a major shift in power, and customers are in control as never before. Loyalty is now very short-lived. There's a lot of talk about trust and rightly so – you can't possibly be chosen or continue to be chosen if people don't trust you. But it's the signals that a business puts out that earns trust, not words or intentions. To be trusted, businesses have to reach the part of a customer's brain that affects behavior, not just complex thought. And the signals that do that have much to do with projecting a profound sense of belonging for customers (and, yes, again, both internal and external).

Nowadays, a business has to earn the right to serve its customers – or it's dead.

Case study 1[3]**:** Under the phenomenal leadership of Terry Lundgren, the world's largest department store group, Macy's, has enjoyed a remarkable renaissance. My vocabulary may have changed over the 4–5 years since I interviewed Mr Lundgren, but this is a perfect exemplar of a mindset that acknowledges Macy's is a business that's in the business of being chosen. Macy's success continues to this date. Not only is the business emotionally precise, engaging its audiences with local intelligence and actions (like never before), but it acknowledges and celebrates the importance of emotional parity with a beautifully crafted and well-performing strategic imperative.

Terry Lundgren, Chairman, President, and CEO of Macy's Inc

Interviewed, March 2010

Ownership is key

Macy's Incorporated, the parent company of Macy's and Bloomingdale's, is the largest department store group and largest mall based operator in the gigantic North American retail market.

But as Chairman, President, and CEO, part of Terry Lundgren's vision is to be chosen by thinking as small as possible.

The Macy's brand accounts for around 90 percent of the parent company's US$23.5 billion turnover and just over 800 of its 850 stores. As Lundgren explains, this iconic mid-market department store chain is embracing monumental change attitudinally and operationally. 'Over the years, Macy's has grown organically and through regional acquisition – we've more than doubled our size, become truly national, and consolidated our operations to leverage scale. Right now, we have just one central operation handling merchandise, planning and marketing functions. It's more efficient, quicker and ensures key talent is in one place: New York City. The rationalization made perfect business sense, but I was determined not to lose 'local relevance.' So we created a program called: *My Macy's*.'

Having worked in retailing through college and university, Lundgren became a career retailer. After just 13 years and at age 35, he was the youngest ever CEO of Bullocks Wilshire, the renowned California-based upscale department store group. Clearly a natural retailer, he is a polished and charming individual. Openly relaxed, he's a bright and phenomenally successful leader. Enjoying a varied retail career, he departed Niemen Marcus in 1994 as Chairman and CEO to join Federated Department Stores, eventually taking the helm in 2003 and changing its name to Macy's Inc in 2007.

My Macy's is a massive logistical challenge. It's taken almost three years to execute. Besides closing down the individual headquarters of more than 75 businesses acquired over the years, Lundgren and his team have recently closed their own regional business units too. But to deliver Lundgren's 'locally relevant' mantra, a unique clutch of customer-centric intelligence units have been formed. An enthusiastic Lundgren explains, 'what we've created is 69 districts – because that's how many we needed! Each strategically located and staffed by a small team of 18 or so executives ... mostly former regional and national buyers and planners. But we were fortunate, it was funded from our rolling consolidation process – we ended up with incredibly experienced, locally based, merchandise

executives focused purely on the customer base of just 10–12 stores – we've never had that before. This structure doesn't exist in retailing to my knowledge. Certainly not in the United States. So imagine, while we have one central buyer in NYC for, say, men's dress shirts, there are 69 district merchandisers and 69 district planners who specialise in men's apparel. Each *qualified* to help and *advise*, each visiting their stores every week, in communities where they live, in markets they understand. Each feeding back highly localized intelligence in real time, through dedicated channels and technology.'

For the early days of the *My Macy's* project, Lundgren talks in glowing terms of like-for-like tests delivering a substantial, three percentage point positive differential for the new districts when benchmarked. 'However you cut it, stores served by the "district units" performed best. And there's no doubt *My Macy's* is changing our merchandising model too. Instead of a push mechanism for merchandising as in the past, pushing down from central ... it's now a pull system. While there's a basic inventory that will satisfy the needs of customers in every market, there's now a substantial change in the 'size detail' of how merchandise deliveries are packed for individual stores. We're seeing major differences in the color and the weights of fabric, substantial shifts between classic and contemporary ... and while we had a general idea before, it was usually our big stores taken care of first and the little stores barely getting their voices heard. Now I'd say it's the smaller stores that are the biggest beneficiary so far in this programme.'

But talk of 'push' and 'pull' can disguise the emotional benefits of *My Macy's*.

Imagine the very real engagement enjoyed by the company's 100,000+ sales associates when interacting with their district executives. Lundgren quotes an example from a recent store visit, 'the famous rapper, Diddy has a unique suit range, Sean John. It proved a massive hit when a district merchandiser brought it to the Pittsburgh area. Although his colleagues in Palm Beach or Boston would never entertain the idea, he knew this type of suit style would sell in *his* stores. They did, his sales associates in the stores thought they'd died and gone to heaven ... at last their voice was being heard and responded to ... they're very, very excited about it. Imagine too, the extra commitment when selling *their* requested merchandise from *their* district executive. Only the other day, another sales associate said to me: "Man, I asked for it, somebody finally listened and gave it to me, and now I'd better sell this stuff."'

My Macy's is acknowledged as a great engagement opportunity having brought about a major shift of emotional ownership for the associates. To formalize this, a log-book protocol has been developed where associates can formally request merchandise and variances. 'There's a 48 hour

deadline to respond to requests and an imperative to say yes. Central executives are questioned harder when rejecting a local request than when accepting them – I'd like to think we say yes first and no, only as a last resort. Interestingly, even though 95 percent of the buying decisions are currently centrally based, to be honest, the central buyers and planners are still finding it a whole new game. They're used to being in control, but we're getting there – the benefits are obvious,' confides Lundgren.

And the benefits of being 'locally relevant' are obvious to customers too, but there have been some surprises. Lundgren again recounts his recent visit to Pittsburgh where a local, much-loved 80-year-old company, Betsy Ann Chocolates, was going out of business. 'The local Macy's team rallied round and ensured that a concession opened in its store. It was front page news in that city because it mattered to local people, which made it good news for us too. Betsy Ann Chocolates sold phenomenally well, but we can't sell them elsewhere – they wouldn't be relevant. But that doesn't matter. If it's important in that market, it's important to us.'

And that's what *My Macy's* is all about.

There's nothing new in an aspiration to edit merchandise like this. But when you're one of the largest retailers on earth, specializing in the ruthlessly unforgiving world of fashion and home apparel, intentions can be easily lost in implementation. Getting customers to choose you isn't just a numbers game, it is about empathy.

And Lundgren understands this. That's why he has ingeniously crafted a customer-centric business model that demands 'local relevance' no matter how large his store estate.

Eloquently, *My Macy's* engages both workforce and customers by encouraging brand ownership. It's a perfect piece of joined-up retailing – and proof you can never be too local.

Case study 2[4]: Zara is the breath-taking global fashion sensation from the Inditex stable of brands. As with Macy's, you will note the precise nature of the grand ambition to make customers feel special. But in this instance, you might argue the business moves a touch closer to part mass-customization even though the (external) customer doesn't realize it. As would be expected, emotional parity offers the business an important part of its emotional edge and is rightly embedded at the very heart of the business because that was at the heart of the founders dream. Zara continues to be chosen despite increasing competition and has now grown to almost 8,000 stores in 80 countries.

Jesús Echevarria Hernández, CCO, Inditex (including Zara)

Interviewed September 2009

Obsessive listening

Many talk about giving customers what they want – few deliver.

But Spain's fast fashion powerhouse, Inditex, has become a global giant by doing just that.

These days, it's the norm for main street fashion groups to swiftly replicate catwalk designs. But it's debatable whether anyone other than Inditex could be chosen by 'picking-up' on a few customers' requests for a certain cut or color tone. Have them designed, manufactured, and transported from Spain to anywhere in the world in less than three weeks. In fact, Inditex pays such attention to live sales data and customer feedback that typically 50 percent of the much adored, Zara fashion collections evolve and adapt during each season.

In immaculate English, on behalf of the group's founders, the CCO, Jesús Echevarria Hernández proudly explains the group's *listening and rapid-response* ethos. 'Maintaining frontline customer-centricity across our 4,300 stores in 73 countries is central to our group's success ... the company's founders are obsessive about this.'

'From the very beginning, every day, the thing that drove this business was talking to the stores and asking: what's liked? what's good? what are customers asking for?' Echevarria explains. 'Today, this type of qualitative feedback is a formalized procedure, reliant on a powerful *triangle* of three key roles: store managers, store directors (who effectively manage regions), and the commercial team based at head office. At each of these three levels, conversations are taking place with customers, and feedback is streaming its way to IT-linked merchandisers, marketers and 250 fashion designers at head office.' Echevarria says that store managers love this role and perform better as a consequence. They know they are an essential part of the Zara fashion-driving process. Rightly, they have a degree of autonomy when ordering and around 80 percent of initiatives are set up internally by the individual stores.

Germane to the business and arguably unique, Inditex does not publicize its collaborative customer model. As Echevarria explains, 'If customers want to share something with us, they are most welcome, but we do not promote it. We want it to happen spontaneously; we want our teams to 'pick-up' on things. That way we are managing expectations and the process too. *Listening hard* is a better way of describing the relationship.' Like so many great retailers, Inditex is effectively making use of the valuable market research their customers give freely. Then reacting quietly and swiftly to what they've heard, delighting their customers.

Now the world's largest fashion retailer by sales, Inditex grew from famously humble beginnings in La Coruña, North Western Spain. As a

young retail sales assistant, the budding entrepreneur Amancio Ortega Gaona always believed people didn't listen enough to customers. So he and his family borrowed the equivalent of 90 euros in 1963 and, having bought a sewing machine, started manufacturing garments including bathrobes – absolutely fixated on giving customers something better. Studiously monitoring customer feedback, they soon developed other lines and found their products becoming increasingly popular.

But over time, the Ortega family realized their lovingly designed and produced goods were not always merchandized with the same degree of care and attention. So in 1975, the first Zara store opened its doors. The merchandise was presented exactly as it should be. By 1980, there were five stores within a 100km radius of La Coruña. 'Their factory was producing for these five stores and delivering new garments twice per week – the same philosophy that applies to this day,' says Echevarria. 'Today, every one of our 4,300 stores around the world receives new merchandise twice a week, quickly replenishing or responding to design inputs. Just as it was in the beginning, it's a quantitative as well as a qualitative reaction to the information our stores give us from their daily conversations with the customers.'

These *effective conversations* between regular shoppers and attentive store staff affect what merchandise is pulled into the stores. Echevarria concedes such conversations may not always be possible in the vast, frenetic flagships of London or Barcelona, but guarantees they take place in towns and smaller cities around the world. 'All the time, store advisors and managers are suggesting products to customers, noting reactions, understanding what's popular, and feeding back specific requests for colors, styles and cuts. In Tokyo, a store manager was asked repeatedly for shorter skirts by young *fashionistas*. This nugget of customer interaction fed back through the company. Very short skirts were produced in record time, and the trend took off in Zara stores – and competitor stores – internationally.' With Echevarria explaining further, 'We manufacture small runs of coats, dresses, and skirts at the beginning of each season. We then modify colors and styles over the coming weeks depending on sales data, even discontinuing designs that aren't an immediate success. But in our terms, we never produce huge runs of anything – our customers don't like to be seen in the same fashions!'

La Coruña is still home to the company's HQ and main manufacturing plants. There are other factories worldwide producing around 50 percent of the merchandise. But all product comes back to one of three logistics 'platforms' in Spain before being sent to stores globally. Inditex's

supply chain is state-of-the-art and exquisitely complex. Simultaneously dispatching winter coats to the southern hemisphere and swimsuits to the northern hemisphere. Yet Inditex's ability to control costs while supplying stores globally is legendary. It is considered by many to be one of the greatest achievements in modern retailing.

Listed on the Madrid Stock Exchange, Inditex launched a second brand, Pull & Bear in 1991, and since then six more brands have been added to the portfolio – Massimo Dutti, Zara Home, Uterqüe, Bershka, Stradivarius, and Oysho – with nearly US$13 billion turnover, the company's magic is now working for women, men, kids, and home too.

But interestingly, one of the world's most respected retailers is a manufacturer.

It all started with the founder's vision of simply wanting to *be chosen* by giving customers what they wanted. Making sure it worked on every level.

Operationally, they've created a near-unique manufacturing and speedy supply chain model where 'opening orders' are relatively small, giving them the choice to either replenish or refine. Not only does this delight the customers, it means costs are lower and end of season (if there is such a thing in the ever-changing world of Inditex) mark-downs are kept to a minimum.

Emotionally, the Ortega genius was the desire to truly engage with their customers. As a manufacturer with unassailable retailing instincts, they knew simply delivering what the customer wanted was not enough. They knew they had to open their own shops to control the shopping experience too – maybe one reason why they change 4,300 store interiors every five or six months!

What's the learning from this case study?

You must engage and listen. You must set out to endlessly surprise and delight. Because that's what customers love and the reason they choose where they shop.

5
The Modern Bank Customer

5.1 What you will find in this chapter

From the previous chapters we have learned that retail banks around the world are facing intense margin pressure, slow balance-sheet growth, an uncertain economic outlook, and a growing threat from new entrants, especially in the payments arena. Banks are also facing growing regulatory costs and demands for greater fairness and clarity in their interactions with customers. All these factors drive them to increase their focus on the most important stakeholders – their customers. Understanding customer behavior, attitudes, and requirements is more vital than ever for banks' strategic thinking, operational planning, and day-to-day customer interaction. This is particularly relevant when retail banks are looking to win the war for the modern bank customer, as other retailers are already facing the same issue.

Even though customer challenges may vary from market to market, there are some common key themes, which are often remarkably consistent across continents and between countries. Some of these themes will be presented in this chapter to try to answer some of the following questions:

- Who is 'controlling' the bank–customer relationship?
- What is driving customer satisfaction, and what improvements do customers want to see?
- Is customer behavior toward banks changing, and if so, how?
- What steps can banks take to enhance their customer-centricity?

5.2 Who is 'controlling' the bank–customer relationship?

For many years, controlling customers was the main issue for most industries, including banks. Now things have changed, and this can no longer be sustained. Now a different bank–customer relationship needs to be developed.

According to the definitions given by the Oxford dictionary, the term 'control' as a noun means 'the power to influence or direct people's behavior or the course of events'; but it can also mean 'the ability to restrain one's own emotions or actions.' The verb 'control' can mean 'to determine the behavior or supervise the running of, maintain influence, or authority over someone or something.'

Control has been the essence of management; and this is because we have been trained to measure inputs, throughputs, and outputs, and to look for increasing efficiency and produce the desired results. All this made sense during the Industrial Age. But everyone is working in today's network economy, the next evolutionary step after the knowledge economy (see Box 5.1). In this historical period, enterprises are complex and need to be adaptive, so to look for control may be counterproductive.

Box 5.1 Knowledge economy versus network economy: a personal revised definition from www.wikipedia.org

The knowledge economy is the use of knowledge to generate tangible and intangible values. Technology, and in particular knowledge technology (artificial intelligence), help to transfer a part of human knowledge to machines. This knowledge can be used by decision support systems in various fields and generate economic values.

The initial notion of the knowledge economy was introduced in 1966 in the book *The Effective Executive* by Peter Drucker. In his book, Drucker described the difference between the manual worker and the knowledge worker. The manual worker, according to him, works with his or her hands and produces goods or services. In contrast, the knowledge worker works with his or her head, not hands, and produces ideas, knowledge, and information. A key concept is that knowledge and education can be both a business product (and this happens when educational and innovative intellectual products and services can be exported for a high-value return) and a productive asset. In the service economy, services are, broadly speaking, the output of knowledge acquired and developed through competences. In fact, the key component of the knowledge economy is a greater reliance on intellectual capabilities than on physical inputs or natural resources.

The knowledge economy (late 1900s–2000s) is the step before the network economy; it is strictly linked to the upheavals in technological innovations and the globally competitive need for innovation with new products and

processes. But according to Drucker, the knowledge economy is also possible without technology, an idea he outlined in his book *The Age of Discontinuity*, where he also pointed out that things change and organizations need to face new situations, where both innovation and obsolescence coexist. According to Michael Porter, the knowledge economy is far more dynamic, and that comparative advantage is less relevant than competitive advantage, which rests on 'making more productive use of inputs, which requires continual innovation.' Hence, knowledge is the catalyst and connective tissue in modern economies, and if this is the case, links related by skills, technologies, and other common inputs are increasingly relevant. In fact, knowledge provides the technical expertise, problem-solving, performance measurement and evaluation, and data management needed for the transboundary, interdisciplinary global scale of today's competition.

It has been suggested that the next evolutionary step after the knowledge economy is the network economy, where the relatively localized knowledge is now being shared among and across various networks for the benefit of the network members as a whole, to gain economies of scale in a wider, more open arena. Commentators suggest there are various interlocking driving forces, which are changing the rules of business and national competitiveness. They are: globalization (markets and products are more global); information/knowledge intensity (efficient production relies on information and know-how); new media (increases the production and distribution of knowledge, which in turn, results in collective intelligence, much easier to access as a result of networked databases which promote online interaction between users and producers); computer networking, and connectivity. As a result, goods and services can be developed, bought, sold, and in many cases even delivered over electronic networks, only depending on how they meet economic demand. The demand remain dormant or make a commercial breakthrough. It can be argued that the knowledge economy differs from the traditional economy in several key respects:

- The economics are not of scarcity, but rather of abundance. Unlike most resources that become depleted when used, information and knowledge can be shared, and actually grow through application;
- The effect of location is diminished in some economic activities: using appropriate technology and methods, virtual marketplaces and virtual organizations that offer benefits of speed, agility, round-the-clock operation, and global reach can be created. Alternatively, the effect of location can be reinforced in other economic fields, by the creation of business clusters around centers of knowledge, such as universities and research centers. However, clusters already existed in the pre-knowledge economy period;
- Laws, barriers, taxes, and ways to measure are difficult to apply solely on a national basis. Knowledge and information 'leak' to where demand is highest and the barriers are lowest;
- Knowledge-enhanced products or services can command price premiums over comparable products with low embedded knowledge or knowledge intensity;

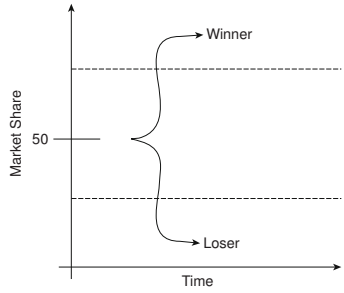
- Pricing and value depends heavily on context. Thus, the same information or knowledge can have vastly different value to different people, or even to the same person at different times;
- When locked into systems or processes, knowledge has higher inherent value than when it can 'walk out of the door' in people's heads;
- Human capital – competencies – are a key component of value in a knowledge-based company, yet few companies report competency levels in annual reports. In contrast, downsizing is often seen as a positive 'cost cutting' measure;
- Communication is increasingly being seen as fundamental to knowledge flows. Social structures, cultural context, and other factors influencing social relations are therefore of fundamental importance to knowledge economies.

These characteristics require new ideas and approaches from policy-makers, managers, and knowledge workers. The knowledge economy may appear in manifold forms but, as past predictions have forecasted, the new economy has created a pattern in which even ideas will be recognized and identified as a commodity. In this regard, the very nature of 'knowledge' itself must be considered, added to the fact that it is the thrust of this new form of economy.

Moving forward to the network economy the aspects to highlight are:

1. Network economies can be considered as the counterpart of scale economies in traditional businesses, and this means that volumes are critical for a platform to succeed and develop; and
2. The fact that these networks rely not only on the information technology side of the society, but are also nurtured by 'social' networks, links of groups and related information on consumer attitudes and behaviors, which are highly relevant when volumes need to be made and something has to be sold in the network.

The modern concept on which network economies are based is called the network's positive feedback, and this can be explained as follows: the more the market share of a given proposal increases, the more users adopt the system (see figure below).



The rationale of a network economy

Source: C. Shapiro & H.R. Varian (1998) *Information Rules: A Strategic Guide to the Network Economy*, Boston: Harvard Business School Press.

The positive feedback effect may facilitate the production of virtuous or vicious circles whereby successful companies will become even more successful and poor performers will lose even more market share. Another important aspect of the network economies, which goes in parallel with the previous effect, is transaction costs, and in particular switching costs. The most notable example in this regard is the change of e-mail address: this implies that the user would be cut out from the previous network of people he or she was connected to. According to this aspect, there is an implicit weaknesses of many platforms, which are close loop, while they need to work properly to have volumes and traffic around the network, both from those who still belong to the community and those who do not yet. An example can be that of the case of peer-to-peer lending communities, which have an implicit, high switching cost that is represented by the products transacted in these communities: loans. In most of these communities, the lender is likely to invest his or her money for a long period of time (in most of the cases three years) and will not have the possibility to withdraw it. Therefore, it is meaningful that an additional strategy that platforms in a peer-to peer lending business are trying to increase their user base allowing interoperability among users. This would mean, for example, that users currently registered in Company X would be able to use their account for example in Company Y and bidding or asking for loans in any of the two platforms that is more convenient in that precise moment. While this strategy may sound at first not logical, it would make a lot of sense for both big and small players. In fact, both would collaborate to increase the common user base with the final goal to extract value from the locked-in borrowers and lenders. One good example of this practice is given by the interaction between the two social networks Facebook and Windows Live.

The positive feedback effect combined with the switching costs embedded in a social network therefore sets a clearly defined strategy that all communities should undertake to be successful: attract most users possible because the more their market share increases, the more users will be attracted. This is the reason why 'attractiveness' of the platform is the issue and the key success factors of the online consumers' communities.

Banks have already volumes to feed the platform, what they have to do is to retain their users, not to let them go away, and this means they have to manage information differently from the past. An asset banks already have, again, is their interoperability, which is a fundamental condition to let the consumer have major opportunities to transact, save, and borrow.

Given the situation, the question is misplaced and should be changed as follows: Who is ready to lose control?

First of all, it could be useful to clarify that the real problem is confusion between control and order.[1] The word 'control' implies centralized control and hierarchical relationships. Such a situation existed in the past, when banks developed their products and sold them to customers, and for the many reasons already discussed in previous chapters, it was for a bank to tell its customers to buy them, whether they were

successful or not. This was possible only because of the lack of choice in the market; but this situation no longer exists.

On the other hand, the word 'order' may emerge from a sense of self-organization, which is strongly committed and engaged in its business. This organization has to have people who know what is expected of them and what they can expect of others. Under these circumstances, a clear strategy is also crucial, and it must be communicated to the market, both defined as internal (the workforce) and external customers (the consumers). Overall, the organization that seeks to implement a strategy, will achieve its goal only if a set of core rules can be stated. These rules need to be simple and consistent, so that people understand them. This is also a way to mitigate the risk of failure in an operational context and to avoid everyone being in charge of his or her own bank organization, but nobody being in charge of the overall operation.

Effectively, banks have started losing 'control' on customer relationships, and there are many reasons for this, but overall because banking is increasingly being carried out through different touch points. Customers do not like to be told what to do, but do like to be allowed to choose and then have it done. But they may be willing to receive some forms of advice to reduce their cognitive asymmetry. It is interesting to note that according to Google data, before making a financial services decision, customers look through an average of nine financial websites.

Cognitive asymmetry may be explained both at a social and at an individual level. With the first, we refer to the difference of reasoning, perception, or knowledge between individuals. At the individual level, we are referring to a cognitive (but also emotional) bias that privileges some memories or responses and neglects others. For example, favoring negative ones over positive ones, or the other way round, with the result that sometimes the choice taken may not be suboptimal to them.

The essence of this new order-centric mindset is to understand that it is something we have all generally sought, and how to plan to carry it forward. Hence, the main issue is to help people (internal and external customers) to understand what is expected of them and what they can expect of others. In this situation, there will be order and not confusion, but without overarching control, such as in the example of a massive flock of starlings, which are so compact in their maneuvers.

At this point, banks should be aware of their customers' attitudes and behaviors. Customers are taking greater control of their banking relationships, because their mobility and market choices have increased. So

they may switch banks and change their behavior easily in comparison with the past. But this does not mean they are willing to switch if they consider that the bank is delivering fair value to them.

In the past, bank customers have been used to having multi-banking relationships, which means that they used more than one bank. In the new scenario, this phenomena could decrease, not only due to economic constraints and consolidation among domestic banks (as is happening in Italy and Spain), but overall because customers are willing to do it. And if banks can clearly communicate how they want to conduct business with their customers, they will also increase their customers' loyalty.

It is interesting to note that at present when customers switch, the majority of them still look for a bank when making product choices about checking accounts, savings, and credit cards. However, they are more likely to choose a non-banking institution for non-core products, such as personal loans and automotive credit.[2] It is interesting also to note that bank customers have increased their sensitivity to fees and charges, which are the main reasons cited for dissatisfaction and the most important driver of attrition. In fact, after several years of minor increases in overall satisfaction scores, customer satisfaction in 2013 has changed trend.[3] The major improvement was experienced in the big banks segment, where they have made great strides in listening to what their customers are asking for. They have also started reducing the number of problems customers encounter and, more importantly, improving satisfaction by reducing fees and introducing new price schemes. This can be also considered an important output from the intervention of the financial authorities, which have been asking for disclosure requirements on opaque pricing situations for a long time. Financial authorities have also asked financial firms to give consumers clear and consistent information. All that is about the consumer protection regulatory framework, which may represent an example of an industry that sometimes does not listen to its customers, and so it has lost the global picture of its business. But it can also be noted that self-regulatory measures[4] have proven to be sometimes insufficient in this regard.

When the customer satisfaction index is increasing mostly because banks have reduced their expenses, the signals need to be read properly. In fact, when pricing is becoming the single most important driver of customer satisfaction and a key tool in the fight against attrition, then the bank offering is consolidating its commoditization trend. But on the other hand, bank customer satisfaction is also increasing because of Internet, mobile, and a different form of branch banking.

A further threat is that today a bank customer is likely to find banks of all sizes offering the level of convenience, technology, and personal service they have come to expect, and they are also able to choose among institutions that are not banks.

Many of these aspects have important impacts on banks' customer base. This is because customers may become less and less loyal to their bank, and this is due not to reduced control but because of self-banking. In situations where customers increasingly see themselves doing their own banking – online, perhaps, or using ATMs – they become less and less attached to the branch and its personnel. Without intending to, banks have created a 'disloyalty program' that actively encourages customers to seek elsewhere for banking services.

Finally, there is both light and shadow in the present bank – customer relationship. As banks develop new initiatives (such as mobile banking, Internet banking, and so on), customers are responding positively to them, and this is an encouraging response for banks. On the other hand, banks still need to focus on further improvements to vital, everyday services and interactions. A way to get out of this situation, we believe, is to differentiate the bank's strategy, which is going to be the next challenge for retail banks in the race to acquire and retain customers.

This is becoming more and more important also because no more business will be done 'as usual,' given the increasingly unsettled market situation, which is also increasingly transparent and connected, making market leadership trickier.

In this regard, retail banks should consider putting some order into their organizations and accept that they must give up a little control. However, to do so, they need managers who are able to add adaptive capacity to their organizations and look for a bigger picture of their business.

5.2.1 Consumer protection and the process of switching

Consumer protection is a group of laws and organizations designed to ensure the rights of consumers as well as fair trade competition and the free flow of truthful information in the marketplace. They are linked to the idea of consumers' rights, enabling them to make better choices in the marketplace and get help with consumer complaints.

These laws are designed to prevent businesses that engage in fraud or specified unfair practices from gaining an advantage over competitors. They may also provide additional protection for the weak and those unable to take care of themselves. Consumer protection can also be asserted via non-government organizations, such as consumer protection

agencies (the National Consumer Council[5] in the UK, for example, and the Consumers Union in the US, which fought to improve the way in which the financial services industry serves the interests of customers); and other organizations (such as the Federal Trade Commission in the US and the Office of Fair Trading[6] in UK).

Consumer interests can also be protected by promoting competition in the markets that, directly or indirectly, serve consumers, consistent with economic efficiency.

As far as the retail banking industry is concerned, consumer protection measures are carried out using prudential regulation tools and the conduct-of-business regulations. Prudential regulation aims at avoiding the failure of institutions, with adverse consequences for individual retail depositors, whose informational disadvantages lessen their ability to look after their own interests. Conduct-of-business regulations are aimed at business functions and how (solvent) firms conduct business with their customers. This is particularly true for the retail sector, while the wholesale sector may largely be governed by codes of conduct among the professionals themselves.

The next step, not yet fulfilled by retail banks, will be to ensure that consumers are better able to make informed choices and achieve fair deals. This is an issue according to the strategic aims of both the FSA and the EC. If consumers do not make informed choices – or if their advisers do not make sufficiently informed recommendations – they may lose out as a result of:

1. Not buying the 'best value' products on offer, such as the products that give them the desired level of quality at the best price; and/or
2. Not buying products that are suitable to their needs. This may include consumers not saving at all, because they find financial decisions too complicated.[7]

The first of these – the extent to which consumers buy poor value products – does not imply that consumers should necessarily buy the cheapest products. Consumers may deliberately choose to buy a relatively expensive product on the basis of other valued characteristics, such as accessibility (for bank accounts), fund choice (for investments), administrative efficiency, financial strength or, more generally, provider reputation. In such cases, consumers may not be losing out – the potential cost saving they could have made by buying a cheaper product represents the implicit price they are prepared to pay for that

characteristic. Our concern, however, is that consumers are not fully aware of the prices (or other characteristics) of other available products, and may not rationally be choosing expensive products, and are losing out as a result.

It is also necessary to enhance consumer protection and improve consumer choice by increasing transparency, and also address product tying and ensuring responsible marketing practices. The aim is to realize effective consumer protection in the financial services field, and in the retail banking services field in particular. With this in mind, a comprehensive approach has been adopted, which is organized as three ideal pillars. Most of the legislative and non-legislative proposals include the following initiatives:

– Access to a basic bank account;
– Switching; and
– Fees transparency and comparison.

Many countries have laws on consumer protection. For example, the UK, as a Member State of the European Union, is bound by the consumer protection directives of the EU (see Appendix 3), but it also has a number of domestic laws. In the US, a variety of laws at both the federal and state levels regulate consumer affairs.

If we look closer at the EU members, for example, we can see that some analysis has been undertaken to understand customer perceptions of retail banking services with the aim of improving competition in this area beyond that of price, which has been the most developed in the market during the last few years. Given this, the European Commission's consumer market study (undertaken during the years 2007 and 2009) showed that more than two thirds of mystery shoppers were not able to switch their bank account successfully. Moreover, the Commission's 2007 inquiry into the retail banking sector identified significant barriers to customer mobility. These findings were followed by extensive consultation, which led the European Commission to urge the Banking Industry Committee (EBIC) to act. The EBIC established a self-regulatory initiative based on common principles, which was expected to bring clarity for consumers and to allow them to easily switch their bank account.

Some important improvements have been made and so, at present, switching banks may be easier than customers think; and most banks have also staff dedicated to supporting new customers who have recently switched (see Box 5.2).

Box 5.2 The shopping around phenomenon in a nutshell

The term 'switching' in retail banking refers to customers moving their banking relationship from their existing provider to a new one.

Why do bank customers switch?

There are many reasons to explain bank switching. Customers switch to make informed choices. When buying financial products, consumers need information on the price, quality, and terms of trade of the range of products available. But financial products are often complex, making it difficult to understand the information collected. They are often long term, so not all relevant information may be available at the point of sale. Furthermore, financial products also tend to be purchased only infrequently, so a consumer has little personal experience on which to base choices.

Sometimes they switch because they are driven either by positive (pull) factors or by negative (push) factors. A pull situation can be explained as a situation where the customer is satisfied with his current bank but simply gets a better offer from another bank or finds the conditions of another bank so attractive that he or she is willing to switch. On the other hand, a push situation can be described as a situation where the customer is 'pushed away' from his or her current bank, such as when he or she is experiencing a dissatisfying situation and has no other option but to switch to another bank.

How do customers switch?

Customers can get to this point by shopping around, either directly, by going to a number of different providers to compare what is on offer, or indirectly, by going to an Independent Financial Adviser (IFA) or to a newspaper/magazine or through comparative information tables produced by different institutions which bring together information on the products available. Customers are also interested in listening to the advice of friends and looking at web sources.

Is switching cost free?

Shopping around is not at all cost free, since consumers have to consider both monetary and non-monetary costs. In the first category of costs, there are the well-known switching costs, which occur when a customer is going to finish his or her bank relationship and has to pay for it, and of course this can have a very direct impact on a customer's decision to leave his or her bank. High exit fees have a 'lock in' effect on customers. Recently, a great deal of work has been done in this area by consumer protection regulation, and the topic has in addition been highlighted in the media, so that a number of banks have started to advertise 'no fees.'

Then there are the non-monetary costs, such as the searching costs, which are incurred when customers face difficulties and/or inconvenience when they try to change bank, in terms of time spent researching new banks and arranging meetings with different bank consultants. Or, when changing banks means having to relay the new account information to third parties such as employers, customers, and so on. To this category of costs also belongs the time and the effort spent making the decision, and this may come from the difficulty of comparing bank services and prices offered. This happens when bank services are heterogeneous, and/or the price structure is so complex that customers cannot understand the 'real' price, due to a lack of transparency.

Through the process of switching, consumers can reward those providers who offer the best value-for-money and products with the features they desire. Providers who do not offer products that offer value-for-money, will either have to improve their offerings or face the risk of being forced out of the market due to poor demand for their products. For a long time, banks have enjoyed a relative absence of customer switching, partly due to customer inertia and a lack or perceived opaqueness of information. This has been one of the known barriers to competition in the retail banking market, but the situation is changing.

Switching bank is the final result of a customer's attitude and behavior to shopping around, which is another phenomenon featured in the retail banking market.

In March 2012, another European Commission survey (known as the *Special Eurobarometer 373 on Retail Financial Services*[8]) noted that: 'Many people who have financial products or services are unaware of the advantages of shopping around for financial products and similarly seem not to see the potential benefits of switching providers in order to secure a better deal. Many respondents are still dependent on face-to-face purchasing and rely on their providers for recommendations. [And this may be even worse for those who are immigrants and expatriates.] Encouraging the use of other purchasing channels, such as the Internet, or making advice recommendations more readily available to citizens would enable them to compare products in a way which is perhaps more limited currently.'[9] In this regard, the EU Commission has identified 'a clear need for improving financial literacy amongst EU citizens.'

But in reforming the retail financial services market, an appropriate balance needs to be struck between regulation, adequate consumer protection, and the way banks should compete in their market to win the war for the modern customer.

As the banking sector will require flexibility on implementation deadlines and a lengthy period of bedding down if consumers and providers alike are to reap the full benefits, any additional regulatory or legislative initiatives will potentially have a further impact in terms of making this intensive work program even more difficult to complete effectively and on time. But on the other hand, this will distract from industry efforts to continuously improve customer focus and services.

5.2.2 Customer mobility: strengths and weaknesses

Customer mobility can be considered both a sign of competition in the market and of a certain customer attitude. According to the first definition, it is widely accepted that customer mobility is a way to improve competition, as customers get the option to freely choose their supplier at all times. This also may result in a market outcome with low prices and maximum welfare benefit for society. The main reason for this relates to the fact that under fierce competition, no suppliers are able to influence the market price. Therefore, a way to obtain improved competition is to ensure the existence of customer mobility, which may pose an important threat to the supplier and thereby minimize its market power.

The threat arises especially when any rational customer is going to choose the cheapest service if two suppliers offer the 'same' one at different prices, if it is possible to detect the differences between given financial services (see Box 5.3), or at least if the customer does not have other preferences, or better still, does not perceive any real difference between the two offers.

Box 5.3 Barriers to customer mobility

Customer mobility may be reduced by a number of factors. We can list five of the more important barriers to customer mobility, which are closely linked to each other. They are:

- Switching costs: the monetary costs have been lowering consistently over time, but the non-monetary costs still remain present in some ways;
- Difficulties in comparing bank services and sometimes also pricing schemes. Consumer protection is working to increase transparency in the market, thereby minimizing sub-optimal decision making by customers;
- Bundling of products, both in terms of product packages and loyalty programs.

In these situations, a low-price supplier will win market share at the expense of an expensive supplier, for a certain time. But price has to

change its meaning and must be used strategically, according to the customer, the context, and the time of delivery.

The expensive supplier will find it profitable to lower his or her price in order to limit the negative effect; when he or she does so, a price mechanism will arise, with the result that suppliers may offer the same (market) price. Again, in this situation, if there are no other barriers in the market, customer mobility is going to meet an infinitely elastic demand with the main result that if the supplier raises the price above the market price, then the demand for its products will be almost zero. As a consequence of this, the supplier is going to take the market price as given. If there are constraints on customers' mobility, the supplier will meet demand with some degree of inelasticity, and in this case the supplier can raise prices above the market price without losing market share. But the latter is not the situation for many retail bank offerings.

From a competition policy point of view, this is a positive result and a trend to develop. But customers switching their banking relationship entirely is not the only desirable goal. Multiple banking relationships can also be a sign of efficient competition in the market, where both full-service and niche banks compete on individual products.

In conclusion, the degree of customer mobility in a market is likely to reflect the level of competition on that market. A lack of customer mobility can, in other words, have a direct, negative impact on the competition level. But it can also be said that low customer mobility can also occur where there is fierce competition in the market.

Now I will try to give a different interpretation of customer mobility, which according to the previous arguments takes place especially when price is the most weighted factor in the decision process regarding some financial services at present. If this is true, customers seem to be very keen to lower prices, so banks will react as a consequence, reinforcing their price competition, with a result that the more banks compete on price, the more their customers look for lower prices; and again banks compete with further price reductions to satisfy their customers. If this is trend continues, banks will lose an opportunity to educate customers to assess their value-for-money offerings. And on the other hand, bank customers will lose their willingness and ability to assess these offerings.

Customer education will be different from that suggested by consumer protection statements. In this regard, price has to be used strategically, which means linking it better to value. If retail banks start working on this, they develop a customer-intimacy approach, which will be rewarding in the medium-long term. Otherwise, they will be driven into

a loop, having the wrong perception of their customers, who should be sensitive to prices when sometimes they would not be.

Retail banks need to change the course of things, and make order in their customer relationships.

This is possible only if they play differently, driving customers away from the rationale factor of price to more 'emotional' factors – such as cultural proximity, intimacy, fitting the way their customers want to do their banking, more knowledge-enhanced services, and so on – so as to give them choices, and conversely, to be chosen by them.

There is another reason why banks should change their approach to customers, and this is that price competition, or a lowering price situation, is something that cannot last forever. The main reason is that there is a limit to this competition, and that limit lies in bank incomes, which in the end should cover their operational costs. Furthermore, the situation could get even worse if banks counter-react to price competition with price subsidization. This is a practice that most banks undertake to cover their costs, increasing the price of other services they sell to the market (see Box 5.4). This often also involves cross-subsidies, either over time or across customer groups.

Box 5.4 A note on price subsidization

Price subsidization is a key issue in pricing for all firms and concerns the relationship between fixed and variable costs. For many banking services (most especially those associated with the payments system), fixed costs are high relative to marginal costs; the cost of providing the infrastructure for the administration of the payments system is high while the cost of processing individual transactions may be low. A series of cross-subsidies between products and consumers can be created, and according to Howcroft and Lavis (1989),[10] there are three forms of cross-subsidization: strategic, business, and marketing. If any particular service is not charged for, then the cost of the service is covered elsewhere within the banking firm. This may take one of four forms: the shareholder implicitly pays to the extent that profits are lower by virtue of non-pricing; other customers pay through higher charges; other products effectively pay for the free service to the extent that it is priced higher than would otherwise be the case; the bank's lending margin is wider (which implies either that the deposit interest rate is lower or the loan rate is higher) than would be the case were charges made for all services. This raises the question of the sustainability of cross-subsidies in two respects: competition may cause banks to lose the subsidizing part of the business because it is priced too highly; and to the extent that overpriced products lead to a reduction in their use this also reduces the cross-subsidy potential. And I could add that consumer protection is also looking at reducing this practice too.

As outlined in Box 5.2, there are pull and push factors which drive bank customer mobility. There is some evidence[11] that major pull factors among customers are better prices and services in other banks. Here the term 'services' can be detailed in a series of different aspects, such as the number of branches, which may be important both to household customers and SMEs, but also Internet and mobile banking for many others, at present. For some financial services, such as financial advice, a local presence and a well-established network of branches is an important factor. We know that a customer's willingness to switch is very much affected by a good relationship with a personal banking adviser in the local branch. This may come as something of a surprise, since most customers use the Internet for their daily bank transactions, but an obvious reason may be that a personal banking adviser is important when serious issues arise. Convenience is also a parameter, but it may not work for every situation. Even though some surveys have shown that prices (interest and fees) for both household customers and SMEs are one of the three most important factors when choosing a bank, transparency of prices is equally important when it comes to customer mobility. Not only are lower interest and fees interesting to new customers, but likewise the absence of fees. With a declining level of interest rates over the last few years, it has been harder for banks to make profits through net interest margins. And this threat can be inverted when developing a bank–customer-intimacy approach looking to differentiate the retail bank offering.

The most obvious push factor is perhaps the situation where the customer becomes dissatisfied with the banking consultant or feels that he or she has been treated badly by the bank. Another important factor relates to a change in life situation (marriage, move, new job, having children, and others). If we look at this issue then we understand why, from a competition point of view, mortgage loans comprise a central product in the personal retail banking market. A mortgage loan is a financial service of substantial size to the customer compared to other banking services, and according to which side you look at, this implies that bank customers requesting mortgage loans may be willing to switch bank/mortgage bank if they can find a better offer, and that the same product may be very interesting for new-customer acquisition.

The importance of housing mortgages also creates a need for professional advice, making a personal and long-term banking relationship more preferable. In this way, level of trust becomes crucial for retail customers to switch banks.

For customer mobility, pull and push situations have the same result, but from a competitive point of view it is important to look at the real factors that are the most favorable. In particular, every single bank should recognize its main advantages over its competitors.

In conclusion, we could also say that switching banks is not for every customer, because there are many who do not compare prices and services, and lack interest and engagement when it comes to financial services. Indeed, this seems to be a common feature among many bank customers. The customers' propensity to switch is low, and this behavior makes them stick with the old banking relationship. For example, there are customers segments who prefer comfort and convenience, and they accept that this raises the need for detailed private information to be given to one supplier or that this can lead to tied-in sales. Other customers will sympathize with financial convergence because cross-selling can lead to price discounts, which they prefer above all. But we have to keep in mind that many others are convinced that they do not need the patronage of a one-stop seller or an integrated service provider, but they rather prefer shopping around for themselves.

5.2.3 Do bank costumers change?

Every company has to earn the *right* to serve customers, and the most successful companies make this apparent in all their thinking and actions. Looking at how customers change is fundamental to achieving this right.

Over time, retail banks have noted that social trends reshape customer attitudes and that banking products are cyclical in nature, changing as a result of modifications in social attitudes and lifestyle that evolve to represent specific economic conditions of the people within a given banking area.[12]

As a consequence of this, banks develop a wide range of products based on the information about various activities and transactions developed by previous generations of banking customers. Simultaneously, banks realize the need to follow the technological developments and model products and services of higher quality, as well as to be continuously responsive to the new demands of customers, that could subsequently become attractive to a larger customer base.

As generation succeeds generation, every business serving them must necessarily evolve too. Today's banking consumers are not the stable brand-loyal and undemanding group that perhaps they once were. Over the past few years, consumers have learned from the retail and consumer services industry that they can expect (and therefore now demand)

instant gratification in terms of information, support, and services. And banks have to respond them. In many ways, they have started answering these demands, beginning with the adoption of ATMs, which effectively changed the consumer infrastructure of retail banking. Other technological innovations, such as the provision of 24-hour banking over the phone, or via Internet, are examples of the same thing. Generation Y[13] has already grown up, and they are financially active and powerful, and the banking sector will depend on this customer group for a long time. The 'Noughties' generation[14] is racing up behind it; this is a socially focused group with more complex expectations still and, even more importantly, huge expectations in terms of flexible, on-demand, technology-enabled service delivery. This group is mobile by default, and may largely bypass phone and PC-based Internet banking in favor of mobile platforms.

If banks cannot make order and drive the situation, the banking market will be increasingly consumer choice driven. It is for this reason that banks should also work at keeping up brand loyalty, which in this situation might be falling away, and so increasingly open the path toward a commoditization of retail banking services.

5.2.4 Pricing is an issue for retail banks

Pricing matters to companies for two key reasons: it impacts on customer satisfaction and profitability, and it also matters for the economy as a whole. Pricing is becoming more and more an issue for retail banks, as they serve as signals in the market, provide information and therefore influence the supply and demand of financial products. Prices are influenced by the following forces:

- Regulation, technology, and consumerism are all influencing the trend toward transparency. Regulation is a driver of transparency and market efficiency. Technology is cutting down information costs and increasing the way customers may make comparisons among the many financial offerings. They are useful to customers because they reduce search costs, and finally consumer activism is changing customers' buying behaviors;
- Customer satisfaction is a complex parameter. It is very important for banks because it opens the way to long-term banking relationships. However, in itself it is not only a performance parameter because it requires a more systematic approach regarding the whole value proposition, where pricing plays a significant role and customer satisfaction becomes the issue of price satisfaction

(see Box 5.5). As we have seen, the customer satisfaction score has improved as bank prices have fallen. According to this, customers identify pricing as an area where they wish to see improvements and regard these as a suitable means of increasing satisfaction with their bank.

Box 5.5 Price satisfaction

Price satisfaction is a product of several elements. For retail finance products in particular, a distinction can be made between the following factors:[15]

- Price-quality ratio: whether the costs are perceived as commensurate for the quality of the service offered;
- Relative price: how the price measures up to competitors' offers;
- Price reliability: whether the price is currently good value and whether the presumed price corresponds with the actual price or contains 'hidden elements' that are not visible at first glance;
- Price fairness: whether the price is judged to be fair and just/justified by the customer;
- Price transparency: whether the price is clear and easily understandable.

There are many challenges for retail banks on the pricing issue. It has a number of dimensions, and there are several threats to it as a market opportunity.

A first point to outline is that bank prices are varied. They come in the form of rates, fees, and penalties both on the asset and liability sides of their balance sheet. In this regard, it should be emphasized that the banks are not at liberty to develop a pricing policy with full freedom of contract. Just think of the different categories of loans, as well as constraints arising from competition and anti-laundering laws. What the bank can do is define a priori the range between the best and the worst conditions that could be offered. Within these limits, the actual interest rates on loans may be negotiated. Moreover, the same competitive transparency does not allow that the distance between the two values (minimum and maximum) is very different from that of the other banks.

The pricing inherent in lending is not, then, the competitive factor in winning, and where there is a widespread practice of multi-lending (this is when a company or individual is financed by several banks) it is even less so. At a time when interest rates change in the market for reasons of monetary policy, such variation has obvious repercussions on the pricing policy of the banks.

It should also be added that interest rates are also linked with the management of public debt, with interrelationships with other markets by virtue of monetary and financial policy, as well as with the choices of competitors, regulatory constraints, and the decisions of the central bank.

Within the given range of interest rates, banks should learn to express a pricing policy that is profitable and does not grant to customers either conditions of quasi-rent (corresponding remuneration on deposits higher than those that customers would accept), or conditions of any benefit (by granting loans at a price lower than customers would be willing to pay). Obviously, one cannot set a price for each individual customer.

Many funding operations involve predetermined contracts, where the customer is simply asked to agree to the bank's offer, and this is done to simplify relationships with customers. The same applies to many non-value-added services, which are sold without any negotiation.

With regard to the pricing of loans, it should be pointed out also that this policy is competing with the companies who may have to appeal directly to the market through the issuing of securities. Likewise, individuals also may opt to settle a portion of their financial resources in securities or in something linked to them. In this way, the banks become less autonomous and less important in the setting of interest rates.

From the perspective of bank management as a whole, it becomes clear that it is not only prices that are relevant, but above all the volumes of credit and funding, which have a critical fall back in the capital structures of banks.

Both of these aspects (stocks of assets/liabilities and prices) impact bank profitability significantly as long as the main determinant of bank profitability is represented by net interest income. In this way, banks find it increasingly difficult to pass on operating costs and operational inefficiencies, which have to be passed downstream to the client, increasing interest rates paid on credit and reducing interest rates paid on savings and deposits.

Retail banks therefore have in prospect a strategic choice of no small importance. If the situation remains similar to the current one (with higher profitability continuing to come from the interest margins), then the banks will see a reduction in their freedom to choose and differentiate their product combinations. If banks choose to organize themselves differently, seeking greater operational efficiency and not a mere contraction of the indicator of cost/income, then they will also be able to exploit their capital structures to expand their activities, and in this

way they will be able to shrink the impact of labor costs and general services. The goal for the banks is therefore to increase profitability in a way that it different from the past.

5.2.4.1 Try to look at prices differently

Another interesting issue about pricing is the need to understand whether services are priced explicitly or implicitly. In the latter, there is a disadvantage, is a series of cross-subsidies between products and consumers. Or the issue might be to analyze different forms of pricing and pricing strategies,[16] along with pricing opaqueness, which still remains an issue for bank customers and regulators.

It is important to underline that pricing is a strategic issue for retail banks, given their cost structure the nature of their offerings, their channels of distribution, and what the market is willing to pay. Most pricing is carried out with the cost structure and less of the other features mentioned uppermost. I believe this is a weakness in bank pricing because it reduces the chance for banks to act on their customers' elasticity. This is an interesting issue, because consumers differ in their pattern of usage (e.g., their average balances, number and type of transactions, and so on), and any pricing structure affects different consumers differently. Enlarging the perspective through which banks consider prices would be a viable strategy. To offer consumers a choice of pricing scheme contracts according to the benefits for them would, in effect mean that banks are offering a limited range of self-selecting contracts.

There is another point to outline, and this regards the special features of financial services, which have a strong impact on pricing policies. When making the purchase, it is from a customer's point of view typically more difficult to assess the actual service bought than is the case of many other products and services.[17] Financial products are bought relatively seldom, and the dates on which they are paid for and used often diverge, which typically makes the assessment and ascription of the value more difficult. There is also a greater uncertainty about evaluating the performance for the service bought and for some of these services there is also a low level of involvement from the customer point of view, because they are not very excited about or interested in the product 'itself.' Banking services are not an end in themselves but a means to an end (you have a credit card to pay; a house to buy; your child's education to pay for; and so on), and they do not get noticed (unless they fail to function).

What does all this mean for a bank when it sets prices? On the one hand, there is a low level of perceived benefit or utility, and this reduces

the willingness to pay. On the other, this notion is counteracted by the fact that the purchase of many financial products is essentially purpose driven (wealth accumulation, hedging, or financing purchases), and/or there is a considerable need to be achieved (financing a major purchase, payment services). There is another issue to underline, and this is that when asked about prices, bank customers are typically very unknowledgeable about what they paid or how the pricing structure works. And more and more they are looking for a better deal. This vicious loop has to be broken somewhere. Otherwise the bank–customer relationship will continue to close in on itself. In fact, the customer will feel more empowered to seek the best price, find the lowest-priced product has satisfied his or her need to rationalize his or her purchasing behavior, finding justification in the fact that it has achieved a better performance or lower cost, *pro tempore*. In doing so, he or she shows that he or she does not to recognize or does not want to recognize, or assess, the content of the offering and the skills of the counterparty. I believe there is a need to return to the correct meaning of price. The urgent need for a change of perspective (see Figure 5.1) is determined by the present situation; and this change is now imperative and not just necessary. Banks must work on this issue today, otherwise, the competition from non-banks could change the parameters of choice and fidelity, with which bank customers at present show their preference toward banks could change.

This holds unless there are highly visible differentiating elements. Such elements must be signposted for the customer because otherwise people may know the price for a given item or service, but this does not mean they are able to assess the related value. The consumer today is attentive to the need for money; but at the same time, the consumer tries not to give up certain items of consumption. This is because in his or her cognitive map these items are positioned differently from items offered by banks. An example is mobile phone technology, where the value proposition is constantly changing over time, interpreting and re-interpreting the changing needs of the market.

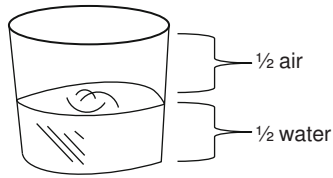


Figure 5.1 What can you see?
Technically, the glass is always full.

Being informed only of the price, and being told insistently that price is the prevailing factor in the choice, tends to impoverish the ability of the individual to understand the value that is being proposed.

For a long time in retail, it was considered important that the customer bought the goods at the price. But in this sector, more and more companies are now paying particular attention to styles of consumption, in an effort to capture a growing market share relative to what the individual consumer can spend and may decide to do so with a given supplier.

To be all-encompassing is an attribute that we can relate to recent innovations, and I do not mean this only in terms of technological innovations. The bank as problem solver should try to 'put on the ground' this thought and try to return to the concept of price in its full meaning; that is, as an indicator of the quality of the service and thereby more effectively informing customers of the value that it is offering them. The concept of value must be brought together with that of price. Only in this way will banks be able to contain customer mobility.

The price, in other words, must be understood by the customer as the monetary value of a mix of benefits and solutions. The customer must regain possession of the necessary tools for choice: considering that the price is only part of the 'sacrifice' that he or she makes by buying a certain service.

It is time to get back to reflecting on the behavior of consumers in the purchase process, recalling that behavior in this situation has both rational and emotional dimensions. In this particular historical phase, the rational seems to prevail over the emotional. Understanding customer behavior in the process of choosing a service, and the variables through which they evaluate a bid, represents a key aspect that allows any organization to create and deliver services that satisfy customers.

Every organization needs to know how to create a significant value proposition that can be a specific package of benefits and solutions, which highlights the key points of the offer that distinguish it from the competition. The price certainly has its place in the process of customer choice, but a low price is not a guarantee of customer satisfaction, and often customers see this only in hindsight.

Logical analysis indicates that the person who consumes a service perceives the quality of the service only after taking into consideration other aspects such as the quality of the features and the price. The perception of the quality of the service follows the perception of satisfaction or dissatisfaction the service procures.

Satisfaction, therefore, is influenced by perceptions regarding the specific features of the service, their quality and price, as well as by the presence of situational factors, such as the opinions of family members and the individual's personal emotional state.

Customer satisfaction with a product/service is also significantly influenced by the assessment the customer makes of the characteristics of the product/service itself.

At this point, the important issue becomes that of the perceived quality of the service and with it the need for a conceptual map to help understand the aspects that are present in a service, and which of them the customer assesses the most in his or her buying process. Even the element of convenience, when seen in the context of a service, can assume dimensions other than the economic. For example, cost-effective service delivery at a location convenient for the customer, or at convenient times, or that is easy to use, could beat out price as the tipping point.

If banks do not recognize what features are of interest to clients, they, in common with all other businesses, will find it difficult to develop an appropriate bidding strategy. If the market environment is characterized by minimal differences between competing alternatives, and customers make their decisions based solely on the lowest price, then, the difficulties banks face could not be worse.

It should be mentioned at this point that it is difficult to accurately conceptualize the role of prices in the context of the quality offered by a good/service. Normally, the price can be assessed in relation to customer expectations regarding quality or to the customer's previous perception of service quality. If the price of a service is considered too high, customers will not buy.

However, the price can also affect expectations and in certain other situations seems to constitute a criterion of quality, particularly when in a context of services that are intangible. In the mind of the customer, a higher price may correspond to better quality. The price, therefore, must be viewed from multiple perspectives, because it can affect the level of demand and, consequently, determine the profitability of a given enterprise.

The price should be an indicator of value and may be useful in trying to interpret what customers are willing to pay. This forces the bank to know and understand the quality required by the customer and the relevant attributes he or she assesses in a service.

Therefore, the banking market should be more driven by value rather than low prices. It would then be up to the customer to decide whether

they want to choose low, medium or high value, and the price of each level of service must be effectively communicated.

It is surprising that many managers believe setting the selling price of a given product/service is not an issue of strategy. Many prices are set simply by defining the cost of the product/service and adding a mark-up to compose the lowest price possible. In other cases, however, managers believe that the price is set by the market, and if the market falls in a certain range, the company is not able to influence it.

In my opinion, a correct policy of setting prices must meet both the needs of the company for an adequate return on income and the actual achievement of marketing objectives previously defined.

Finally, the information that customers gather about banking services influences their expectations and judgment of prices. Pricing needs to take into account also customers' information behavior, what price and product components they focus on, and on what basis they compare offers.

If customers are uncertain about what they will get, it is less clear what price can actually be convincing or corresponds with a certain level of satisfaction from the customer's point of view. At the same time, prices are important beyond a single transaction as they feed into longer-term buyer-seller relationships. When it comes to the assessment of performance and evaluation of products, pricing policy can mitigate this only to a limited extent. Nonetheless, it remains a decisive factor in whether price level and price models have a negative effect on customer satisfaction and profitability. It must be taken into account that – due to uncertainty when it comes to the assessment of performance – factors such as perceived fairness play an important role in customer satisfaction with prices.

On top of this, one precondition for the purchase of financial products is a certain degree of trust – precisely because it is often difficult for the customer to make a performance assessment for products. Correspondingly, reputation, (perceived) competence, and security also play an important role. Factors other than price levels that play a part in the purchasing decision may reduce price elasticity and are a reason why price differences among suppliers in a market may exist over a longer period of time.

All this clearly shows that pricing policy for operating decisions has to factor in very specific product characteristics as well as the purchasing situation, but that a product cannot be examined in isolation because substitution options influence demand. At the same time, exogenous influences have a differing impact on supply and demand for individual

retail financial products. For example, macroeconomic conditions have a bigger impact on loan and investment products, whereas the demand for 'bread-and-butter financial products,' such as bank accounts, is relatively stable. For the latter, by contrast, the trend toward online banking, the competition between traditional banks and direct banks, as well as the increased use of comparison tools to assist in purchase decisions is a key issue for pricing. The job of pricing policy is to know the relevant market and product characteristics, to correctly assess their relative importance and their combined effect, and to use these as the basis for decisions about the price level and models.

5.3 From retailers to retail banks: how to win the war for the modern bank customer

Consumers are human beings, and this makes retail banking a people business. Retailers are increasingly aware of this fact, and they have developed their strategy over the last few years accordingly.

When considering retail banking customers as human beings, we see that they may have no book keeping, no balance sheets, no controllers, no advisers, no economic education, no market power, and above all, they might pursue very different goals. What they want from banks can only partially be defined in financial terms.

In order to approach this market, banks have to revise their role, purpose, and activities with regard to what services to deliver to customers and how. The key to success will be through a reassessment of the voluminous set of unconscious or half-forgotten convictions – rules, values, goals – that have influenced any banking business in the past and will go on to dominate commercial banking in the future. To be successful, you need to serve customers first and investors second, and investors should start appreciating this. What customers want is for life to be easy, and for the path to their goals to be a simple one.

Such a mindset today is frequently called a paradigm. Retail banks need to find theirs. Nobody will ever grasp its essence who is not willing to reconsider much of what was previously regarded as certain. If banks are genuine in their aspiration to win out over competitors in the field of financial services, they must take a conscious step away from the past. They must be bold. Banks must step up and away from their idea of selling 'many products' to a real understanding of the value of a true relationship with each of their customers and serve them according both to them and to the bank's internal strengths. Therefore, they must downplay the importance of offering *ad hoc* initiatives, they must offer

more knowledge-enhanced services and instead encourage loyalty and lifelong confidence. All this means that banks must look for more integrated consumer banking (IC banking).

This construct was first mentioned by Stefan W. Kaminsky,[18] who intended it as a totally new way of serving the needs of consumers. It is an approach that was neither premised on – nor measured by – volume of sales, but rather on the ability of a bank to provide solutions to its customers through the span of life changes: employment, unemployment, marriage, divorce, child-rearing, and retirement. Its emphasis is on establishing and maintaining long-term relationships between customers and branch staff – these, argues Kaminsky, are the sources of value in retail banking. But to achieve success and win the modern customer, the workforce, that is the internal customer to a retail bank, needs to understand the big picture – how the business will be chosen by external customers and what might motivate bank shoppers to choose a given retail bank. This is part of the emotional edge that makes one retail bank different from the others, because if change is good, to be different is better. Kaminsky sums up his vision thus:

> IC banking is run by people, not by abstract rules. It is a business based on appreciation, not on apprehension. Its structure is not hierarchical but determined by human interaction. It is like a tree. The visible part in the sun is your staff and your outlets. Then there is a solid trunk, caring for the visible part and linking it with the hidden part. The hidden parts are the roots, giving supporting strength through a wide base. No one part can live without the other. The management's place, formerly defined as being on the top, is now in the center between the visible and the hidden part.[19]

Box 5.6 IC banks and IC banking in a nutshell

IC banking is more complex than any other kind of banking. Whereas commercial customers are well educated and act within a limited set of rational goals, the retail customer wants help on a much broader range of problems that are frequently deeply influenced by emotion. Managing an IC bank entails the use of unfamiliar methods, such as information processing, social responsibility, customer education, self-organization, and even gossip.

IC banking is a permanent task for individual human beings on all levels. It challenges the will and the brain as well as emotions, compassion, instinct, vision, judgment, and self-esteem. IC banking is not about fighting but about caring. It does not produce glorious managers, but satisfied customers. It is a commitment to steady – almost biological – growth with no place for blitzes. It flourishes in a modest, patient and peaceful company culture. And

this gives relevance to the organization's value story. An IC bank deteriorates when senior management feel that sudden and permanent changes of company goals, supervisors, management rules, or even reporting forms are important. IC banking is based on lasting symbiotic relations between staff and consumers.

An IC bank should be a separate entity that is given a lot of freedom to develop its own culture, reputation, image, management style, and support systems. The new bank will challenge many long-standing conventions and convictions, and this is the price to be paid for exploiting fully all the incomparable advantages of IC banking:

- Unlimited opportunities for growth;
- Steady high profits;
- Fewer and smoother business cycles;
- Less exposure to competition;
- Greater customer loyalty.

A genuine IC bank will be in a much stronger position than mere retail banking units. Since it is based on customer needs and maintained by long-term relationships, there is no need for furious marketing campaigns, where numbers and not people decide success or failure. Since the customers of an IC bank can see and feel its constant and consistent personal atmosphere, they will be less vulnerable to political agitation.

The emergence of the mega-product

Instead of loans, deposits, or other traditional products, the IC bank has a single 'mega-product,' which includes:

- All feasible traditional products integrated into one;
- Plus integrated expert advice;
- Plus emotional components such as confidence or helpfulness;
- Plus incorporation of any future service;
- Plus the fundamental element of continuity.

The name of this mega-product and at the same time its substance – is the customer relationship. Traditional products become subordinated to it and consequently have no meaning outside a relationship. That is why a new name for the operations and services of an IC bank has to be found to replace the traditional products. They will be called instruments. *At present they are called products, but the word 'product' should be used exclusively in its customary sense. We can also add that some offices should change their names to something like 'support offices.'*

The financial instruments of an IC bank are individually tailored, highly-integrated, and related to the financial life plan of the customer. They become part of a comprehensive, long-lasting, confidence-supported symbiosis. They must lose the character of unrelated products offered by anybody anywhere. This point is important because public attacks will always concentrate on

commonplace 'products,' regardless of which bank or organization delivers them.

The 'nonsense' of segmentation

Initially there is a temptation to research and define segments within the group of potential customers. But by the inherent logic of the matter, the result is always the same. The most promising group in this market are families in the 30–40 years range with a stable middle class income, a home, good payment records, and a high level of consumption. The first failure of research is that all the criteria chosen become obsolete over time and therefore cannot be built into a long-term business. The second mistake is that this approach leads to a trap, that it means looking at the market from the bank's point of view. A better way is to look at the bank from the market's point of view, i.e., through the customer's eyes. Try to find out what they need, what their deepest and wildest dreams are, how they feel when entering a bank, why they are longing to be respected, to be taken seriously with their problems, to be listened to, to find a friend to help, and to guide them. Find out about the youngsters, ask after the elderly people, investigate the way in which families are managing their money. Collect stories about how consumers were exploited, cheated, misinformed, or robbed by financial institutions. Register the complaints about aggressively sold mortgages that turn into nightmares at the borrower's first financial crisis. Ask people how they were treated after losing their job. Find out their opinions about the role of banks in the economy and in their private life. Show a typical loan agreement to a potential borrower and ask them how many of the clauses they do not understand. Although it may seem difficult, study the emerging picture without any bias. It will become apparent how badly consumers are served in general and how limitless the opportunities are in this market if they are served better. Forget about segmentation. It is not the bank who chooses the customer, but the customer who chooses the bank. The way the branches are designed, the choice of staff, the design of instruments to solve their core problem, the referrals of customers, all these elements and many more, in a complicated and continuous interaction, will do the selection for the bank.

This is true also if we think of the control issue we have been discussing. Banks should no longer seek to control their customers; they have to be chosen by them.

Threats to IC banking

The threat to IC banking comes from the autonomy of a product, which kills the relationship. And this means that banks need to understand the price it has to pay for this ideal relationship, which is to acknowledge how misleading the notion of standalone 'products' is.

Source: paraphrased from Lafferty Group (2012*)* 'Real Banks for Real People,' Report. Interpolations by the author indicated in italic.

All this evokes a feeling that a holistic perspective is more effective when selling solutions to customers, as this, indeed, is what they are looking for. Another important issue will be to look at what constitutes value for customers and how to deliver it. With this in mind, we would like to look at some theoretical frameworks – which are known as the 'value disciplines' – and adapt them to a given retail bank. This will be done in Section 5.7 where I discuss customer-intimacy.

The essence of the IC banking approach is the notion that in place of traditional savings and loans, customers should be provided with integrated instruments and integrated pricing, supported by integrated information. In this regard, an important role will be played by the bank staff. Especially, if we consider that at present there are various channels through which banks connect with customers, and each one may influence and support the others. This situation will require a high degree of coordination between people working in different channels (branch managers, branch staff, call/contact center staff, mobile platforms staff, and so on). Because of this, every retail business needs to have its silo walls demolished. Everyone needs to be engaged in the people business, which means that both those who serve the customer directly and those who serve them are both equal in their endeavor to be chosen.

5.4 Being market-oriented

When the issue is to be chosen by customers, banks need to rethink and renew, according to the context, the way they orient themselves toward the market. To be market-oriented is not only the implementation of marketing concepts, but also a concept of strategy development.[20]

Three dimensions can be useful to describe market orientation:

- Customer orientation;
- Competition orientation; and the
- Organizational culture of internal functional coordination.

We will only focus on the first and third dimensions, as they seem to be leading some retailers at present.

Customer orientation can be described as the importance a bank gives to customers' ideas and takes customer satisfaction as its goal.[21] In this regard, customer satisfaction is a direct factor in customer loyalty and trust, which are both important in developing customer retention and entrepreneurial profits.

Customer orientation may also have different significant impacts at different levels of a bank, such as on relationship quality, performance, and customer satisfaction (see Table 5.1).

Table 5.1 A customer-oriented market approach

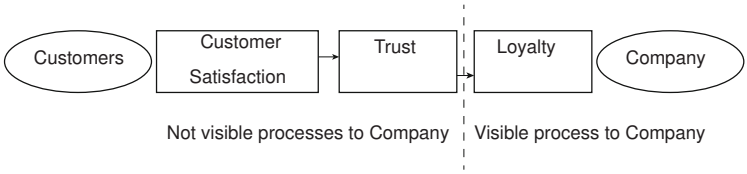
A customer orientation strategy has impact on:	• Product design (what do customers buy?) • Point of contact design (How customers interact with the bank: one-to-one, one-to-many, or a two-way interaction) • Increase information disclosure and communication (Give customers the tools to assess the offering's value and a reason to buy it from you) • Train and engage the internal customer (Give them skills to assess the market strategy and understand it) • Develop customer-oriented processes to give your customers a simple (not easy) life	Main results:	– Service quality – Performance – Customer satisfaction – Trust – Loyalty – Increase customer confidence and reduce customer's uncertainty in decision making – More effective selling behaviors and situations

Customer orientation also has impacts on customer trust and loyalty (see Box 5.7).

Box 5.7 Loyalty and trust in a nutshell

There is an important distinction to be made between loyalty and trust. Trust refers to a party's perception of his or her counterpart's integrity, honesty, and confidence, and the process of building trust is based on a long-term interaction between both parties. When a person trusts another, he or she feels relaxed yet confident. On the other hand, loyalty refers to the precision with which we attend to our affairs and keep our promises. The semantic origin of customer loyalty, therefore, leads to two different meanings: one refers to the outward behavior of keeping one's promises by making them come true, and the other refers to a mental belief (idealistic/cognitive nature) that we feel sure about someone or something. Therefore, it is best for banks first to focus attention on client trust before paying attention customer loyalty.[22] Trust has been analyzed from several different perspectives (economic, sociological, psychological, and organizational) and this has led to a multidimensional understanding of the word. There are many different definitions of trust. Economists favor a view of trust based on calculations regarding costs and benefits (Williamson, 1993). Psychologists commonly focus their attention on individual traits that lead to a trust-based relationship (Williams, 1988;

Rotter & Tyler, 1990). Organizational theorists, on the other hand, explore the role of trust in intra- and inter-organizational dynamics (Ring & Van De Ven, 1994; Zaheer *et al.*, 1998). Sociologists study how trust can be woven into the network that ties interpersonal relationships between people and institutions (Granovetter, 1985; Zucker, 1986). For financial firms that wish to develop the trust of their clients, a combination of the various aforementioned definitions are most likely to be used or emphasized. Given that the trust of clients cannot be directly measured, one has introduce and recognize those resources from which customer trust flows. They are represented by a set of important variables such as image, client loyalty, and relations created by the bank over the years. Every company has its own 'trust resources' that are the result of its past history, which no other company can copy. The very nature of trust resources represents a lasting competitive advantage for a company. Trust can therefore be described as the middle link of a chain that sees customer satisfaction in regards to what the company offers and looks back on customer loyalty as shown below with the chain of trust.



Customer satisfaction engenders trust in the value propositions of a company, which then leads to enhanced loyalty and the perpetuation of the buying process. But as noted in the chain of trust, customer satisfaction and trust are customer's internal features, so they are not visible to a bank unless it undertakes studies to identify the trust embedded in customer satisfaction assessments of clients. The link between trust and loyalty then has to be evaluated.

For client retention purposes (obviously, the latter is the most important. Difficulties in measuring loyalty can arise as bankers typically assume that retention of clients equals loyalty – but there is no clear guarantee that because, say retention rates increase, the private banking service offering is a reflection of any enhanced faith by clients. For example, client retention may increase because of greater market uncertainty or volatility, or because they may be confused about the complexity of alternative product offerings, and so on. This is important for bank managers because it suggests that existing measures of loyalty may be seriously flawed, and thus strategies developed on the strength of such measures may be inadequate. The very term 'loyalty' implies commitment rather than just repetitive behavior, which suggests that there is a need for a cognitive as well as a behavioral view. This has led many bankers to use various customer satisfaction measures as a proxy indicator of loyalty because it has been assumed that satisfaction affects buying intentions in a positive way. However, research indicates that it is overly simplistic to assume that dissatisfied customers will defect, and that satisfied customers will remain loyal. Indeed, despite being 'satisfied' or 'very satisfied,' many customers still defect. Therefore, there are two things to consider: the first

is that attitudinal measures of satisfaction are poor predictors or measures of behavior, and second, it casts some doubt on the concept of 100 percent loyalty.[23] When furthering our understanding of the word loyalty in retail banking, we have to face the fact that it is made up of two main assets:

– The image of the bank, as far as trust is concerned, is represented through the esteem, and the familiarity that the customer might summarize by saying, 'I can trust my bank';
– The coherence between bank image and behavior, from which we may gather what relation exists between promising, for example to place money in the bank and the bank keeping the promise to manage this money in an appropriate manner.

So far, much of what has been discussed focuses on loyalty from a client's perspective, but it is also important to remember that in bank jargon 'loyalty' is often used as a synonym for *cross-selling* and *retention*, which takes us back to the old idea of controlling bank–customer relationships.

5.4.1 The customer relationship management approach comes before customer-intimacy

Before elaborating on customer-intimacy, its meaning, and the fundamental principles of this strategy, we want to outline an old issue which is the customer relationship management approach in retail banking.

Once upon a time, retailers, banks, and insurance companies had close relationships with their customers. As they invested in getting to know their customers individually, they attempted to understand their needs and tried to satisfy them through personalized service. Such practice increased the loyalty of customers and resulted in committed and often inherited relationships between customers and their banks. Soon after realizing that such a system was inefficient and costly, even if subsidized effectively by customers through higher prices, and assuming that customers would remain loyal despite changes, the retail banks developed new marketing policies. These were product- and transaction-oriented, reactionary, and focused on discrete rather than continuous activities.[24] The philosophy of a mass market for financial services was reflected in the reduced variety of products and services offered, lower prices, and an increased use of anonymity. Today, banks cannot rely on committed relationships and need to use new marketing techniques to attract and retain customers. Information communication technology (ICT) enables every financial institution to offer their customers an increased variety of customized products and personalized services at lower prices. As a result, the development of one-to-one relationships, customer value analysis and mass customization became possible.[25] In addition, the need for an enlarged geographical reach has

pushed retail banks to introduce various distribution channels (ATMs, Internet, digital TV, smart cards, mobile platforms, and so on), which have lowered customers' dependence on the high-street branches, and given customers non-stop access to services regardless of geographical barriers. The beneficiaries of such changes in the environment of retail banking are the customers, who receive an increased degree of power and control, as already mentioned, also due to tighter competition in the retail banking marketplace.

There is evidence[26] that some banks went so far as to allow customers to tell them precisely how their needs should be met. But the practice of this customer-managed approach was not successful, and banks were forced to take relationship management under their control. At that time, there was a kind of contradiction, because a customer relationship management (CRM) approach takes a long-term perspective while most bank planning was, and still is, for the short term. This makes banks working to get immediate results look for control of their customers. But this is a view of the past, as we have already noted. In a networked economy, controlling the customer is becoming more and more counterproductive. Retailing is more and more in the business of being chosen, and this is makes the situation different from the past. So it is urgent to change and seek to be different; but in all this, CRM goals still remain valid. The literature review[27] suggests that CRM can be defined from at least three perspectives:

1. Narrowly and tactically, as a particular technology solution;
2. Wide-ranging technology, designed to solve customer-oriented technology problems; and
3. Broadly and strategically, fostering the organization's management of customer relationships in order to create shareholder value.

In Table 5.2, I synthesize the three ideal stages, where the third stage narrows to a customer-intimacy approach.

Table 5.2 A revised picture of the CRM continuum

'First stage'	**'Second stage'**	**'Third stage'**
The implementation of a specific technology solution. It is technology driven. Its functions are mostly tactical.	The implementation of an integrated series of customer-oriented technology solutions. Still technology-dependent, still tactical, but starts being marketing driven.	A holistic approach to managing customer relationships to create shareholder value. Mostly organization-driven and developed among the bank's internal customers, at first.

From a strategic viewpoint, CRM is well known to be something that goes far beyond IT, as it should be ensured throughout the entire organization, so the bank can develop its own holistic approach. The evidence of the beneficial consequences of effective CRM is well-documented, and its benefits can be summarized as follows:[28]

- Relationship marketing increases retention. Research shows that high levels of customer satisfaction are associated with increased retention of customers;
- Relationships build more easily when there is two-way communication and where organizations set up feedback loops, there is a potential to learn from customers;
- Relationship behavior anticipates customer demands or can be adaptive to it. By engaging in an interactive dialogue, customer preferences can be determined; and, as already mentioned;
- Retained customers are inevitably more profitable.

As banks have to face a new order in managing their customer relationships, they need to focus on the overall experience, this time, of both their external and internal customers. For external customers in retail banking, there is much evidence that the overall experience is getting to be an important key differentiator. This is equally valuable and relevant to internal customers and needs to be implemented more consistently than it has been so far. Because part of the service is delivered by internal customers and sometimes dissatisfaction could come both from them and from bank processes alike, it is interesting to notice that this gap of satisfaction can be filled, because many customers are willing to help banks sell them better. In fact, 70 percent of them worldwide are willing to provide more personal information to their bank, as long as they receive a more tailored offering in return or better service.[29] In this regard, personalization goes beyond appropriate products, and this is always good news for banks willing to differentiate themselves. It is well known that in many countries, the majority of customers have been surveyed for many years by their banks; and so these banks have certainly gathered important information, which is all in their customer databases. But the critical issue is not to gather information but to turn that information into customer knowledge and insights that are useful when it comes to acting commercially. Another weakness is that sometimes retail banks have forgotten that there is an implied contract involved when asking customers questions. Customers are human beings, and they wait for their bank to deliver its side of the bargain. When this customer-centric

approach comes with a long-term profitability horizon attached, then we can say that we are on the way to customer-intimacy. It is a way of delivering bank value to customers, and the focus on customers is embedded throughout the entire organization and may consequently be developed into a customer-intimacy strategy. To follow a strategy of customer-intimacy, segmenting and targeting markets is also required, but not using the old-style formulas (such as assets under management, and others) but looking at new criteria. Even though we are not going to discuss this issue, it is important to note the strategic role played in this by customer segmentation.

5.5 A renewed focus on customer retention

The analysis of consumer behavior and the assessment of the high competitiveness of the financial services sector leads banks and other financial institutions to realize that acquisition of new customers is very much more expensive than retaining existing ones.

Customer retention is an essential part of relationship development, and the critical issue is that once customers are lost, they are difficult to regain. So, more attention is now being dedicated to customer retention although many banks still consider the acquisition of new customers more important. (But who are these new customers and how do they behave? This is an important issue to assess when seeking to acquire customers.)

There are some other reasons explaining this shift and they are: an increased focus on customer value; competition and consumerist pressures; technological innovation; recent regulation and legislation; and the development of relationship marketing in other sectors.

In particular, the recent rising cost of customer acquisition has been caused by the fact that the penetration rate of the market place or the market segment has risen and that the value of customers at the margins of the segment is generally lower than that of those already served. As the significance of the long-term individual customer value is realized, banks are becoming motivated to focus more on customer profitability as opposed to product profitability, and the overall value of the business is assessed with reference to aggregated customer worth. On the other hand, the increased competition – spurred by the fact that low entry barriers have invited new entrants to the already highly penetrated market segments, and that existing financial services organizations have found it easy to diversify into new areas – has highlighted the importance of the retention of existing valuable customers as they could switch to the provider of a more attractive service.

The consumerist pressure has been amplified with the establishment of organizations representing the customer interest, such as the National Consumer Council in the UK, the Consumers Union in US, and others in many countries, which have fought to improve the way in which the financial services industry serves the interests of customers. These organizations have tackled issues such as product charges, the use of orphan funds, mortgage endowments, etc., and have tried to eliminate practices through which financial institutions caught the attention of new customers with attractive propositions, only to subject them to detriment once they became customers. As a result, retail banks have needed to develop more effective and sophisticated marketing policies and practices with regard to existing customers.

The regulatory and legislative developments have certainly increased the operating costs and introduced new criteria of compliance.

The technological innovations in telecommunications, database management, and worldwide web have stretched the techniques and applications of customer management, while the development of relationship marketing in other commercial sectors, especially the business-to-business sector, has provided techniques to be used in forging genuine banker-client relationships.

As a consequence of the pressures mentioned above, financial service providers across the world are now expressing more interest in the development and the management of relationships with their clients.

Going back to the customer retention issue, this is the activity every company undertakes to prevent customers from defecting to alternative companies. Successful customer retention starts with the first contact and continues throughout the entire lifetime of the relationship. Its main benefits are: increased revenues, lower customer acquisition costs, and increased referrals.

As a consequence, more banks have been growing their interest in customer retention, and so are starting to move away from devoting high levels of marketing effort to acquiring new customers. The evidence in support of such a shift is impressive for retail banking. A 1995 report[30] showed that increasing customer retention by five percent adds more than three years to the average customer lifetime, and demonstrated that account usage per relationship increases over time. Similarly, another report[31] revealed that the top five percent of customers generate 40 percent of total deposits, and calculates that a five percent increase in retention among top customers yields a 24 percent increase in profitability. Even though these figures speak of past situations, it is clear that if customers are effectively unprofitable at the beginning of their relationship with

the bank, and that it takes some years for the relationship to become a net profit contributor to the bank,[32] the customer propensity to shop around can be seen as a direct threat to profitability.

Here is some evidence in the literature that the value of individual customers rises over time as they increase their holdings of other financial products, contribute to the bank's understanding of their needs and preferences, reduce operating costs by getting used to the service, organization, methods, and procedures, and become a positive referral source. Given this, the economic value of customer retention is widely recognized. It has also been found that customer retention has a more positive effect on profits than market share, scale economies, and other variables that are commonly associated with competitive advantage (see Box 5.8).[33]

There are several methods to increase customer retention, but we think that the most important, especially when we are looking at services, is to develop customer service training. Employees who are better skilled, engaged, and more aware of the importance of providing a positive customer experience, are an important driver for increasing customer retention.

Box 5.8 How to measure customer retention?

There are several ways of measuring customer retention. The following are the most frequently used in the market:

- Customer retention rate: the percentage of customers who stay with you over the total number of customers. The downside is that this number ignores the fact that some customers are more important/valuable than others;
- Revenue retention rate: percentage of total potential revenue retained. This metric misses the impact of account expansion but works better in environments with predictable customer contracts;
- Average customer revenue (revenue yield): total revenue divided by the number of customers. This gives you a sense of how well you are growing your wallet share with customers;
- Repeat purchase rate: this reflects the percentage of business from existing customers;
- Net promoter score: based on the fundamental perspective that every company's customers can be divided into three categories. Customers respond on a 0–10 point rating scale and are categorized as: promoters (score 9–10) are loyal enthusiasts who will keep buying and refer others; passive (score 7–8) are satisfied but unenthusiastic customers who are vulnerable to competitive offerings; detractors (score 0–6) are unhappy customers who can damage your brand and impede growth through negative word-of-mouth. By asking one simple question – How likely is it that you would recommend (your bank) to a friend or colleague? – the company can track these groups and get a clear measure of the company's performance through its customers' eyes.

Often, customer retention and cross-selling efforts are complementary. In fact, in order to determine the effect of one, the calculation really needs to include both. Cross-selling programs that increase the number of purchases or relationships that a customer has will always have a positive effect on retention. Conversely, retention efforts will always create opportunities to increase the depth of the relationship through cross-selling. Most of the time, cross-selling is initiated by the company, through pushing a given service to customers.

In this regard, customer retention can be viewed as a measure of relationship continuation, which is in turn a result of the decision that customers make on the basis of their previous experiences, and it shows the intention to continue contracts.

5.6 From customer retention to cross-buying

Now, we want to change our perspective and think about customers who do not buy a single product/service at a time. During their buying process they might be interested to buy more products under certain circumstances. This phenomenon can be described as passive cross-selling or better still, cross-buying. This requires every company to strengthen its emphasis on analyzing customers' purchase combinations.

We can explain cross-buying as an extension or a deepening and development of relationships with existing customers, and it reflects current and anticipated future experiences.

There can be many interpretations of cross-buying; among them at this stage we can refer to the one which considers the total numbers of different categories of purchased services.[34]

Most of the literature has focused on customer retention, but recently some authors[35] have started enlarging this perspective and developing research frameworks on cross-buying. This is particularly useful when the market situation changes because of the development of the network economy that in particular increases customer mobility. Given this, customer retention might not be enough for the development of a strategy that seeks to be chosen over the long-term.

In a competitive environment, cross-buying may offer an interesting source of profits, and it may contribute to the stabilization of relationships with bank customers.

From a managerial point of view, at the beginning, we have defined cross-buying only as the numbers of different categories of purchased goods, but a cross-buying strategy may be much more than that, because

it can be focused on other elements, which have their main impacts at the organization level; and they are:

- Customer orientation: when the bank looks on customer ideas and satisfaction as its primary goals;
- Relational selling behavior: to maintain and promote business relations with customers, the sales personnel adopt certain behaviors, including interaction intensity behavior and a major disclosure of information behavior. Customers may be asked to answer some questions;
- Relationship quality. The feelings of customers about the interaction with their service suppliers, including satisfaction and trust.

From an operational viewpoint, every element needs to be synthesized in a set of questions[36] a retail bank organization could ask itself to assess whether or not it is near a long-term customer approach, using the five-point Likert scale (where 1 is strongly disagree and 5 is strongly agree). At this point, cross-buying by itself can be measured with the sum of categories of products purchased, where the higher the score means the stronger variable (see Table 5.3).

Even though I myself have found no empirical evidence[37] on the cross-buying phenomenon, we can infer that at present cross-buying behavior seems to be low in the retail banking arena, and the number of products is just a limited proxy of that phenomenon. We infer this because the previous factors we described (such as banking push campaigns; bank customers shopping around and mobility; customer satisfaction on pricing; and so on) seem to reinforce the idea that customers are still far from cross-buying.

Finally, we think that some further questions should be asked to deepen our knowledge of this phenomenon:

- What might be the causes for the low cross-buying situation?
- How much do we differ from our competitors?
- Does the emotional edge matter in our business?
- Do we have the right to serve our customers?
- Do we have formalized procedures for assessing what customers like and ask for?
- Do the financial staff love their roles?
- Do we have a collaborative customer model?
- How do we listen to customers? (Phone and Internet only!)
- Do we have an overview of our customers' experiences?

– Do we have a system to collect qualitative information from our staff and treat it appropriately?
– Do we measure internal service quality and employee satisfaction?

Table 5.3 Questionnaire items we may use to assess a cross-buying approach

Customer orientation	**Relational selling behavior**	**Relationship quality**
– The financial staff take customer satisfaction as their goal. – The financial staff are able to transfer their commitment. Emotional versus rational dimensions according to the typology of services (such as, payment is more rational as it requires a functional approach – that is, how to send/receive money; while investments are more emotional as customers invest their earnings and savings). – The financial staff attach importance to my ideas (see Zara case – Chapter 4).	– My financial advisers or financial staff keep in touch with me. – My financial advisers tell me if I need to change the products that I have already invested in. – My financial advisers would explain why I need to have this kind of investment product. – The financial staff would give me new information or tell me about new products.	– My feeling about interaction with the financial staff is good. – I feel satisfied with the financial staff's professionalism. – I feel satisfied with the financial staff's service quality. – I feel satisfied about my relationship with the financial staff according to the different contact points used. – I feel satisfied with the overall service provided by the bank staff.
Results: Cross-buying? Yes/No		

Organizations should not seek to bias or restrict customers to buying their products or engaging with their brand only through a single way or channel. In fact, banks should be actively seeking to engage their customers to cross-buy digitally as well, considering that context works in the banking arena and that some banking products are highly contextual. This is important if banks are looking to regain their centrality in their customers' everyday lives. For example:

– A mortgage can be sold both in a branch and online, but also potentially at a home or through a realtor;
– Car lease or loan (at a car dealership or when purchasing a car);
– Credit card (potentially at a mall or getting ready for a trip overseas);
– Travel insurance (when booking a holiday or at the airport);

– Student loan (when enrolling at college or university).

These days, through modern mobile technology, it is possible to know a person's location when he takes advantage of a certain banking opportunity, and this is extremely useful when gathering context data and using this to extrapolate a set of customer opportunities with respect to banking.[38] In this way, retail banking can also be about context and journey in service selling. With engaged and skilful employees, banks may be able to make the shift from products to processes and places, to get to customers when and where they need banking services most.

5.7 Next step: customer-intimacy

As seen in previous paragraphs, retail banks and other financial institutions are realizing the importance and power their customers have, especially when they engage in a search for the best deals. They are more discerning and demand to be treated as individuals.

If this is true, then investing in long-term relationships means realizing that in order to retain customers there is a need for extended, emotive, and intimate service encounters.[39]

The emotive contact is considered to stimulate a trusting environment and allow a deeper understanding of a specific customer's situation. For these reasons, customer-intimacy may be interpreted as a prerequisite for establishing a relationship and is a relevant condition for mutually beneficial two-way communication between the service provider and the recipient. As a consequence of this, we could also stress the need to integrate interaction, exchanges, feedback, and so on between the stakeholders. That is, more interactions and information exchanges with customers are needed. Such relational selling behavior can be expressed in terms of interaction intensity, disclosure of information, and willingness to cooperate, and this is an interesting part of the cross-buying paradigm.

The notion of customer-intimacy was first mentioned and developed by Treacy and Wiersema in 1993. In their article, the authors explained the success of different companies by their ability to deliver value to customers. They considered that customers had changed their interpretation of value and no longer treated it as merely a combination of quality and price, but they also judged other attributes of the product or the service, such as convenience of purchase, after-sale service, dependability, and so on. In their attempt to deliver superior

customer value, firms could follow one of the three value disciplines they suggested:

– Operational excellence mainly focused on operational competence;
– Customer-intimacy focused on customer responsiveness; or
– Product leadership focused on product differentiation[40] (see Figure 5.2).

Leadership positions were said to be achieved by those companies who concentrated on delivering superior customer value and became champions in one of the value disciplines while meeting industry averages in the other two.

In this context, customer-intimacy, the second value discipline, is defined as 'segmenting and targeting markets precisely and then tailoring offerings to match exactly the demands of those niches.'[41] The institutions that follow this strategy need to combine detailed customer knowledge with operational flexibility in a way that will enable them to respond quickly to any need of the customer, from customizing a product to fulfilling special requests. This can be expensive, but companies that practice customer-intimacy need to invest in building customer loyalty for the long term. But for an organization to become customer-centric requires it to develop an in-depth understanding of the customer's experience cycle through a life-stage analysis and develop a hierarchy of customer needs, anticipate those needs, and develop mechanisms that communicate them back to the organization. A crucial role in all this is played by the workforce, who need to

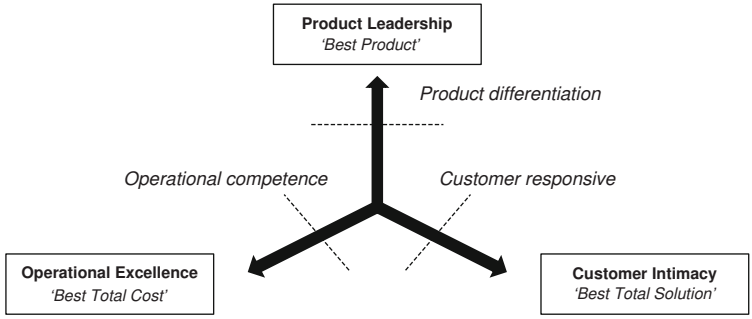


Figure 5.2 The three value disciplines

Source: Extracted from A. Hart & O. Sacasa (2009) 'The Case for Customer Intimacy: Transforming Retail Financial Services Firms,' p.3. Downloaded from http://cmgpartners.com/userfiles/file/ipPDFs/CMGP_IP_CaseForCustomerIntimacy_200906.pdf

be trained to understand the business picture. It also requires looking at the customer's lifetime value more than the value of any single transaction. Employees are strongly encouraged to satisfy, completely and exhaustively, all the needs and requests of customers irrespective of the initial cost. In the financial services sector, it is also important to recognize that not all customers require the same level of service or will generate the same level of revenues. For this reason, the profitability of a financial institution is reliant on its ability to quickly and accurately differentiate between customers, based on both the required level of service and potential revenue generation. The goal of such a system is to identify which customers require greater attention and an elevated level of service and which, by contrast, are simply looking for the best deal.

The literature has widely supported such a view of customer-intimacy and has also suggested other important strategic elements that should be considered. For example, there is also the idea that to be successful with the customer-intimacy strategy,[42] a company must align all its cultural elements with this strategy. As a consequence of this, a framework can be produced to assess the depth of an organization's customer-intimacy, based on the analysis of the three value disciplines from the internal perspective, and it compares their core organizational capability and the key people strategies as shown in Table 5.4. Following this logic, the strength of the customer-intimacy culture in a financial organization depends on its ability to match all the dimensions listed.

For Habryn *et al.* (2010), customer-intimacy is:

> not only about having a high quality relationship with a customer: it is also about how an organization and its members are able to leverage the knowledge acquired through this relationship in order to shape the offering and to achieve a competitive advantage.

Practicing customer-intimacy requires excellence in two dimensions of the diagram (see Figure 5.3), which are crucial, and they are:

- The quality of the relationship with the customer (low/high quality with regard to the 'target' segment) and the mutual willingness to create a partnership (x-axis); and
- The ability to leverage this relationship and to adapt the offering to better fulfill the individual needs of the customer (y-axis).

Table 5.4 Key people strategies in the value disciplines

	Value discipline:		
	Operational excellence	**Product leadership**	**Customer-intimacy**
CORE ORGANIZATIONAL CAPABILITY	Providing reliable products or services at competitive prices and delivered with minimal difficulty and inconvenience.	Providing leading services consistently enhancing the use of the product/service –making rivals' goods obsolete.	Segmenting and targeting markets precisely, and tailoring offerings to match exactly the demands of those niches. Customer sensitivity and flexibility.
DIMENSIONS			
A: Personal strategy	Emphasize motivation and corporate spirit. Build teams that deliver cost-effective value, and high quality, user-friendly products and services.	Provide a comfortable, positive, creative environment. Provide basic needs. Remove them from HR policies and management concerns. Do not differentiate between people.	'Satisfied employees satisfy customers.' Rely on values to shape culture and messages. Promote relationship building as priority.
B: Organizing	Teams: Project, process, product, or customer based. Knowledge is shared. Best practice applications.	Product groupings based on creative structure – team or individual. Separate sales and creation functions.	Customer needs driven, but can be individual or team based. Strong focus on relationship building. All individuals constantly selling to customers – improving relations.
C: Personnel procurement (Criteria)	Logical, efficient, cost conscious, resourceful, analytical, following procedures, initiating self-growth, short term focus, systematic, team player, good communicator, detail-oriented, problem solver.	Courage, innovation, creativity, high technological development, long-term focus, future focus, possibility focused, pride in being first in product quality, getting it right.	Highly responsive, excellent listening skills, empathetic, consultative, perceptive, flexible values driven. Good communication, technical skills. Able to assess needs. Spontaneous problem-solvers, understand motivation. Long-term relationship focus.

Continued

Table 5.4 – Continued

	Value discipline:		
	Operational excellence	**Product leadership**	**Customer-intimacy**
E: Achievement (Measures)	Results, on time, on budget, project completion and quality, cost reduction. Peer feedback on team behaviors.	Contribution made to new and innovative product/service development. Revenues from new products and shipment statistics.	Relationship productive behaviors. New customers gained, customers retained, and cross-selling.
F: Remuneration	Strategic approach. Pay for performance individual and team basis, below market base plus incentives. Variable incentives based on organization, unit or team results. Profit sharing.	Rewards not used as a strategic tool, no direct differentiation. Rewards kept neutral. Salaries and benefits above market. Profit sharing – equal distribution. Defined benefit plans.	Rewards tied to values. Based on behavioral, subjective assessments. Profit sharing – individual contribution recognized. Broad benefit choices.
G: Strategy	Process and systems based.	Innovation, research, and development based.	Relationship management based.
H: Core values	Reliability, accessibility, quality, market leadership.	Change sensitivity, focus on internal value adding.	Customer-centricity and sensitivity to customer expectations.
I: Core abilities	Consistency in provision, follow-up, and support.	Market leadership and continuous benchmarking.	Customer relationship building and retention strategies.
J: Business model	Structured – process driven. Functional groupings.	Flexible – change sensitive. Project team groupings.	Flexible: people centered, 'flat' organization.

Source: Adjusted from Potgieter, A. & Roodt, G. (2004) 'Measuring a Customer-intimacy Culture in a Value Discipline Context,' *Journal of Human Resource Management*, p.26.

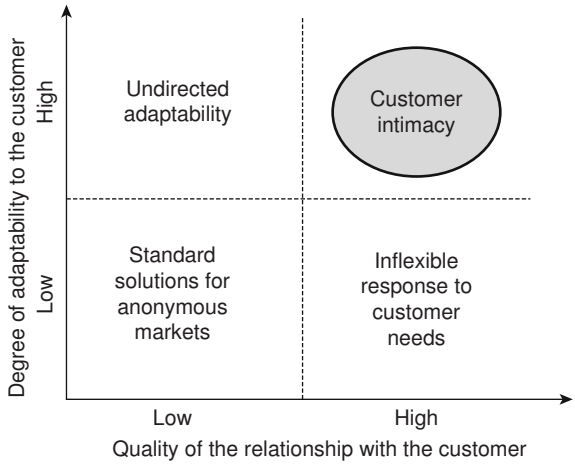


Figure 5.3 The two dimensions of customer-intimacy

Source: Habryn *et al*. (2010) 'Towards a Model for Measuring Customer-Intimacy in B2B Services,' p.4.

Customer-intimacy exists when both the relationship with the customer and the ability to adapt to the customer are high.

Some authors have also attempted to identify a measure of customer-intimacy from a subjective assessment of different attributes or characteristics of the firm culture. In a balanced scorecard evaluation, a set of five attributes has been proposed,[43] as a means of measuring customer-intimacy:

- Customer knowledge;
- Diversity of solutions offered;
- Penetration ability;
- Culture of driving client success; and
- The presence of relationships for the long term.

A combination of these characteristics influences the ability of the institution to respond to customers' demands and preferences. A further contribution[44] developed a six-layer approach for evaluating customer-intimacy. Companies could be differentiated from one another according to whether they:

1. Were involved in the customer's planning process;
2. Involved customers in their planning process;

3. Partnered and jointly planned together with customers;
4. Aligned each other's operating processes;
5. Designed operational interfaces; and
6. Formalized a system of joint decision making.

In this situation, they use this scale to correlate the degree of customer-intimacy with the internal market intelligence capability of the organization, which is broadly speaking the market orientation of an organization. However, only a few suggestions are presented on how to actually measure these layers, which focus merely on the organizational level. Also, considering the co-creation of services, the authors recognize the importance of partnership and collaboration in the development and implementation of a customer-intimacy strategy.

Later on, other researchers tried to use accounting numbers from sales or marketing departments to explain some tacit concepts, including customer-intimacy. For example, two modes were suggested[45] to calculate customer-intimacy in the financial services industry. Both are essentially focused on market intelligence data and customer penetration, and they are: a sales calculation approach and a numeric calculation approach.

Elsewhere, a performance indicator called the Customer-intimacy Grade was suggested.[46] This depends both on the quality of the relationship (evaluated as communication, commitment, and trust) and on the degree of adaptability (defined as a cultural trait of effective organizations that are driven by customers, take risks, and learn from mistakes, in order to provide value for customers). Such interpretation of customer-intimacy should be done separately for both the individual and organizational (team, business unit, or entire enterprise) levels.

5.7.1 Customers' interpretation of intimacy

At this point, it is crucial to understand what intimacy means to customers, and to what degree such intimacy is wanted by them.

First, in order for a relationship to be present in the minds of these customers, there has to be ongoing contact with them, and the interaction would have to involve something more than mere transactions. Customers should develop an idea of cross-buying from their bank, and this is because they expect more of their financial services providers and are open to a closer long-term relationship.

An interesting study[47] proves the importance of emotion and of the affective side in building and maintaining relationships with customers, and it concludes with the idea that the emotional tone of the relationship

is the best predictor of closeness, strength, and satisfaction experienced by customers.

Nowadays, in the market, there are people who see a bank only as a place to hold money temporarily, mostly because of their past banking experiences. But there are many others who consider a bank an institution responsible for their ability to increase their quality of life. Therefore, customers are increasingly expecting to receive a personalized service[48] and are strongly rejecting mass targeting in financial services.[49]

Such personalization means for them the attempt of the banks to identify and meet their unique needs and is the main indicator of intimacy. Unfortunately, many customers are not satisfied in this respect. Recent research shows that almost 70 percent of customers do not feel valued by their retail banking institutions, and more than 50 percent of insurance policy holders said policies are not tailored to meet their needs.[50]

Banks have also to realize that not all customers want a very close, intimate relationship or ask for the same level of service quality. Some prefer to transact their business on a less personal level. This leads to the idea that closeness in the relationship does not always contribute to satisfaction. Thus, to satisfy customers with diverse intimacy preferences, bank marketers must be able to identify and differentiate those customers who would prefer a more arm's-length relationship from those who are quite satisfied being able to transact their business through ATMs or by telephone or online. The main idea is that each bank has to look for its own future depending on its customer base and what it knows about them.

5.7.2 Banks' interpretation of intimacy

From the banks' perspective, having a strategy of customer-intimacy means knowing about customers' strategic issues and challenges within the industry, and delivering products or services tailored to individual needs. Also, it means understanding customers' interests and anticipating their future needs and/or responses to potential service offerings. Cuganesan cited one bank's summary their interpretation of the notion of customer-intimacy (for privacy reasons, the bank was given the name FinCo):

> Customer relationships are integral to the successful execution of FinCo's customer intimacy strategy and our vision [...] customer intimacy means knowing: where the customer fits in their industry, customer needs and whether and how customers respond to product offerings (solutions). According to FinCo's executive management, customer intimacy would allow the anticipation of customers'

> financial needs and the making of sales pitches that pre-empted competitive tendering. At FinCo, 'customer intimacy' meant both knowing and delivering customer needs in the present, and being able to anticipate these needs into the future through an understanding of customer interests. Enactments of this, however, were heterogeneous, with different modes of calculating customers and attributes of customer relationships engendered through alternative actor-networks.[51]

The way banks achieve their goal of customer-intimacy depends on the CRM methods employed, and these vary from one bank to another. Even if the goal of the management team is to provide customers what they need, managers can have different views on how to achieve this objective. Some believe that marketers, by collecting and analyzing the data about the customers, can develop the right products and then suggest them to customers. Others prefer to engage in a productive two-way communication and provide ways for customers to express more about who they are, their actions, thoughts, and intentions. The information collected is used to develop the products wanted and needed by the customers, and the collection of feedback is used to understand whether the products or services satisfy previous and current needs.[52]

In regards to the development of the relationship, there are some institutions in the market that focus primarily on improving the quality and frequency of the direct contact through direct mail, help desk, and call center operations. While some others interpret CRM mainly as data warehouse, data mining, e-commerce solutions or databases for sales automation. And the rest translate CRM into diverse customer retention projects, such as loyalty schemes. Therefore, because of many and diverse interpretations of CRM and customer-intimacy, it is possible that retail banks set different objectives and look to achieve them by various methods.

An important issue is that when banks are most comfortable with CRM they also have a clear and unconstrained strategy aimed at where they want to go. In contrast, banks that are struggling with CRM initiatives are allowing the technology to decide where they need to go. This suggests that to be successful at developing a close, long-term relationship with the customers it is important to understand what the other side wants and expects from this relationship, and follow a thought through plan. It is not only about the knowledge of customers, the decisive part is the execution of such a plan. Managers should not be over-optimistic about the benefits of CRM and should be ready to face the challenges of its execution.

5.7.3 Benefits and drawbacks of a strategy of customer-intimacy

Developing a strategy of customer-intimacy requires long-term investment, especially for building and developing relationships with customers. Thus, before committing to it, an institution has to fully understand the benefits and the drawbacks of such a strategy. Furthermore, to make the right strategy choice, it is important to compare the available possibilities. I report in Table 5.5 what Hart and Sacasa (2009)[53] summarized in terms of strategic goals, benefits, and drawbacks of the three value disciplines.

Table 5.5 Pros and cons of the value disciplines

	Operational excellence	**Product leadership**	**Customer-intimacy**
Strategic goals	• Best value-for-money • Organization improves operations working to increase efficiency	• Emphasis on innovation and development of products/services • R&D investment as a competitive advantage	• Work at differentiated customer experience • Look for excellence in customer attention and service thanks to CRM
Benefits	• Provides leverage to set market price and influence customer perceptions • Increase cost reduction	• Develop some possibilities to act on pricing strategy (premium price) • Looking for developing a virtuous cycle on product/service innovation	• Increase understanding customer's needs and wishing • Increase ability to answer customer requests • Empowers employees on customers' issues
Drawbacks	• Work inside before getting to customers' needs • Deters innovations and variety of products, which could be valuable to customers • Open space to competitors on differentiated offer and price elasticity	• Customers' needs may shift to value other offerings or attributes • Customers may be unable to differentiate properly (or may not be interested to differentiate) between products or services	• Experience may differ if delivery is not managed consistently • Customers may not want to be collaborative or are unable to give useful information • May lose market opportunities which the market is not able to signal

Source: Adjusted from Hart & Sacasa (2009), pp.3–4.

The initial benefit of pursuing a customer-focused strategy is the profound understanding of customer needs and wants. Such knowledge is used to further manage customer relationships. Second, receiving a 360º view of a customer from multiple engagement channels enables the institution to discover opportunities to improve revenue through up-sell and cross-sell. Also, the information can help avoid unnecessary expenses by targeting promotions and activities, and by delivering services at the levels preferred by customers. Furthermore, the ability to improve customer experience, to deliver tailored offerings and to improve the quality of direct contact through empowered employees can lead to price indifference, reduced competition, positive word-of-mouth communication, and better reputation.

On the other hand, pursuing a strategy of customer-intimacy may be not the best choice. Being too focused on customers, the firm can miss opportunities that are not signaled by the marketplace. Moreover, some customers may be not motivated enough to communicate their true needs and preferences, others may not know how to do it. It is also possible that a small group of proactive customers can mislead the firm to develop overly sophisticated products that are not suitable for others. However, the main drawback of this strategy is the need to be consistent and keep giving the same level of attention to customers. A failure to do this can lead to lower satisfaction, higher defection rates, and lower effectiveness of any customer retention program.

5.7.4 Customer-intimacy: some precautions

As mentioned previously, diverse interpretations of CRM and customer-intimacy cause retail banks to set different objectives and look to achieve them by various methods.

The true driver in a strategy of customer-intimacy is execution of the planned activities, which is the final factor influencing the result, and any human or technological intervention might lead to a gap between the objectives set and the results achieved. Thus, it is important for a bank not only to understand customer-intimacy but to be competent at putting it into practice. There is some documented research about the success of customer-intimacy in retail banks (see Table 5.6).

Some other studies[54] also highlighted the difficulties faced by banks in this regard. Among the remarkable factors identified there was the gap between bank's expressed strategic goals and the tactical actions it takes relative to those intentions. In particular, it was noted that the financial institutions indicated that their highest priority was to

Table 5.6 Banks successful at practicing customer-intimacy

Banks	**Source**
National Australia Bank Bank of Montreal Capital One	Coltman (2007, p.102)
Bank of the West Raymond James Amica American Express	Hart and Sacasa (2009, p.4)
Boston Private & Trust Goldman Sachs Morgan Stanley	Tallon (2010, p.224)

be more customer-intimate and focus on improving service quality. However, their actions and spending habits underline that the true focus was to reduce cost through operational excellence and product leadership, with little attention to the expressed goal of customer-intimacy. We think this is still tricky for banks in the present situation because they are driven by financial investors' choices and not by their customers' choices. An important shift in this situation will be possible when retail banks realize that customer-intimacy is not only something to be squeezed into the mission statement, but is a product of a persistent process to improve performance in managing customers' expectations, and requires continuous planning and monitoring of its execution. Overall this means focusing on customer-intimacy from:

- An external bank customer's viewpoint, which does not mean educating customers to assess a bank's value; and also
- An internal customer's viewpoint, which means delivering the big picture of their business to employees.

Finally, the greater challenge facing retail banks – whether large or small (see Box 5.9) – will be at the organizational level. And this is true because a retail bank is ought to face a series of difficulties, such as: inertia, historical distribution of decision-making power, inability of the marketing department to collect and manage data about the market, inconsistency of the focus on customers, rigid division of responsibilities, and a lack of a more effective internal communication to deliver a vision of where the business is going.

Box 5.9 Is there a difference between small and large banks on customer-intimacy?

Banks both large and small are both motivated to develop a customer-intimacy strategy, but they will certainly act differently, along the same lines. Small banks are more inclined to customer-intimacy because they are more geographically focused, and thus, they tend to know their customers and their banking needs personally. They can also be more flexible in providing a differentiated service. Moreover, in contrast to large banks, they build a specific relationship with each customer, based on trust, familiarity, flexibility, and commitment. Thus, their customer-intimacy is a function of their service delivery rather than their exclusivity, and their attempt to be closer to the customer in diverse ways. Tallon[55] enumerates some of the ways in which small banks are trying to reach customers:

> Small banks such as Emigrant Bank in Long Island, New York (34 branches; 31 ATMs) and Southbridge Savings Bank in Massachusetts (13 branches; 14 ATMs) train their employees to be more engaging and to focus on developing lifelong customer relationships. Others, such as ING, which has no physical bank branches, use café concepts in major cities (similar to apple stores) to identify, attract, and educate customers. Boston-based Wainwright Bank (13 branches; 13 ATMs) also utilizes showroom concepts and in-branch cafés to offer a different service experience.

Large banks usually claim to offer relationship banking, but in practice it is hard to combine a personalized service offering with low-cost strategies. It is expensive to offer high-touch services, and it is difficult to do it for a mass market. Moreover, high-touch services can limit productivity growth if such growth is built on cost cutting. Where offering personalized services and low-cost strategies comes into conflict, service differentiation may turn out to be the ultimate driver.

There are still many banks in the market at the stage where operational excellence is the goal. While some others are moving toward value and customer-intimacy.

The greatest challenge for both large and small banks is to grow without undermining service quality and customer satisfaction. Increasing the size of an institution can lead to operational excellence being more attractive and to a reduction in the closeness and intimacy levels initially set, which could be unwelcome to customers used to the previous conditions.

Part III
The Retail Banking of Tomorrow

Introduction

Parts I and II outlined some key points that may be useful as a starting point from which to begin developing an idea of the retail banking of tomorrow:

- Banks sell services, and most of them are characterized by high credence qualities;
- Some of these services may involve perceived high-risk exchange encounters;
- They are mostly based on professional capability; and
- In a context of professional services, professionals are responsible for the delivery of such services, which is their primary professional commitment toward the customer.

The professional capabilities and customer knowledge of bank employees can encourage customers to feel that their bank has the expertise to provide them with services that are suitable for them. When customers consider whether to purchase other products from the same bank (cross-buying, according to the way we can measure it), trust can simplify the decision-making process and psychological barriers because it reduces complexity. Thus, a relationship of trust will help customers' cross-buying.

It is also possible that in this context trust can function as an independent variable, a dependent variable, as well as an interaction variable in the development of relationships. It is nevertheless evident that the level of trust must be viewed as a key discriminating indicator in the development of any relationship typology and overall when the relationship may involve customer savings and risk management.

Strategies are remarkably similar around the globe, in part because local banks are competing for retail business with global institutions that bring ever more sophisticated products from their home markets.

Many banks around the world often have similar retail strategies, but are having varying degrees of success in implementing them; this is because strategy is important, but it is nothing without its execution.

This is not simply tactics, but every company has to find its own way of getting things done through questioning, analysis, and follow-through. The gist of all this is to align people with goals so as to achieve the results promised. This requires a comprehensive understanding of the business, its people, and its environment.

6

Business Transformation, Strategy, and Organization: The Issue is in the Execution

6.1 What you will find in this chapter

Market trends are affecting business transformation in many industries and in many countries. Here, I would like to focus not on the trends themselves but on how retail banks should structure their organizations, in order to confront new rules, regulations, and customer demands.

Business transformation is currently at the top of many bank corporate agendas, and there are many issues to face, including:

1. What type of transformation should a retail bank look at?
2. How should it execute its strategy once it has been developed?
3. How should a retail bank be organized in the future; how does it need to differ from today's organization?
4. Do we still need an organization that merely executes strategy?

A key point from which I would like to start in this chapter is the following: looking outside the banking sector, we can see that some growth outliers seem to be pursuing strategies with a long-term perspective on where they want to go, but they contemporaneously recognize that whatever they are doing today will not drive their future growth. They seem to be successful because they are exploiting temporary competitive advantages. This can be true especially when market boundaries are changing ever more quickly, targets are elusive, and capture is at best temporary. The critical task for management is to create an organization capable of infusing products with irresistible functionality or, better still, creating products that customers need but have not yet even imagined. This is a

difficult task. Ultimately, it requires radical change in the management of major banks. It means, first, that top management of some banks must assume responsibility for competitive decline. There is also the need to reform certain principles of management.

6.2 Market trends and changes boost bank transformation

No decision about the future shape or services of an organization can ever be made without a full understanding of the market conditions and dynamic changes within and outside the business. But it would be unfair to ignore the impact of the past few years' difficulties as a fundamental driver of change for this sector.

The actual implementation and details of the strategic orientation vary remarkably across countries and between individual banks. Strategic responses are also largely associated with the organizational structure and core values of banks (see also Appendix 2).

There are three external changes whose impact is very evident in bank strategies:

- Consumers changing in attitudes and behaviors. Most of these changes may also depend on changes in demographics (such as birth rate, inheritance, changes in personal wealth, and others), which affecting the retail banking business differently according each environment. This is extremely important because retail banking is a people business, and it must follow people in their main processes, attitudes, goals, and aspirations;
- Technology evolution[1]; and
- Regulation.

Given this, banks have begun to undertake their transformation (see Box 6.1).

Box 6.1 A framework of some ongoing bank transformations[2]

According to the EFMA/Microsoft survey (2010),[3] the current turmoil in the global economy is transforming retail banking to reflect the changing economic environment. There are three general areas of change, although many other related issues can be found:

– Creating a new operating model. Most banks are involved in major initiatives to try to drive costs down. There are different approaches to this, which vary both within and between countries. In many instances, technology will play an important role in reducing costs while maintaining efficiency and productivity;

– Creating a better online experience. Banks across Europe are trying to increase their ability to sell more products online. Many have made progress in driving online transactions, but banks generally have been less successful than other industries;
– Transforming the retail network. A number of large banks already have major branch transformation programs in place. However, some are increasing the number of branches in the network while others are closing branches. Next comes the issue of the future role of the branch and the optimal level of coverage in geographical terms;
– There is a need to develop customers' use of the online channel and to provide them with more value from this channel and the different channels that are now available and need to be integrated more effectively;
– Banks need to look at new ways of reducing the cost of serving customers; new migration strategies; and the possibility of lower-cost channels.

According to the Accenture survey (2012),[4] banks are mapping out their flight paths to adjust to the 'new normal,' and they are finding that the level of change required is far beyond the tactical responses they have made to past challenges. This greater scale and impact can be seen in the sheer size and scope of the transformation programs now being launched and worked through. More significantly, all areas of banks' business models are being required to change. A number of common themes have emerged in the programs announced to date. In many cases, banks are seeking to drive their transformation programs faster and further by setting aggressive goals across a number of metrics. They are targeting large reductions in the cost base and staff numbers to generate greater cost efficiency and profitability. However, banks are embarking on this change from different starting points. While many banks are seeking a new operating model to support smaller balance sheets with lower income at lower cost, others are building capabilities to expand from an efficient and scalable platform.

Three styles of transformation are emerging to address banks' profitability challenges and growth ambitions.

Operational excellence 'Pit stop'	**Capability renewal 'Panel beating'**	**New size/New shape 'Engine rebuild'**
• Customer-centricity/ selective renewal of distribution architecture • Efficient growth • Execution cost reduction • Capital and balance sheet efficiency	• New operating model (scalable/replicable) • Disposal of non-core capabilities (outsourcing/ monetize assets) • Significant deleveraging • Industrialization of process/core banking renewal	• New business model • New operating model (radical cost take out) • Balance sheet restructuring • Reduce non-core portfolio
		
'Leaner and meaner'	'Right sized'	'New bank'

According to the A.T. Kearney report (2012),[5] some of the forward focus can be summarized as follows:

- Operations. An abundance of opportunities exists in consolidating, cooperating, and improving operational excellence. Cost-income ratios are still significant and all organizational levers – process, IT, smart sourcing, skills, and capacity management –need improvement;
- Complexity. Legacy burdens, ranging from products and sales structures to processes and IT, need to be discarded. It is important to separate the 'good' complexity from the 'bad' to maintain focus on those areas of the business that generate the most value;
- Pricing. This requires a structural and cultural transformation;
- Innovation. This is a way to retail loyal customers;
- Channel changes. Activities will revolve around the rapidly evolving technologies for data storage, analytics, communication, and end-customer devices such as mobile. Changing over to digital delivery models will be key to creating resilient retail banking models in the years ahead.

According to the McKinsey working paper (2012),[6] most of the Europe's retail banks are entering a period of regulatory reform,[7] which leads to business transformation. In particular they regard:

- Improving the efficiency of capital and funding;
- Changing their product mix and characteristics in an effort to reduce risk-weighted-assets (RWA);
- Pursuing collateral more vigorously; and
- Improving their ability to outplace risks.

Some leading banks in Europe have already run stringent optimization programs leading to RWAs savings of over 20 percent. With regard to the improving efficiency of capital, funding, and liquidity use, some of them are attacking the problem in three ways. First, they are improving data quality throughout the enterprise, and especially in capital-intensive businesses such as small business lending and in mortgage lending. Data quality can be improved by extending the effort to collect more detailed information on RWAs. A second way is to boost efficient use of scarce resources and to upgrade related processes. Increasing the level of automation and avoiding manual adjustments in the calculation process so as to reduce errors. And the third way is to explore methodological improvements, including refinements to risk models, to better estimate risk parameters, also increasing their granularity.

Finally, it is said that traditionally, most retail banking executives have built performance-management approaches that use incentives based on volumes and revenues; some have extended these to include some notion of profitability; but in the new world, while these ideas continue to be meaningful, some emphasis should shift to ROE or risk-adjusted profitability measures. Banks must understand the impact of every business decision on ROE. They should also adapt the steering of the bank, including the front office, in a way that enables it to optimize ROE.

According to The Boston Consulting Group survey (2013),[8] the world's top retail banks in the Americas, Europe, and Asia-Pacific are laboring under tough market conditions, transforming themselves to achieve the cost-reduction

mandate, and some of them have been able to create a competitive advantage over their peers by improving the speed and quality of customer service. Four levers are paramount in delivering operational excellence:

- Client excellence can be achieved in 'moments of truth' for the customer, providing effective sales and service across channels, contacting and assisting customers proactively, and delivering 'easy to buy, easy to sell, easy to service' products with key features that are instantly functional;
- Efficient and effective processes is when design processes are simple, fast, and, ideally paper free, and get things right the first time so that customers do not experience delays or errors. When fulfillment cannot be provided at the point of sale, have the ability to hand off the task to operations through data or images, then route it to the right individual for completion;
- Streamlined organization, to achieve a lean structure with a clear sales and service focus, as few layers as possible between the frontline and executives, tight single-point accountability, and minimal bureaucracy; and
- Developing strong underlying capabilities, which allow the bank to continuously improve its end-to-end operating model and cost performance through complexity reduction, rigorous management of performance, linkages to incentives, and other initiatives. It is also stated in the report that there has to be a perspective on achieving operational excellence which should go beyond KPIs.

According to the KPMG survey (2014)[9] of a large number of companies, including the banking industry, the approach to transformation is mostly ongoing and strategic. The biggest group of respondents (51 percent) define transformation as a continuous process aligning business model to support strategy. The second largest group (31 percent) define transformation as narrower efforts limited to specific functions, processes or areas, continuous or finite. Then once the transformation is in place in one area, decisions can be made as to how and when it can be adapted and implemented in other areas of the business to meet that area's unique needs. But this can be an approach that could change over time based on the way customers and suppliers go to market. Fewer respondents (18 percent) define transformation as an all-out turnaround effort that results in an overhaul of a business model. The common thinking among the respondents with regard to the concept and execution of transformation is that neither is ever complete because the market constantly changes.

Respondents also added that a business model assessment is a continuous improvement process, and the operating model requires ongoing refinement to adjust to the constantly changing marketplace dynamics. Others noted that business transformation is a continuous process that is integrated into all the components of the company and the way they operate. One interesting remark points out that one of the biggest barriers to successful transformation is a leader who is wedded to a past success.

Finally, more than a third of the respondents from retail and commercial banking said that customer demand is a primary trigger for transformation, compared with a 59 percent of automotive respondents and 46 percent from medical devices.

Many of these changes are focused on finding the bank's operational excellence so as to address the cost-reduction mandate (see Box 6.2). However, a holistic approach to operational excellence should yield the biggest benefits, and careful design choices that will align the operating model with the business model (see Box 6.3) are also necessary.

Box 6.2 When over-emphasizing cost reduction may be a 'false friend' for retail banks

Technology tends to weaken industry profitability – because it is considered to be costless in respect to other channels – without providing proprietary operational advantages. Sometimes reducing cost by increasing high-tech delivery ends up being irrelevant for both bank profitability and customer retention or acquisition purposes. Banks therefore need to distinguish themselves through strategy.

The industry has provided more ways for consumers to access their accounts. They have added significant costs to each institution. A need to combat these costs resulted in a major cost savings period, where many banks successfully got much of the costs out of the back office. These cost savings came largely through back office automation. Now, after adding significant costs through added distribution channels and cutting as much as possible in the back office, banks have realized that sometimes an excessive focus on cost reduction cannot always be commercially effective. Various cost-reducing strategies must be distinguished, such as regular slim downs, multi-channeling, and out-in and co-sourcing.[10] Slim downs refer to banks' assessments of ways to improve their internal cost structure and to increase efficiency, also thanks to a massive introduction and development of ICT.

A frequent byproduct of the technology revolution has been to shift consumers out of the bank (and now how do you bring them back?), and toward 'alternative distribution channels.' Some banks supplemented the new channels with videoconferencing kiosks where customers talk to bank officers, and others were convinced that if they did really give their customers a choice to make that is realistic, then they would move away from branches. The result was that a significant proportion of the public has turned to the direct channels, and this has reduced the number of visits to the bank. At the same time, banks have started experimenting with reducing their fee incomes because bank customers have become more price sensitive, especially when they use direct channels. In this situation, many banks have decided to re-examine their distribution processes. And in this respect, cost reduction seems not to be a viable long-term strategy. Constantly focusing on cost reduction will eventually affect the quality of products and services as well as the innovative strength of the institution, which would endanger its competitive position and continuity. Too much focus on cost reduction will also lead to poorly motivated employees and a decreasing capability to benefit from new market opportunities when the economic climate improves.[11]

The reality is, however, that many banks are already experimenting. There is clear data showing reduction across the board for branch activity, whether it is measured as transactions per month, average number of visits per customer per year, or indeed the most critical measure, revenue per product line. On the contrary, banks would be squeezed into a trap, which is driven by branch and the default conversion measure for advertising and marketing activities. Even more, if banks do not engage their compliance department to the issue of serving their customers' needs, the compliance would ask them to provide interactive data visualization (IDV) and cross-sells in-branch. Furthermore, this would mean adopting a 'know your customer' (KYC rule[12]) from the regulator perspective. With a result that you could gather a large number of false positives.

Box 6.3 A note on business models

Strategy and business models matter consistently if banks are to reach the goal of customer-centricity because there is an important correlation between battles and business models. An interesting argument may be that sustainable business models can guarantee success for any company in an increasingly competitive world.

Simple labels such as 'retail bank' or 'investment bank' do not adequately describe the business model of a bank, its performance, and riskiness. There is significant diversity between bank business models.

While it is essential to know what a retail bank does and what are its main sources of revenue, it is also crucial to know how these activities and revenues are achieved. A systemic approach is therefore necessary to assess the role of the business model and its strategy, and so gain additional information about the sustainability and soundness of every bank.

Business model design is a crucial task for bank managers charged with making their institutions fit for the future. In order to choose the proper business model, a bank should look for business opportunities that create value for the parties involved. This includes fulfilling customers' needs and creating customer surplus while generating a profit for the local firms and their partners.[13] Business models relate to many of the following aspects:

– The structure for the flow of products, services, and information including a description of the different actors in the model and their roles;
– A description of the benefits of each actor in the model; and
– A description of revenue sources.

Business models are different in many dimensions, such as size, activities, as evident from the customer base and the asset structure and income model; capital and funding structure; ownership (such as a mutual ownership structure or a public company) and governance;[14] corporate and legal structure; and geographic scope, including how cross-border operations are legally and operationally structured.

Also, over time, business models evolve to fit with the situation.

The strength of a business model is that it tells a story about the business by focusing attention on not just the individual pieces of the business but also on how they fit together. Understanding the risks associated with a business model would greatly improve their use, especially during their formative or experimenting phase. This is because decision making for an established business is more or less embedded in its strategies, operations, and organizational routines. A focus on business model risks may also be a more profitable use of the business model concept and more useful in an entrepreneurial sense for retail banks.

The interest for going into this issue more deeply comes from the possibility of looking at and discovering which business model, among others, may be associated with different relative advantages and disadvantages and also assess if a company is more stable and resilient to many different risks.

This being the case, an important issue is to restore the role of strategy, which becomes relevant for banks in the face of the business transformation agenda. Strategy has to be a decision-making model that is consistent, uniform, and integrated. The concept of policy coherence means that if the strategy is to be successful, it must be consistent with both the characteristics of the external environment to the bank and with those of the internal environment. Strategy must go back to that ecosystem in which are defined the long-term objectives, action programs, and resource allocation.

6.2.1 Look for 'your' business opportunities

Banks say that they know their customers, and they probably do. Often customers are neither aware of their financial problems nor do they know enough about their bank's offering to buy what they need from them.

The thing is to get the right information from both sides so as to serve the customer better and not to concentrate on whether the bank's product line is good enough for them to buy. There are many interesting opportunities for a retail bank to grasp. Most of them are achievable simply by observing that customers do not know what banks sell and what they might be able to sell to them; and sometimes this works not only for the external customers, but for the internal customers as well. Second, for too long now banks have been selling customers products that did not be fit the customer's profile properly. This is still a problem of customer knowledge, but it does not mean that banks have to reinforce only their database. Instead, they should seek to increase the skill of their employees, help them to gain insight from the way customers

interact and bank with them. Some of these opportunities may require the bank to focus on:

- Products that customers already hold, but do not effectively and efficiently utilize, such as certain payment tools, insurance schemes, and so on;
- Aspirational products that may improve their customer's life and could offer a way to upgrade a customer;
- Products that the customer has purchased before but currently does not utilize; and
- Context products, such as a holiday or vacation loan when customers are booking their holiday, or other products that can be developed through everyday situations.

In future, retail banks will not necessarily be called upon to provide many more services than those already available in the market, but they should encourage the market to make a better use of them and to cross-buy services. Attention should be paid to the overriding objective of stabilizing market relations, with important and positive impacts on their financial statements. Where possible, banks should try to reduce their strong dependence on their customers' (both individuals and companies) actions, for example, the kinds of loans that leave the customers free to withdraw and deposit the sums at will; or when with a current account a customer can pay whenever he or she wants using the different payment services. This is fine for customers but obliges the bank to manage its cash flow and the associated risks more closely. Retail banks need to go back to their origin (Chapter 1) and start developing service to close their financial circles inside them with great advantages: on the financial side, on the economic side, and overall they increase customer data knowledge, especially at present as we are entering a golden age where most of the business will be data-driven (see Box 6.4).

Box 6.4 An interesting new idea

Square, the mobile payments startup launched by Twitter co-founder Jack Dorsey, has launched Square Capital, a program that will provide SMEs in the US with quick cash advances. Square uses the extensive data compiled through transactions via its reader and other products to determine how much to lend to merchants and at what point in their business cycle. In this way, it lends working capital to merchants based on their transactions. The service boasts a low-paperwork application process and the ability to

have firms receive the funds they need the following business day. A typical loan from Square Capital is about $10,000, and the repayment will total around $11,000. Square will take a set percentage of daily card sales and SMEs availing themselves of the service will therefore pay more of the loan back when sales are strong and less on days where there are low takings. Square expects that sellers will pay off the advance in approximately 10 months, although there is no set time frame for repayment. Square makes the money back through transactions made by the merchants. The reason Square does not have a strict repayment schedule is because small businesses do not typically have the same predictability as bigger, more established businesses. By offering repayment through credit card transactions, Square is making the process of loan repayment an afterthought. Square can tailor products to suit the needs of merchants and make managing the financial side of the business easier. In theory, businesses will hand over a specific amount, in the region of 10 percent per day, of their future card sales to Square, until the amount plus the service fee is paid off. I do not want to go along with some media reports that highlight the cost of this form of financing. The main point here is that Square has introduced a product that has a closed circuit within the company. The more merchants use Square to pay, the more they are able to get the sums paid back from SMEs. This is because in order to avail themselves of Square Capital, merchants need to be actively running their business with Square and selection for participation will be based on their processing volume and history with Square.

As this book went to press in June 2014, it was unclear whether this initiative would be successful or not. However, this is a good example of an 'old way' to stabilize bank–customer relationships, bank profits, and bank liquidity.

The big issue for the retail bank of tomorrow is not to settle for being a bank in the service of the customer, but to become the customer's bank. This is neither a new nor a fresh idea, but it is certainly going to drive the future of retail banking. Sometimes retail banks seem to lose sight of that goal. But to achieve this goal they might start working to:

1. Develop customers' wealth management needs, putting investments, brokerage, trust, and insurance all in one business;
2. Develop consistent bank of choice to satisfy commercial customers' needs;
3. Look to become the customers' payment processor of first choice.

Thus, banks should be involved in managing a portfolio of opportunities before they structure a portfolio of options to effectively take advantage of flexibilities provided by each project.

6.3 Before starting the journey, the industrial model needs to be overcome

Banks are, by their own – but not necessarily strategic – choice, multi-business companies, and so they cannot be treated as unitary and homogeneous from a strategic viewpoint. Banks are represented as a set of strategic business units (SBUs). They may coincide with the various target groups, such as the mass market, the affluent, the small business, and so on. But they could also be configured in the logic of the functional services that they sell to the market, namely payment services, investment and finance, or risk management. These SBUs have different competitive dynamics, and these differences become particularly accentuated where banking and non-banking competition are concerned. Approaching retail banking from a strategic viewpoint means considering the multiplicity of competitive arenas that need to be addressed appropriately. In this regard, retail banks should develop new or renewed competitive variables, but there is also the need for them to further strengthen certain business functions such as marketing, and strategic planning and make the organization evolve. Every retail bank should also look for the most appropriate strategy.

The main topics on the theme of a multi-business strategy are from industrial enterprises, which demonstrates the presence of a system of decisions and actions that configures the overall model of firm-environment interaction. It refers to the structural position of the company with respect to its stakeholders and markets. This overall vision emphasizes that its goals do not permit it to deal in detail with the relationships with every single market, and therefore, one is forced to have to synthesize this aspect. The result is that when one tries to synthesize, one loses the big picture and the bulk of the related information.

In fact, the level of business portfolio strategy in which the bank operates, is the system of choices and actions that determines its simultaneous positioning with respect to all parties and to all markets, representing a summary of the results of economic, competitive, and organizational management relating to each of the individual SBUs. This is important overall because many bank products could increase the bank's robustness only if the bank could close the financial loop. This is extremely important for banks because even though they look for an economic balance, it is on the financial balance that they need to rely because it leads to sound and prudent bank management.

Although it has been established that every business enterprise management should be whole and not fragmented, the introduction of the conceptual paradigm that tends to distinguish the portfolio strategy (corporate level) on the one hand, and the other competitive strategy (business level) may lead, in the banking context, to an additional problem: when one gives precedence to one level relative to the other one introduces a possible bias in the perspective of the analysis, management, and execution of the strategy. One result of this is that short-term profitability is emphasized over the medium-long term.

Another aspect to remember, which can further weaken the banking production process, is the incorrect interpretation and classification of the banking businesses into divisions: retail banking, corporate banking, and private/wealth management divisions.

The only way for a bank to achieve stability is to work at the true and only business in which the bank operates, which is that of trust. Trust is also the main factor of production, and it is essential for banking activity. It is fundamental to review this framework and work to contain the contagion effect between these three areas of business. The old situation created some substitution effects, and not the new value instead (think of the case of asset management and the funding activity of the bank). This happens especially when the boundaries between businesses wear managers down and they lose sight of the impact of each business compared to the overall economy of the bank. Managers may also lose sight of the big picture of risk management at the unitary level.

Banking without boundaries will grow in the future, because everything is going digital. Many products and services look alike interaction platforms linked to the end-user market and to their own network.

If this picture represents the future, current accounts are also going to be more and more a platform of interaction for banks to build on and defend from the competition.

In the multi-business bank, it is not useful to over-emphasize the differences between the two levels of strategy, but instead to raise awareness about the fact that bank management is essential to the unique view of the customer. Having this in mind, a bank should more accurately plan the life-cycle relationship with its customers, which is not yet very visible to customers. So, if the external environment evolves, and the inner environment does not grasp the full significance of the changes taking place, banks should be more keen on their 'production lines' (managing money, and therefore the payments, the financial management and the management of savings and loans, and in the future a greater focus on risk management), and not so much on the market

segments (retail, corporate, and private), which could change over time. This is not to say that market segmentation is irrelevant, however.

This perspective requires a bank to take care and manage the interdependencies among its business lines, differently from the past, and more effectively and consistently with its mission.

Redesigning the strategy for the banking market is possible and necessary. To do so, one must read the market differently from the competition and this certainly is value innovation, because it moves toward neutralizing the competition and instead focusing on the objective of the competition. However, it is essential not to go in search of innovation without value or no-value innovation. The first case can be solved with a technological (see Box 6.5) or commercial pioneering, or even futuristic approach. In the second case, what results is value – due to higher revenues and/or lower costs – but without any innovative result.

Box 6.5 Technology in banks: from push to pull

The historical use of the Internet by banks was as a kind of a publishing platform. This gradually evolved into a platform for driving sales, and eventually it became a fully fledged sales channel. But in doing so, the key issue for banks was about the channel migration process, and then the focus was on functionality, transactional stability, and security. Most of the attention went to reducing the cost of serving customers instead of developing revenue. Most of the banks developed all this because of a 'me too' approach.

But technology development is not useful for the sake of it. It becomes most valuable when companies look for a better use of technology to personalize service, not to depersonalize it. This is true if we think of the many start-ups being developed to transform some manual activity into a technological activity. This sometimes does not prove to be successful for the customer because he or she does not gain enough to warrant a behavioral shift from the old way of doing things (think of the many examples in payments services innovation). Banks need to deliver increases in value if customers are to change their behavior. They need to develop more incentives than just doing something more easily. Furthermore, the competitive advantage follows from the fact that clients are primarily looking for relatively certain solutions to their problems and not for services that have low prices as their main attribute. Technology allows banks to connect with their customers in new ways every day. It enables bank customers to control when, where, and how they do business with them, and it gives customer-contact team members the ability to quickly access the information they need to earn 100 percent of every customer's business.

Banks have already volumes to feed the platform; what they have to do is to retain users, not let them get away. Again, one asset banks already have is their interoperability, which is a fundamental condition for offering consumers major opportunities to transact, save, and borrow.

Almost every bank in the world today has some form of internet website and internet web capability. However, for most banks, the web and mobile are considered costs – platforms that certainly improve service levels, and lower the cost of serving customers, but they are considered a net cost to the business. Most retail banking leads are not immediately rewarding. And because of this, banks could pull back on investments.

Technology has shifted from a push to a pull factor, but it can only be used as a pull factor if it is managed in tandem with both business strategy and consumer marketing. Banks should work to reduce and even eliminate the separations between marketing, business strategy, and technology – to manage all three as a continuous value-creation engine.[15]

Aside from impacting business paradigms, customer attitudes and behaviors, technology evolution introduces two forms of competition: one is based on access and the second on the content to be delivered. The first one regards the evolution of technology providers. The second one is linked with the idea that the technological platforms that have been developed in the market, require content to offer and exchange to give them a meaning. Some of the content may focus on a transaction of some kind, but this is different from the goal of developing long-lasting relationships. To achieve this goal, one needs to have a relationship footprint and relationship consistency. The first refers to the number of relationships banks have had/have before/after settling for the one. The second has to do with the richness of each relationship and customization of information. They are both equally important in building a relationship. To illustrate: a transaction has a relationship footprint and consistency both equal to zero when, for example, the customer pays a certain price for a securities trade and nothing else is required. This transaction by itself does not develop a relationship. To build a relationship, banks need to broaden transactions and deepen services to increase cross-buying. The relationship is made by a combination of interdependent transactions by which the bank can create a longer-term rapport; developing its knowledge of the client leads to the construction of a long-term relationship.

Compared to the classic conception of business in terms of product-technology-use functions (Abell, 1980) in the digital economy, technology and use function can blend into one another. And at this point, the use of only two dimensions would allow the market to:

– Remove the distinction between goods and services, using a different conceptual notation (the product);
– Emphasize the organizational component (the process);
– Mitigate the role of technology, understood as technical know-how, because of its pervasiveness it has decreased in importance in terms of being distinctive and characteristic;
– Pay attention to all the actors involved in the production process, not the single integrated enterprise, but the network; and
– Re-allocate more attention to the analysis of competition.

In this way, we would work at making a more balanced situation between what is stated in terms of customer-centricity compared with the goal that has been achieved.

Value innovation can exist if the bank is able to open new market space, managing to combine innovation utility, price, and cost. Banks need to re-interpret their business. Multi-channel banking, and the new trend of omnichannel banking (see Box 6.6), must become a business in itself, as evidenced by the fact that if you do not fit the managerial approach, this will continue to remain ancillary to the 'other part' of the bank, demonstrating its strategic incoherence.

Box 6.6 A note on omnichannel banking

In omnichannel banking, customers are in control of the channels they wish to use, and this allows them to begin an interaction using one channel and end it with another. Omnichannel banking is going to bring the industry closer to the promise of true contextual banking in which financial services become seamlessly embedded into the lives of individual and business customers. This is not only about the use of technology; it is also a question of mission, vision, and strategy, but also of execution. Given this, cooperation between the different departments of the bank can no longer be in the form of silos functioning near each other. All departments must now function and integrate more closely than ever. In 2012, Google[16] published data about how consumers are using different devices together, and both the trends and insights described in the report will have impacts on banks and affect the way people will do their banking. If cross-platforming and the multi-screening environment are influencing the nature of modern customers while impacting the practices of a number of different businesses, then it is surely something that banks need to take notice of. Just to mention a few these insights:

1. Consumers are a world of multi-screeners (computer, smartphone, tablet, and TV). Multiple screens make them feel more efficient because they can act spontaneously and get a sense of accomplishment – this results in a feeling of 'found time.' Among them, smartphones are the backbone of their daily media interactions. They have the highest number of user interactions per day and serve as the most common starting point for activities across multiple screens;
2. The device they choose to use is often driven by their context: where they are, what they want to accomplish, and the amount of time needed;
3. There are two main modes of multi-screening: sequential screening, where they move between devices; and simultaneous screening, where they use multiple devices at the same time;
4. Portable screens allow us to move easily from one device to another to complete a task. Search is the most common bridge between devices in this sequential usage; and
5. The majority of the time that they use devices simultaneously, their attention is split between distinct activities on each device.

A report from Cisco (2012)[17] outlined the need for omnichannel customer engagement. The report found that the physical branch continues to be the

preferred channel for personal attention and advice, including new services. Twenty-six percent of consumers say they would leave their current bank if advisers and personal advice were eliminated from their bank branch. Eighty-three percent of consumers say they would be somewhat or highly interested in bank branches that offered an expanded portfolio of financial and advisory services such as financial education, legal, accounting, tax, and insurance. Customers are also open to having advice delivered to them virtually in the branch as long as quality and personalization do not suffer. In a finding that may surprise some, the report measured a high interest in video as a channel for communication among those surveyed. Twenty-three percent of consumers in developed countries and 43 percent of consumers in emerging markets saw the use of video conferencing with remote experts as a way to enhance the quality of advice in situations where access to quality expertise is a concern.

When trying to write the rules of a new generation of banking strategies, one must recognize that it is necessary also to change the way of thinking about them and re-allocate a different weight of management techniques. Banks must note that being flexible and agile is the rule. Rather than trying to predict a future that cannot be known, it is preferable to build an organization that can take advantage of expected and unexpected opportunities as they arise.

The strength to compete and rewrite new strategies will require banks to stay focused and strengthen at the same time their core business strictly linked with its core competencies. And, this again is a question of the people the bank has.

To face the future, banks need to have a unified vision of themselves. While the many different contributions to the literature on economy and banking management have certainly advanced our understanding, they have been on the whole fragmented and have in some cases led to distortions in management practice.

6.4 Customer-centered means organizational change

In many banks, the retail banking activity has been split into divisions (retail banking division, business unit, and so on), which were, and in many banks still are, laid side-by-side with other divisions, such as corporate banking, private banking or wealth management, treasury, and so on. Within these divisions, the business has been built to reinforce product revenue and sales through the traditional and new channels driven by technology. All of the channels are product focused, and the organizational structure is revenue focused. Marketing seeks to

generate activity, volumes of product sold, and customer acquisition. In most banks, there are separate departments for the call center, internet banking, ATMs, branches, POSs, and so on.

But product and the way the product is delivered and used will become increasingly all one. This is not happening now because of the web, the network, and the digital economy, but because services have been always all one with the way they are delivered used. What is new is that the digital aspect is just getting more acute and more visible. This issue is going to require a deep change. Retail banks need to become aware that in future they will have no control over customers. For many banks, the branch will no longer be able to claim ownership of customers, and other channels (usually called as alternative or direct channels) will no longer be subordinated to the power of the branch. In the past, the branch had to be protected from other delivery options, which would have cannibalized it. This is a true cultural change because retail banking will no longer be so much centered on the branch, but there will be an increasingly whole bank feeling, and the whole institution will be totally dedicated to the needs of the customer.

But saying this does not mean that branches and branch managers will lose relevance in the retail bank. Every channel manages information, but branch managers are part of a face-to-face interaction, and so they need to be given more influence within the organization's structure. They should be the ears of the CEO as store managers are at Zara. It is a question of understanding where the revenues are actually generated and not just an issue of compliance. The issue is that the organization has to match customer behavior.

An important step forward is for banks to start asking themselves:

– Where do your 'alternative channels' sit in relationship to your distribution head?

And a second important question would be:

– How are your 'alternative channels' treated within the organization? That is to say, are they cost centers, revenue centers, or profit centers (see Box 6.7)?

Nowadays, there are no good and bad revenues; all of them can be good if you look at the customers and their bank experience and not just the channels.

Box 6.7 Note on bank channels from an accounting viewpoint

In business, a revenue center is a unit that gains revenue from product sales or service provided. The manager in a revenue center is accountable for revenue only. A cost center is part of an organization that does not produce direct profit and adds to the cost of running a company.

A profit center is a section of a company treated as a separate business. Thus, profits or losses for a profit center are calculated separately. A profit center manager is held accountable for both revenues, and costs (expenses), and therefore, profits. What this means in terms of managerial responsibilities is that the manager has to drive the sales revenue generating activities which lead to cash inflows and at the same time control the cost (cash outflows) causing activities. This makes profit center management more challenging than cost center management. Profit center management is equivalent to running an independent business because a profit center business unit or department is treated as a distinct entity, enabling revenues and expenses to be determined and its profitability to be measured.

Usually, different profit centers are separated for accounting purposes so that the management can follow how much profit each center makes and compare their relative efficiency and profit. Examples of typical profit centers are a store and a sales organization.

6.4.1 Technology and organizations: a cultural issue

Financial innovation and technology, beyond certain limits, may put at risk the compatibility of the existing organization. Most of the time, this is a high cultural issue because often the underlying organizational cultures may be intrinsically incompatible if not properly supported by an understanding of the projects to be developed.

Technology has brought with it an evolution of the organization, and sometimes it changes the bank itself.

There is causal link between organizational and technological evolution. Usually, structure follows strategy, but often, observation of the market would seem to lead to situations where the opposite prevails, meaning that strategy follows structure. In this case, the strategic choices would be determined by morphology and organizational culture. The above sentence can be summed up in the question, does 'technology follow structure' or does 'structure follow technology'? This is not a purely academic perspective, but may even undermine the historical archetypal business model of the bank and lead to new and somewhat unexpected configurations.

The importance of this subject lies in the fact that the market situation makes technology an independent variable. Up to this point, it was

dependent on the development of processes and organizational structures to fit. However, technology does not follow but precedes; this does not mean that it constrains the feasibility of certain business or the development of initiatives, but that it becomes the determinant of some initiatives. It also becomes the cause of new initiatives, because often technology enables you to do something greater than what you can do right now.

Organizationally, this involves a review of the roles of technology in the context of the bank but especially it is no longer something exogenous with respect to the rest of the bank. Its processing capacity and transmission to the market can generate new content that can become new business for the retail bank of tomorrow. At present, there are already new roles and responsibilities (just think of the following professionals: computerized financial adviser, director for web development and interaction media, web marketing officer, and so on). Soon, some banks will also have a head of social media, if they don't have one already. But this is not just about a 'question' of must have. Even though technology is going to play an increasingly important role, it is not a guarantee of success. A good business model needs to be backed up with a good offer and clever positioning. At present, when it comes to technology, one's thought turn immediately to digital innovation. It is important to note that the impact of digital innovation may vary depending on the specific market in which the bank operates. But it can be said that high levels of digital innovation do not necessarily guarantee high levels of positive customer experience. This may be due to high customer expectations – some banks may struggle to keep up with the increasingly digital lifestyle.

A customer experience driver is also a must for delivering consistent service.[18] It is useful to underline here that there is a very important cultural aspect to keep in mind. As technology is autonomous and strategically important, often its source array is outside the tradition of the banking profession, and it brings an exogenous culture into the bank. In this situation, a bank could face a contrast, which may be more striking because the bank of the future will be more integrated in a network economy ecosystem. In such a situation, banks need to develop strong osmosis, which cannot stop at a first level of hybridization of cultures. It is already a long time since this happened, when bank first inserted e-banking facilities. At that time, the critical issue was not assimilation of cultures; e-banking was simply considered an add-on. But the ancients were right in saying that: '*errare humanum est, perseverare autem diabolicum … '*.[19]

In the future, banks will exhibit a very different organizational structure. 'Product departments' will probably remain mostly as they are at present, but major attention must be paid to the new rule: even though employees in product departments are not face-to-face with customers, it is always the customer's needs that should drive their job. They need to change the way they produce these services, which are often customized based on net worth, demographics criteria, and many old ways of doing the job. Segmentation will be a key input in the design of these arrays of products, as well as considering in the design phase as well as channels.

6.5 Toward a transdisciplinary perspective for retail banks

Having guiding principles (see Box 6.8) and models, which ensure the efficient and effective functioning of the bank and the banking and financial system in general, is certainly a need that is making itself felt. However, the generalization and standardization of some behaviors, when faithfully followed, may reduce the pressure to seek possible improvements to the same conditions of efficiency and effectiveness.

Box 6.8 Some guiding principles for the management of the retail bank

Guiding principles are:

- Centrality of sound and prudent management in the management and organizational models;
- Preference for the philosophy of governance to be widened, so that the value-creation benefits not only shareholders but also customers and the economy in which the bank operates;
- Banks are considered to be essentially an infrastructure for the operation and development of the economy and cannot operate as an end in themselves;
- Competitive strategies of the banks have to produce the improvement of its services for business growth and national wealth, at the same time protecting savings and savers; and
- Management of banks should also feel responsible for their own social role, developing an ethical culture and overseeing bank management to enhance the contribution of the financial asset to the real economy from the perspective of the common good.

There is no intention at all to question the contribution that the doctrine gave the elaboration of the principles of good governance of the bank, which remains essential, but rather to think about how the received wisdom can be put into practice.

The theory refers to the rules of good behavior, which should lead to spontaneous mechanisms of self-regulation with regard to the issues of efficiency, effectiveness, and operational conditions of stability and protection for savers. But when these standards become absent or inadequate, then the regulation of banks and markets comes to the fore.

In a competitive market, strategic management is crucial to the success of individual banks, but the opposite is also true, namely: a market is competitive if the strategies are oriented toward competition.

Healthy and fair competition is a key factor in the allocative and operational efficiency of the financial system. However, despite prudential regulations by regulators, a culture of growth and profit has prevailed, bring with it the polar opposite of what the theory preaches in terms of respect for economic, financial, and equity balance. Many situations of instability bypassed the controls some banks put in place.

Banks have thus taken on excessive risk and have proved that they do not know how to self-regulate. External control systems and corporate governance systems have also proved to be ineffective. But the financial crisis was the ultimate manifestation of a progressive deterioration in the managerial practices and organizational strategic models of many banks. An excessive focus on risk management, rather than empowering the management to prevail over the forms of control with respect to the substance of them. This again highlights the need to deepen the contextual factors that go beyond the crisis and go back and think about the goodness of the doctrine, which was often rather confused and flattened on the adoption of practices of conduct converging toward similar models. The effect of this was to reduce differences and consolidate competitive oligopolistic market structures, which attenuated the degree of competition in the market for banking and financial services.[20] The reference is to a gradual increase in the concentration of the market, and its diversification and proliferation of conflicts of interest and the development of opportunistic behaviors that involve distorting effects in the efficient operation of markets for banking and financial services. Often deregulation has made all this possible, and the homogenization of management models has consolidated them. In particular, we need a profound renewal of managerial culture, and to reduce the over-reliance on tools for financial control and, as shown recently, even changing certain systems of governance that led the bank managers to pursue strategies of high risk. Banks cannot further delay the redefinition of their strategic position. They must reorganize to improve their efficiency and competitiveness. In this regard, it is necessary to put an end to the fragmentation in the literature on the banking economics and management, and instead proceed in the direction of the recovery and

strengthening of the unified vision of bank management that is inter- and transdisciplinary (see Box 6.9).

Box 6.9 Transdisciplinary: what does it mean?

Transdisciplinarity connotes a research strategy that crosses many disciplinary boundaries to create a holistic approach. Transdisciplinarity is also used to signify a unity of knowledge beyond disciplines. Jean Piaget introduced this usage of the term in 1970. Transdisciplinarity is distinct from interdisciplinarity. Interdisciplinarity concerns the transfer of methods from one discipline to another, allowing research to spill over disciplinary boundaries but staying within the framework of disciplinary research. As the prefix 'trans' indicates, transdisciplinarity concerns that which is at once between the disciplines, across the different disciplines, and beyond each individual discipline. Its goal is the understanding of the present world, of which one of the imperatives is the overarching unity of knowledge. Another critical defining characteristic of transdisciplinary research is the inclusion of stakeholders in defining research objectives and strategies in order to better incorporate the diffusion of learning produced by the research. Collaboration between stakeholders is deemed essential – not merely at an academic or disciplinary collaboration level, but through active collaboration with people affected by the research and community-based stakeholders. In such a way, transdisciplinary collaboration becomes capable of engaging with different ways of knowing the world, generating new knowledge, and helping stakeholders understand and incorporate the results or lessons learned by the research.

Transdisciplinarity is nourished by disciplinary research; in turn, disciplinary research is clarified by transdisciplinary knowledge in a new, fertile way. In this sense, disciplinary and transdisciplinary research are not antagonistic but complementary. As in the case of disciplinarity, transdisciplinary research is not antagonistic but complementary to multidisciplinary and interdisciplinary research.

In German-speaking countries, *Transdisziplinarität* refers to the integration of diverse forms of research and includes specific methods for relating knowledge in problem-solving. When the very nature of a problem is under dispute, transdisciplinarity can help determine the most relevant problems and research questions involved. A first type of question concerns the cause of the present problems and their future development (system knowledge). Another concerns which values and norms can be used to form goals of the problem-solving process (target knowledge). A third relates to how a problematic situation can be transformed and improved (transformation knowledge). Transdisciplinarity requires adequate addressing of the complexity of problems and the diversity of perceptions of them, that abstract and case-specific knowledge are linked, and that practices promote the common good.

Transdisciplinarity arises when participating experts interact in an open discussion and dialogue, giving equal weight to each perspective and relating them to each other. This is difficult because of the overwhelming amount

of information involved and because of incommensurability of specialized languages in each field of expertise. To excel under these conditions, researchers need not only in-depth knowledge and know-how of the disciplines involved, but skills in moderation, mediation, association, and transfer.

Source: Adapted from www.wikipedia.com

This research approach may help to conceive a different set of perspectives from which to understand the interdependencies between internal and external variables, and evaluate the use of excessive balance, which has arisen through the use of static mathematical models, giving equal dignity to both models in the logical-conceptual tradition, while also considering qualitative factors that cannot be measured and have been considered, often wrongly, irrelevant.

Qualitative factors have been shown to be crucial for efficiency and stability, as in the recent analysis of the causes of the 2008 financial crisis. This refers to the role of organizational models, their relationships with operational and allocative efficiency, and their ability to compete in the market. It also considers the role of corporate culture and ethics in determining individual behavior and business. These variables were underestimated also by regulators, because of the small significance attached to them by the models of risk management. The conclusion is that we must re-establish a *logical prius*, on a theoretical level, between the conceptual models of basic, sectorial, and operational.

To reverse this sequence would be to abandon the principle of unity of bank management to follow fashion, the claims of primacy of one aspect over the other, forgetting another important principle, namely the complementarity of the various aspects of management, which must lead to the whole.

Following the financial crisis of 2007–2008, a wide-ranging debate has developed about the capacity of economists to make predictions and to understand the workings of the economy. Akerlof and Shiller (2009) have raised severe criticism of economic theories as simplistic and poorly conscious and irrational psychological factors that characterize personal choices and individual behavior. They claimed that theory was deficient in that it had ignored the importance of ideas in the conduct of the economy. They refer to personal choices and individual behavior as animal spirits, and they define them as follows:

> [...] in modern economics *animal spirits* has acquired a somewhat different meaning; it is now an economic term, referring to a restless

> and inconsistent element in the economy. It refers to our peculiar relationship with ambiguity or uncertainty. Sometimes we are paralyzed by it. Yet at other times it refreshes and energizes us, overcoming our fears and indecisions. (...) The social fabric changes. Our level of trust in one another varies. And our willingness to undertake effort and engage in self-sacrifice is by no means constant.
>
> The idea that economic crises, (...) are mainly caused by changing thought patterns goes against standard economic thinking. But the current crisis bears witness to the role of such changes in thinking. It was caused precisely by our changing confidence, temptations, envy, resentment, and illusions – and especially by changing stories about the nature of the economy. These intangibles were the reason why people paid small fortunes for houses in cornfields; why others financed those purchases; why the Dow Jones average peaked above 14,000 and a little more than a year later fell below 7,500.[21]

The authors suggest reviewing the models for interpreting behavior taking into account the following factors: confidence, or the lack of it; concern for fairness; money illusion; reliance on stories. These factors have been neglected, and the vision of reality has, therefore, proved to be limiting.

Models of interpretation of reality have ignited a debate that shows how the issues of interdisciplinarity and also transdisciplinarity are relevant and contemporary.

Following an identical line of reasoning, this approach may also be useful if you think of the effects of change, which can be predicted using the laws of supply and demand, but it is the prediction of change itself that is the real issue. Equilibrium becomes uncertain because the interrelations of various factors are so complicated, and the functions themselves are so inaccurately known and are affected by so many unknown variables that predictions extending any considerable distance into the future are out of the question. It then becomes important to recognize the need to change patterns of analysis in practice, but in the meantime it is important to understand how we can learn from mistakes and experience how it is possible to obtain new and better behaviors to follow. So, we should start from the realization that what matters today is to understand the real functioning of the economy, and the economy of the bank, and how such functioning changes over time. As we progress from this point, we could provide new ideas for improving the functioning of banks and finding remedies to their problems. It is

also important to know how other players in the market behave and change themselves.

What must be recognized is the difficulty of adopting deterministic models of input-output. Because more and more companies, and banks too, are cognitive systems and their dynamics are linked to learning processes and logic transformation. Often the bank organization is neglected because the pooled analysis is not able to capture the phenomenon of internal quality, or the organization is not thought to be able to affect either the input or output.

The perception of the environment is filtered, depending on the internal structure of the bank: the organizational structure is not, in fact, an executive instrument only, namely the implementation of the strategy, but also a set of perceptual forces, computing and transformative. The decisions a bank takes reflect the specific characteristics of its internal context. Environmental forces are a variable that enters into the decision-making framework, inducing change in conduct only when the strategic management in their corporate environment realize that they can be used positively or as a reaction against them to prevent them from compromising the balance.

Strategy and actions will determine the bank's market positioning and the future of the bank. The role of the organization should be to trigger transformative action. Thus, attention to the internal operation system should be a way to develop business contexts that can act as a fertile soil, encouraging the growth of an organization oriented toward continuous learning company aimed at the production of new knowledge and the ability to determine original choices. Actions are needed that not only to make the organizational structure more efficient and more effective at the operational level on the competitive plane, but especially for guiding the organization toward greater transformative capacity and to better meet the expectations of the market.

Learning has more value if corporations are aware of the particular equilibrium state they are in. This kind of learning results in value-added knowledge. This could require a bank to have a new role or a group of people, which can provide the CEO with the ever-needed strategic insight regarding the future of the corporation.

In doing so, they need to embrace the idea of managing the bank as a portfolio of projects, businesses, activities, and units in real time and in a more integrated vision. This also means to develop a new set of relationship and interdependency metrics, which increases a holistic customer's

view according to the spectrum of opportunities for a customer to get in touch and deal with his or her bank.

A new approach is needed also for the authorities that make decisions about the forms of regulation, the control of risks to the governance structure, and the structure of banking and financial services markets.

In this context, research has the task of unifying what is currently piecemeal and to reformulate the questions at the basis of scientific inquiry in order to produce not only new knowledge but also knowledge that is closer to reality. It must also involve many more actors in this analysis, such as the customer, the manager, and so on. However, it also needs to give strategic and organizational theories their meaning, which is to provide the reader with points of view that are offered to decision makers who should deal with it like the elements of context. The move away from the theoretical is not in itself an error and can sometimes generate important strategic and competitive differentials. What the decision makers should not lose sight of, however, is that the values are the guiding principles of ethics, which should guide management, especially in unexplored fields and cognitive aspects, so as to avoid dangerous roads and serious errors.

6.6 From business transformation to organizational changes

The transformation agenda is also introducing a new set of problems, which regard how to face coordination and incentive problems. The former class of problems refers to the challenge of designing an optimal organization even when everyone in the firm fully internalizes its goals and puts self-interest aside in helping it to pursue those goals. On the other hand, incentive problems represent the challenge of inducing people whose private goals might diverge from the firm's to take actions that are consistent with achieving the firm's goals.[22]

They are relevant to retail banks because most overhyped change programs ultimately fail due to a lack of accountability, credibility, and authenticity. Retail banks need a big picture change program, and this requires them to build tangible evidence that their plans make sense and will deliver results. They need to present what they are doing in such a way as to make people see their accomplishments (see Box 6.10).

Box 6.10 A possible approach

Disciplined thought: Fox or hedgehog?

Picture two animals: a fox and a hedgehog. Which are you? An ancient Greek parable distinguishes between foxes, which know many small things, and hedgehogs, which know one big thing. All good to great leaders, it turns out, are hedgehogs. They know how to simplify a complex world into a single, organizing idea – the kind of basic principle that unifies, organizes, and guides all decisions. That's not to say hedgehogs are simplistic. Like great thinkers, who take complexities and boil them down into simple, yet profound, ideas (Adam Smith and the invisible hand; Darwin and evolution), leaders of good to great companies develop a hedgehog concept that is simple but that reflects penetrating insight and deep understanding.

The first step in order to come up with a hedgehog concept for your company is starting to ask where has our profit come from in the last ten years?

During meetings, managers, moving from good to great, have to come up with the best answers, locking onto a hedgehog concept that could work for their company.

You get closer to your hedgehog concept when you align three intersecting circles, which represent three pivotal questions you have to answer honestly:

1. What can we be the best in the world at? And, equally, important – what can we not be the best at?
2. What is the economic denominator that best drives our economic engine (profit or cash flow per 'x')?
3. What are our core people deeply passionate about?

In his book *Good to Great*[23] James C. Collins gave the following example:

> ... before Wells Fargo understood its hedgehog concept, its leaders had tried to make it a global bank: it operated like a mini-Citicorp – and a mediocre one at that. Then the Wells Fargo team asked itself, 'What can we potentially do better than any other company?' The brutal fact was that Wells Fargo would never be the best global bank in the world – and so the leadership team pulled the plug on the vast majority of the bank's international operations. When the team asked the question about the bank's economic engine, Wells Fargo's leaders confronted a second brutal fact: in a deregulated world, commercial banking would be a commodity. The essential economic driver would no longer be profit per loan, but profit per employee. The bank switched its operations to become a pioneering leader in electronic banking and to open utilitarian branches run by small crews of superb people. Profit per employee skyrocketed. Finally, when it came to passion, members of the Wells Fargo team all agreed: the mindless waste and self-awarded perks of traditional banking culture were revolting. They proudly saw themselves as stoic Spartans in an industry that had been dominated by the wasteful, elitist culture of banking. The Wells Fargo team eventually translated the three circles into a simple, crystalline hedgehog concept: run a bank like

a business, with a focus on the western United States, and consistently increase profit per employee. 'Run it like a business' and 'run it like you own it' became mantras; simplicity and focus made all the difference. With fanatical adherence to that simple idea, Wells Fargo made the leap from good results to superior results.

This journey took a lot of time to develop and fix the cultural turnaround. It took an inherently iterative process – consisting of questions, debates, actions, and autopsies without blame – a cycle repeated over and over by the right people, and driven by facts to monitor. And overall, it is crucial for every institution to assess 'What should change and what should never change?' And as Collins states:

> This is a matter of distinguishing timeless core values from operating practices and cultural norms. Timeless core values should never change; operating practices and cultural norms should never stop changing.

Source: paraphrased from *Good to Great*, www.jimcollins.com

This means overall starting not with where you are going, but who is going with you. That is to say, first the people, then the direction. Starting with where before who is the wrong approach. Banks need to get a big picture to drive into a single organizing idea, instead of keeping up with the many small things that are run separately.

6.7 Operational leadership for retail banks

A bright future for retail banks will depend above all on taking the right actions to achieve their operational leadership, which is based upon two elements. The first is operations efficiency, which is fine, as a fast and consistent delivery of the bank's financial service is necessary. Processes matter, because banking processes, deliver the bank's service to the customer (see Box 6.11). But this is not sufficient. The second element of operational leadership is customer (both internal and external) value transfer. This is not just making banking operations lean and reliable. It is also the degree of perceived value being transferred from the bank to both set of customers.

Box 6.11 What is a process?[24]

A process[25] is a coherent set of activities to be carried out in some order that can be executed repeatedly involving one or more entities, with a definable beginning and ending point, having identifiable inputs and outputs, achieving one or more goals of a function, identified by a verb or verb phrase that describes

what must be accomplished. Organizationally, stages in the banking process are identified with locations in a retail bank and their respective proximity to the client. These stages are classified as front office, middle office, and back office.

The front office. This is the direct link between the customer and the bank. The front office interprets the requirements of the potential customer. It performs a marketing function to acquire new customers and endeavors to create a longer-term relationship with existing customers. Among the specific functions that professionals in the front office perform is gathering information with the objective of 'knowing the customer' so that interpretation of the customer's expectations is not misplaced. This may be done in conjunction with the marketing research group and the back office, both of which store information on customer profiles.

The middle office. Professionals in the middle office are not directly customer-facing, but rather enable the process by assessing, for example, the credit risk to the bank in lending to a customer, or the money-laundering risk for the bank in accepting a deposit. Apart from risk management, the middle office (such as the legal department) ensures that all banking operations are subject to regulatory and statutory compliance such as the Sarbanes-Oxley Act, Dodd-Frank Act and Basel III, as well as the ethical principles and guidelines that the bank has adopted. The middle office sets the terms and conditions (namely price, repayment terms) of the financial service. The middle office also includes human resource management and finance and accounting functions.

The back office. Professionals in the back office, similar to the middle office, are not directly customer-facing but enable the process by recording and storing the information arising from the operation. For example, the back office processes loan applications, facilitates payment services, and settles trades. The back office manages various information databases, keeping track of future payments to depositors, receipt of due payments from loans, and so on.

There are two important points still to be raised:

(1) It is a costly error in terms of customer experience to separate the process in terms of front office, middle office, and back office. Customers do not see or care about this structural division. They care mainly about the outcome of their inquiry or application.
(2) It is not very useful to study front office, middle office, and back office activities in isolation. Rather, all of them belong to banking operations. However, the importance of the middle office is predominant, especially for banking operations that arise from the asset side of the balance sheet. The main reason is that risks on the asset side impact the risks on the liability side of the bank's balance sheet. This cross-correlation of risks – emanating from the asset side of the balance – places a great onus on the front office, middle office, and back office professionals, but mostly on the middle office.

At this point, we identify an important trade-off in the management of bank operations. It is important to highlight that banking operations are complex; we do not want to imply that banking operations are based on

one-dimensional, simple processes, which are cross-correlated with other processes. Indeed, modern retail banking is characterized by multiple products, multiple channels, and multiple customers. This means that processes in retail banks may originate with a client in one channel (namely branches, call centers, bank's website, mobile equipment) but be completed in another. For example, a client may apply for a loan on the internet and have funds deposited in a branch account. This is an example of depth complexity, where a client can deal in several points of contact that are provided by the bank for the convenience of customers.

In a similar way, the customer may access a portfolio of products within each distribution system. For example, a customer can access information and application documentation within each channel on deposits (in all variations), loans, mortgages, debit cards, credit cards, etc. Dealing with this major issue affords much scope for process efficiency. But when management of a retail bank endeavors to achieve optimal operational efficiency, it faces a fundamental trade-off: management desires process productivity (lean process, that is, high speed) with consistent outputs at each node (low process variation), but the other side of the coin is customer service quality (zero error rate). Therein lies the conflict. A fast process will likely increase the probability of human error and mistakes that may impair customer service quality. As is usual in the solutions of trade-offs, the manager must decide which side of the trade-off is important. Then the other side is a constraint. Here is an example from macroeconomics. We believe that the correct question is: how to deliver customer service quality (that is, zero error rate) subject to the constraint that delivery is done in a lean manner and with low process variation?

Notice how we phrase the question. The objective is to deliver on customer service quality. The constraint is a lean process with low process variation. Process efficiency is NOT an objective of the bank. It is a constraint! A retail bank is in the business of delivering financial intermediation services to a customer – first and foremost – that best meet the customer needs. All roads begin and end with the customer. The constraint is to deliver in a lean and consistent manner. The strategic objective for a retail bank is to maximize customer value, subject to the constraint that the bank's services are delivered in an efficient and reliable manner.

In fact, the key to long profitability is customer loyalty, and this is a long-term goal to achieve. It is fair to say the customer long-term objectives are not part of the focus of the strategy of many retail banks. A mediocre strategy cannot be rectified by superior execution over long time horizons. The rule is leadership and strategies for employee engagement; both are a prerequisites for operational leadership.

This leads to the conclusion that in a changing environment often synthetically law change is the new normal; the bank must develop entrepreneurial skills among its spread. It is a question of intervening on

organizational models, processes, and style of management. And to this end it is necessary that the working world is willing to collaborate with the research that aims to monitor the processes of defining and evolving strategies. This is necessary to avoid that the representation of reality proves to be false and then not be adequately investigated. This applies accordingly for the dissemination of knowledge and training activities of the bank management, which should be focused on understanding the different viewpoints in order to foster critical thinking, questioning theories, ways of thinking, and behavior.

It is also the time to counteract the excess of macroeconomic theory, which has considered banking as a 'black box' designed to mediate cash flows and income-oriented balance conditions at the global level, paying less attention to its counterparties; and it is time also to be less influenced by financial derivative models (based on discounted cash flows).

It should instead reaffirm the microeconomic/managerial and business of the bank, as a company that meets customers' financial needs. But money, credit, savings, and their derivatives, however, are also social 'objects,' which owe their success to the long-term persistence of their social utility, namely the persistence of a strong and collective perception of the same.

7
Conclusions and Recommendations

7.1 No clear path back

History tells us that, at the beginning, retail banking was predominantly supply led and was able to set its own course, but that at a certain point it became customer driven with varying degrees of customer-orientation. In the past 15 years or so, retail banking essentially lost its way, developing a range of miscellaneous strategies with various objectives, tools, and channels to pursue in an attempt to cope with it all. As a consequence, the industry as a whole lost its grip on any strategy that might meet the real needs of retail bank customers. At the same time, among the many issues it faces, the industry also pursued its conviction that it needed to become multinational and, for some, even global.

Mergers and acquisitions became a driving desire in many countries, as the larger banking players reached for size, they said, to compete internationally and achieve economies of scale. But, in doing so, some of them lost control over their organizations and left their employees to become less engaged with their bank's vision, mission, and values.

Most of them joined the drive for expansion, which raised an interesting question: 'Is retail banking, at heart, a global or a local business?'

The answer will depend on what you want to mean by 'retail' in the banking sector. And that, I believe, remains unanswered as there is not a clear and widely agreed upon definition. This can be both treated as a threat and an opportunity.

Indeed, some of the confusion assuredly stems from the fact that strategists often agree that in most markets, the definition of a core business has traditionally focused on the kind of products offered. And at bottom, this makes many retail banks focus on merely moving large amounts of product, while they are actually solutions providers!

In fact, too much is said about retail banking products, because they cover only a part of the business, which may not be so relevant very often! Rather, it would be better to push some managers to find solutions for customers. Many, instead, have fallen back to a more industrial perspective, placing the retail bank even farther from their customers.

While confronting these marketplace challenges, banks have also increasingly been subjected to the scrutiny of the equity markets, which increasingly demand efficiency in every sphere of their operations. Efficiency in a shareholder value sense has two important features for our present purposes. First, it is externally focused: as a result of deregulation, the open market (supplied with ever more information on banks and their competitors) is the ultimate arbiter on bank efficiency. Second, (and related to the first), it is 'opportunistic' in the sense that bank performance (efficiency) is compared increasingly to the 'next best alternative' investment.

Given the current dynamics, a fundamental and strategic repositioning is needed. The crisis and related developments – especially stricter regulation – have shown that retail bank management is not a one-size-fits-all business model.

Retail banking is a business with a global service proposition and regional models for delivery. But the essence of this approach is the notion that in place of traditional savings and loans, customers should be provided with integrated instruments and integrated pricing, supported by integrated information. And probably retail banking is going to be a market of many niches, where customers may jump from one to another. The challenge is to keep the entire 'customer game' inside the retail bank, making it clear how a bank works for and better serves its customers. I do not think bank strategy should be driven by the sales process, unless we understand better what is 'core banking' to us, as this is going to have a huge impact on the sales process too. But I consider it useful also to have a functional approach, by which I mean making customers competent to use banks, not to let the customers know what banks know.

Another threat for retail banks has come from the erosion of banks' funding advantage, which limits their effectiveness as intermediaries and also impacts on the economics of individual banks and the bank system as a whole.

In a world of globalized markets, productive efficiency is more important than ever before, but it is not the only issue. For a long time, we have been talking about the importance of country systems. Now this turns the bank system into an enabler of market competition in order to

ensure constant improvements to the services offered. This role has to be played by banks in their own territories, which we think one of this is the payment territories, such as developing payment hubs for businesses but also keeping up with the retail payments to increase them in terms of numbers and volumes, so to lead to an important goal for bank management, which is to close financial flows into a single same bank circuit. This means that creditors and debtors are clients of the same bank, and the bank does not have to go outside its own 'walls' to process payments. Keeping these transactions within the bank's own walls maintains liquidity, which is a strategic resource for the bank's functioning and stability. On the other hand, in their strategies and actions, banks must be even more aware of the fact that they will be increasingly called upon to service the intermediation function (this relates to corporate lending in particular). Indeed, if we continue to believe in net interest income as a measure of the traditional profitability of a bank, either the bank must redefine its core business or it must develop and achieve greater synergies between the businesses in its portfolio (which correspond to the various products and services offered), at the same time seeking to complete the financial circuit. It can also be added that the pricing inherent in lending is not the competitive factor in winning, and where there is a widespread practice of multi-lending, this is even less the case. Therefore, in trying to rewrite the rules of a new generation of banking strategies, one must recognize that it is necessary to also change the way of thinking about strategy and assign a different weight to management techniques. In doing this, one must keep in mind that, in the current market environment, being flexible and agile is the rule. Rather than trying to predict a future that cannot be known, it is preferable to build an organization that can take advantage of both expected and unexpected opportunities as they arise, in answer to the following question: what will remain of retail banking? The answer can only be the following: it depends on how banks understand and interpret their function in market contexts that are very different from those of the past. But it will not be enough to make it easier to use banks. The value of the bank customer experience must go further than this. Everything will be influenced by customers' behavior as they experience non-banks first and then look for something that seems similar but is not the same as with a bank. Because the reason why a bank exists may still belong to the ways it provides solutions to financial problems but in a wider spectrum. The smart examples are those which increase the value exchange with the customer in a way that this is embedded in an overall brand engagement model, and not just a simple way of doing things (such as

paying or getting a loan). Every bank should remember that a behavioral shift among customers is possible only when the customer perceives that there is value in it for them, and not just for the sake of change. Furthermore, banks need to work at long-term profitability, which comes from customer loyalty. I want to underline that a mediocre strategy cannot be rectified by superior execution over long-time horizons.

All this will reveal the need for solid core competencies on which to base a recovery. It is then essential to give importance to a single vision of bank management. Because while the different contributions to the literature on the economy and management of banks have certainly advanced our knowledge, they have sometimes tended toward recommending specializations that have fragmented our vision of bank management as a whole.

Finally, retail banks need to move themselves upward to increase the satisfaction of customers. This is based on a simple premise. I believe customers across all business segments can be better served, and could save time and money, if they bring all their financial services to one trusted provider who knows them well, provides trusted guidance and advice, and can serve their main financial needs. Only in this way are banks able to protect their customers and act appropriately.

7.2 Lessons learned and hot questions still to answer

7.2.1 Lesson 1

Retail banking means doing business with individuals and small businesses. But this seems not to define a kind of business that is specific to banks. Even within closed banking circles, it is used to refer only to a *portmanteau* of departments and products. For those outside that charmed circle, it is even less well defined.

Many competitive boundaries have started coming down due to deregulation, and also some lines of demarcation have been eroded so banks have found themselves facing massive competition in many of their business areas (card payments, current accounts, consumer loans, some insurance products, and recently also financial planning and family cash management).

The main challenges are especially from product retailers, technology vendors, and telecommunications companies, which in recent years have started to offer financial services to the market. These players view value differently, and are prepared to give up bank services in favor of other sources of value. They also have a valuable network, a new

approach to customers' knowledge, and overall they have trained their employees to be customer committed.

As a consequence of this situation, the retail banking business has become a battleground, and banks find themselves fighting on many fronts. On top of this, carrying the *status* of a bank does not help, as banks are heavily regulated with the well-known consequences that can arise from this situation.

The question then is:

- *In what ways does retail banking differ from the increasingly ubiquitous term 'financial services,' as used by so many non-bank competitors?*

7.2.2 Lesson 2

Times have changed, and not a single one of the main products mentioned as belonging to retail banking has remained exclusively in the hands of banks. All are now available to everybody (from post offices, insurance companies, brokers and intermediaries of all kinds, building societies, retail outlets and supermarkets, credit unions, and many other institutions).

The questions then are:

- *What is the activity that differentiates the banks from the rest of the crowd?*
- *What makes retail banks unique in the eyes of consumers?*
- *What do they offer that nobody else can?*

7.2.3 Lesson 3

Banks have also structurally changed themselves due to a combination of increased diversification and reduced diversity. In many ways, they followed a common policy of diversification, applied new business models, used similar risk analysis models and developed rates of return on equity strategies more forcefully. Given this, it seems that the more banks increase in diversification, the more they become high systemic risk, and this is mainly the result of their choice of diversification. Most of the time, they diversified into each other's traditional areas and mostly in the capital market business. In this way, they became strongly interconnected via increasingly long chains of claims, as well as correlated risk exposures arising from increasingly similar investments strategies. Leverage increased strongly, and the average maturity of bank debts shortened. Given this situation, the entire sector has become less diverse and potentially more vulnerable

to common shocks. In fact, most financial institutions have begun to look alike.

The question then is:

- *Do bankers need to seek to be different instead of being similar?*

7.2.4 Lesson 4

Banking as a business is not in search of relevance, although this may be true for banks.

The question then is:

- *How can retail banks build upon themselves to compete and defend their business?*

7.2.5 Lesson 5

Over the last few decades, the banking services sector has undergone unprecedented change, which has altered both the structure of the sector and the nature of competition within it. It is not surprising that over this time, financial institutions (particularly traditional financial institutions) have had to adapt themselves to remain competitive.

The questions then are:

- *Is an adaptive strategy still possible in the future to compete in the market?*
- *Should the future guide the present or vice versa?*

7.2.6 Lesson 6

Commercial banking has moved consistently away from customer relationship-based banking; and this is not only because of shadow banking but also because banks have sought to increase customer acquisition rather than developing long-lasting relationships through customer retention and loyalty schemes. The increasing influence of an investment banking-oriented management culture has also spurred a focus on short-term profits in commercial banking, reinforced by shareholder pressure and short-term performance-based managerial compensation schemes. Given this, the management vision needs to be broader than it was in the past. For a long time, a company's financial performance was paramount – for some stakeholders it still is – and 'externalities' were secondary. Now CEOs and others managers have to be aware that companies do not operate in a void, and they must take responsibility for their total impact on people's lives and the economy as a whole if

they are to retain society's permission to exist. Every firm is part of an overall societal system, and they must understand where and how they fit into that system, and how to fulfill that purpose profitably.

The question then is:

- *Do retail banks deserve to be chosen?*

7.2.7 Lesson 7

Retail banking is a business in transformation, and this can mean different things to different people. Certainly, I agree that transformation can be a continuous process of aligning a business model in support of a long-term vision of the future and making it a reality through the execution of a strategy. The truth is that every retail bank has to look for its own strategy, otherwise any transformation is blind and may develop inconsistent and unaligned innovations that can be a recipe for disaster.

The retail banking concept itself might be changing, and the digital era is just accelerating this. If this is true, then the process has to be integrated into all the components of the bank and the way it operates. Whatever the result is, it will certainly lead to a new or different organization.

In this regard, process design is more and more the responsibility of management, and because a large part of the market is moving toward becoming a service economy, retail banks need to regain control over the design and management processes if they want to survive and prosper in the next customer-driven era. All service companies, including retail banks, also need to instigate ownership attitudes in their employees. Helping employees feel like they are part of something bigger, part of the team, and in the loop is essential. The more people know about the organization, and where it is going, the more they will care. If there is anything a company can do to enhance communication with its employees, it should do it. In addition, it is also important for a company that sells service to deal consistently and continuously with its support processes. Again, all of these aspects are critical in such a business because the 'product' sold is a promise: a promise made and a promise kept.

The question then is:

- *Are retail banks ready to integrate the digital era into their culture, organization, and processes?*

7.2.8 Lesson 8

The most damaging enemy for a bank can be its own organization when it starts growing and losing its focus. Under these circumstances, banks become fragile and less agile in the face of changes.

It is true that regulatory authorities have in some cases incentivized banks to become bigger to face especially the incumbent competition and their international strategies. And so many global institutions have grown ever bigger in size and scope, and their organizational complexity has increased.

The questions then are:

- *Under the present market conditions, are some bank organizations more able to face new competition? And in what way?*
- *Should regulatory authorities take into account the fact that a retail bank is a 'people business'?*
- *Do regulatory authorities realize that impoverishing the bank customer relationship by increasing the disintermediation of the bank might lead to a bank or a banking system losing the ability to protect the customer?*

7.2.9 Lesson 9

For some time, the commercial policies of retail banks have not always led them to build relationships for the medium–long term. By contrast, a retail bank, should in fact be helping each customer to formulate a long-term wealth-creation plan and enhance the likelihood of customer success. In return, the bank gains customer fidelity and consequently, long-term profits. This is the only successful business strategy for a retail bank. But the retail bank is faced with an interesting behavioral problem.

The question then is:

- *Are customers long-term planners but short-term doers?*

This is a very important question, since, if the answer is in the affirmative, then the retail bank has a crucial role to play in guiding the customer toward an alignment of both planning and action in the long term. The future issue is to look at the value function for customers. We are entering the field of 'mental accounting,' which is an economic concept established around 1988[1] that contends that individuals divide their current and future assets into separate non-transferable portions. Individuals, therefore, assign different levels of utility to each asset group, which affects their consumption decisions, and other behaviors.

7.2.10 Lesson 10

Executing a real market-oriented strategy is still a weakness for many retail banks, and in the long run, this can be an important threat to legitimate retail banks who want to maintain their right to serve customers.

The question then is:

- *Why should retail customers chose a certain retail bank?*

7.2.11 Lesson 11

I believe that retail banking is in transition toward a more efficient approach, furthermore realizing that this whole development is definitely not an end point, but simply a step forward. Achieving greater efficiency will be a dominant strategic theme for the near future, but this should not be attained by reducing service quality or disregarding customer needs. The organization will play a key role in this development.

In the short run, banks will continue to compete by cutting costs and striving to be more efficient. In the long run, they need to have a vision inspiring them to effectively and consistently execute their strategy, as they need to work to legitimate themselves to serve their customers also by developing new frameworks.

At this point, it would be useful for a retail bank to combine the two ideas – recurring revenues (*this lesson*) and value-based fees (*the next lesson*) – which could even be two lines of the retail banking business. There is a number of business models that work on recurring revenues (such as pay TV, billboards, and finance – just think about the regular bank fees and interest payments they receive). Studies have shown that people who pay their fee on a regular basis (such as weekly or monthly) attended to the service more regularly than those who paid it annually. If you pay for something every month, you are more likely to want to get value for money. Banks should try to work on this opportunity and institute something similar (moving from push to pull services). The key is being able to sell a service that requires more than a one-off transaction. The most effective models of recurring revenue come about where there is an ongoing relationship between the customer and the provider, and the customer is receiving something of value for the money they are paying. In fact, that is one of the main selling points when introducing recurring fees to clients. It says, 'I want to have a long-term business relationship with you, rather than a one-off transaction.' Banks would then need to demonstrate to customers the benefits of working with them over time.

Another benefit of recurring fees is that they allow you to budget and plan for the future more effectively. Finally, if banks are looking to introduce recurring fees, they must understand the things they do that the client sees as being valuable. They must survey their clients, ask them lots of questions – find out things that clients do (and don't) consider valuable to them. And you need to find a way to demonstrate this value, even if clients cannot see it directly. Banks need to communicate

regularly with their customers, and help them understand that even though they may not have spoken with them that month, they are still doing things behind the scenes that benefit them. Banks need to look at ways they can remain in contact with the client and provide value beyond a face-to-face meeting. Costumers should not have to wait 'too long' to find the right person to help them or give them answers.

The question then is:

- *Are banks ready for that mindset?*

7.2.12 Lesson 12

In the service business, clients buy knowledge, and knowledge can build up high switching costs over time. This is because as we know more about our clients, we can work more effectively with them, being more responsive to their needs and introducing products and services to them that they would not have thought of themselves. The financial planning industry is a good example – as we learn more about our clients (and we learn a lot of personal things about them), it becomes too much of an inconvenience for them to go somewhere else. The inconvenience is not just based on costs (such as fees to set up a new financial plan), but time and trust are also major factors.

The question then is:

- *Are banks aware that working on customer retention rather than being driven primarily by acquisition brings the bank knowledge without which it would lose its ability to protect and act on behalf of customers?*

7.3 Where do we start?

There are many ways to decide where retail banks need to start: looking outside at the market *versus* looking inside their own organizations. On balance, I would say that retail banks should start from internal factors.

Internal factors can make all the difference. In good and bad times, some companies succeed while others fail. Success is determined in large part by the particular mix of capabilities – the combination of processes, tools, knowledge, skills, human capital, and organizational forms – that companies deploy.

And so every corporate leader should be asking:

- *Do we have the capabilities we need to win in our industry going forward?*

We are back again to the need to recognize the soul of the banking business in order to see off the many challenges in the market.

Retail banks should start reconsidering the unique features of their offering, and overall it is time for them to start considering themselves as special intermediaries. This requires that a retail bank, first, needs to be aware that every company has 'competitive necessities,' which are the capabilities belonging to the way its business needs to be done properly. Just as every telecom operator needs to develop and reliably maintain its network technology, bank operators need to do the same. Then there is a second set of capabilities, which are 'distinctive,' and they are unique to each company's identity, link to its strategy, and are hard for competitors to copy. These are the assets banks need to protect and on which they need to build useful innovation.

The question then is:

- *Is all that working for retail banks too?*

The answer is 'yes.' The more these capabilities are linked, the more they reinforce each other in a system to be positioned in such a way as to outperform competitors. If we go with the lexicon, some of the job they have to do implies reorientation rather than reinvention. This reorientation would not necessitate abandonment of some traditional core concepts.

Retail banks will always deal with these four elements – the offering or its funding mechanism, the employee management system or the customer management system – which can be considered both a threat and a business opportunity to grasp. What is clear, however, is that there is no 'right' way to combine the elements. The appropriate design of any one of them depends upon the other three, and their effective integration stands out more than the ability of any element taken individually. This means looking back at the bank's specific core competencies, which are collective learning in the organization, especially about how to coordinate diverse production and delivery skills. This could introduce to the industry a demand supply chain management approach, a subject on which it would be interesting to undertake further research.

These latter observations may enrich the retail banking picture, which can take advantage of networks, co-branding, and other kinds of alliances that for some years have not always been satisfactory to all the partners.

Given this, there is a further aspect to underline, which can leverage on today's relatively boundary- and barrier-free markets. This is that the

traditional approach of building a business around a competitive advantage and then defending it and milking it for profits, seems no longer to make sense. And in general, pursuing strategies with a short-term perspective on where the bank wants to go is not any more sustainable, because of both market and regulatory constraints. It is for this reason we think of retail banking as a transition business, which requires a clear long-term perspective on where it wants to go, and to recognize that whatever it is doing today is not going to drive its future growth.

The roadmap to the future is to gather skills and competencies to exploit temporary competitive advantages that, however, will not be sustainable over time, and therefore forge both the corporate strategy and the organizational structure around the principle that for a certain time any business will need to be prepared for transient competitive advantages.

And so, where do we start?

Answer the following questions:

What is retail banking for us?
What is retail banking for others?
What is a retail bank for us today?
What will a retail bank be for us tomorrow?
What should a retail bank be for our customers today and tomorrow?

7.4 Staying competitive: a to-do list

Staying competitive will depend on the decisions banks make as events of the past few years clearly show the price banks will pay for poor strategic decisions. But in future, successful banks will have to work at some of the following actions:

- Run a bank like a business with a focus;
- Change a bank *versus* make it different and consistent;
- Show no lack in accountability;
- Nurture a culture of fact-based decision-making;
- Capitalize on unique data, creating an approach that works for them, instead of copying the competition;
- Create a clear strategy for analytics implementation, and renovate and renew all that when really needed;
- Innovate, but keep an eye on the combination of creativity and implementation. Innovation does not always have to be disruptive; it can also include doing old things in new ways. This may include

ideas originating outside the bank organization that can be customized for an organizational context or clientele.

Retail banking, in general, is simple, but it isn't easy!

Making life easy is a customer issue, and this is what customers want.

Nevertheless, retail banking is a highly profitable operation when managed appropriately. The reasons behind this paradox are simple, albeit manifold. Bank customers should pay their bank fair and good prices for something they cannot find elsewhere – an individual service based on confidence and continuity.

To be successful, you need to serve customers first and investors second. And investors should start to appreciate this fact.

Appendix 1

Some Highlights on Bank Practices: Packaged Products, Bundling, and Tying

Bundling and tying are distinct practices with the common purpose of cross-selling to customers. When these products are available only as a bundle, we have pure bundling. Mixed bundling is when products are available separately and can be offered at a discount relative to their individual prices. Bundling products can be differentiated with the help of the following criteria:[1]

– The level of customization and integration between the different products and services involved;
– The underlying degree of expertise with the service provider for each of the products and services involved; and
– The value added for the customer, which is the ultimate goal of bundling.

Many types of bundled services are developed at great speed in the market for financial services. Although it is not always easy for an outside observer to evaluate the degree of integration and customization as well as the level of expertise of the service providers and consequently the value added for the customer, some broad lines are clearly observable. The graph below gives a visual picture of the different types of bundling.

Table A1.1 Types of bundling: a representation

Main dimensions to bundle products/ services	**Mix of variables and degree of integration**		
	Low	**Medium**	**High**
Level of integration and customization	X	X	X
Value added	X	X	X
Degree of expertise	X	X	X
Main result	Cross-selling	Packaging	Fully integrated services

Source: Adapted from L.A.A. Van den Berghe & K. Verweire (1998) *Creating the Future with All Finance and Financial Conglomerates*, Kluwer Academic Publishers, Dordrecht.

Two extreme cases can be observed, and between them a wide range is possible. At one end of the spectrum stands cross-selling with the lowest degree of integration and customization, with a limited scope of different expertise involved and a relatively low level of value added. Here, the emphasis of the supplier's strategy is more on the volume of business and this from a perspective of transactional marketing.

At the other extreme, we find the fully integrated services with a high degree of integration and customization, many experts involved, and a high value added for the customer. Here, the supplier is looking for a competitive edge in tailoring different complementary products and services, such as personalized from a lifetime perspective or built around specific needs or events. This is a typical approach for relationship marketing and builds customer loyalty. Such an approach supposes a great deal of individual information per client, long-term planning in relation to the life cycle of the client with different event scenarios, and a dynamic approach for flexible updating and adaptation.

In between, all types of packaging can be found, with intermediate positions on the level of integration, customization, expertise, and value added. It must be said that products produced in different factories are unbundled and re-bundled to tailor them to the needs of specific client segments in order to offer them an integrated personalized solution.

The main idea for the future is to work with modular concepts. These modules form the building blocks around which new financial products can be built. This new approach allows for some standardization (there are only a few modules), but on the other hand, the combination of different modules and other features makes it possible for a financial firm to develop products tailored to the specific needs of a customer. For the moment, this is at best in the planning phase: a small number of companies are thinking of applying this idea in practice shortly.

Tying is another bank practice in which the purchase of one product is conditional on the purchase of another. In other words, tying occurs when two or more products are sold together in a package, and at least one of these products is not sold separately. Product tying is a common strategy for retail banks throughout the EU. Because it is relatively expensive and difficult for banks to win new customers, they often decide to focus their growth strategy on increasing cross-selling to existing customers. Product tying offers a simple way of increasing cross-selling. Such product ties are found in a range of core retail banking products, such as:

- Selling a current account to a consumer buying a mortgage or personal loan;
- Selling payment protection insurance or life insurance to a mortgage customer; or
- Selling a current account to an SME taking out a business loan.

The main advantages for financial institutions that sell packaged products, product bundles, or who tie products, are essentially concerned with the amount of cross-selling, since the customer is sold a number of products at the same time to meet a range of needs. For example, mortgages are usually accompanied by home insurance and possibly life assurance. The customer may also be required to open a current account if they are not already customers of the institution providing the mortgage. From the customer's point of view, this does simplify the process, since all products can be purchased at the same time. The financial institution hopes that this bundle of products is going to strengthen its ties with the customer. Packaged products or bundles are most effective when they are meaningful to the customer and his or her needs, and also when the value of the bundle is more than the total value of the individual products. However, in many situations, it is difficult for the customer to assess the relative value of each of the components of the bundle.

Appendix 2

How Some Retail Banks Describe their Retail Banking Activities

In the following Tables A2.1–2, we illustrate how several large banks around the world describe their retail banking activities in their own words.

This group of banks certainly does not constitute an exhaustive list of institutions that provide detailed information on their retail banking activities. However, it is interesting to look at the passages cited here because they are representative of the information provided by some large banking organizations that identify distinct retail business segments on their website, even though some of them do not refer to such activity with this term but mostly explain their activity for individuals, families, and businesses.

We outline the key sentences to give a flavor of the different retail banking styles; in particular, we outline some profile information, the vision and mission, and the key values and beliefs. All this is taken and adapted from the banks' websites on May 12, 2014.

Table A2.1 How do European banks define their retail business, vision, and mission?

Banks and their profile in the EU market	Vision and mission	Key values and beliefs
Deutsche Bank (www.db.com): Retail business is: private and business clients with a broad range of banking services to private individuals, self-employed clients as well as small and medium-sized businesses.	**We aspire to be the leading client-centric global universal bank.** We serve shareholders best by putting our clients first and by building a global network of balanced businesses underpinned by strong capital and liquidity. We value our German roots and remain dedicated to our global presence. We commit to a culture that aligns risks and rewards, attracts and develops talented individuals, fosters teamwork and partnership and is sensitive to the society in which we operate.	**Integrity:** • We live by the highest standards of integrity in everything we say and do. • We will do what is right – not just what is allowed. • We communicate openly; we invite, provide and respect challenging views. Sustainable performance: • We drive value for shareholders by putting long-term success over short-term gain. • We encourage entrepreneurial spirit which responsibly balances risk and returns. • We pursue lasting performance by developing, nurturing and investing in the best talent and by managing based on merit. Client-centricity: • We earn our clients' trust by placing them at the core of our organization. • We deliver true value by understanding and serving our clients' needs best. • We strive to pursue mutually beneficial client relationships in which the value created is shared fairly. Innovation: • We foster innovation by valuing intellectual curiosity in our people. • We enable our clients' success by constantly seeking suitable solutions to their problems. • We continuously improve our processes and platforms by embracing new and better ways of doing things. Discipline: • We protect the firm's resources by always thinking and acting like owners. • We live by the rules and hold ourselves accountable to deliver on our promises – no excuses. • We achieve operational excellence by striving to 'get it right the first time'.

		Partnership: • We build diverse teams to generate better ideas and reach more balanced decisions. • We put the common goals of the firm before 'silo' loyalty by trusting, respecting and working with each other. • We act as responsible partners with all our stakeholders and regulators, and in serving the wider interests of society.
Banco Santander (www.santander.com): Banco Santander is a retail bank based in Spain and present in ten major markets. Based on a business model that focuses on retail banking products and services for private customers, SMEs, and companies, Santander currently serves more than 102 million customers through a global network of 14,400 offices as well as through multichanneling, with 187,000 employees. Distribution of these activities is facilitated by the bank's geographical diversification in Europe, Latin America, and the United States, through local, legally independent and autonomous entities in terms of capital and liquidity.	**Vision:** **Large international financial group.** We have established ourselves as the largest bank in the Eurozone and we are positioned among the world's leading banks in terms of both capitalization and profit. **Comprehensive solutions to satisfy the financial needs of our clients.** We develop a range of banking product and service solutions for individuals of all income levels, companies of any size, private corporations, public institutions, and university communities. **Increasing value for shareholders.** Since 2007, we have consistently met our shareholder remuneration objective, disbursing a minimum of €0.60 per share, despite the global economic crisis. **Important presence in diversified local markets.** We are the sector's leading bank and we are present in ten major markets, with an appropriate balance between mature and emerging economies. All of our subsidiaries rely on the support of our corporate policies and our global organizational and technological capacity.	**Values:** • Dynamism. We take the initiative, with the agility to pinpoint and maximize business opportunities ahead of the competition, and the flexibility to adapt to changes in the market. • Strength. Our strong balance sheet and prudent approach to risk management ensure our capacity for growth and the generation of long-term value for our shareholders. • Leadership. Our mission is leadership in all the markets where we operate. Our highly-qualified staff focuses on customer service and achieving results. • Innovation. We are constantly looking for products and services that cover the changing needs of our clientele, and which allow us to obtain higher returns than those of the competition. • Quality service and customer satisfaction. The customer is the focus of the Banco Santander business model: we are a bank for customers' ideas. We want to understand their needs, provide innovative solutions, and build long-term relationships of trust. • Professional ethics and sustainability. In addition to strict compliance with laws, codes of conduct, and internal regulations, all Santander employees work with the utmost transparency and honesty, integrating the bank's commitment to economic, social, and environmental progress into their daily functions.

Table A2.1 Continued

Banks and their profile in the EU market	Vision and mission	Key values and beliefs
BNP Paribas (www.bnpparibas.com/en): With a presence in 75 countries and nearly 185,000 employees, BNP Paribas is a leading bank in the Euro Zone and a first-class player on a global scale. The Retail Banking division plays a key role in the international expansion of the Group: 70% of its revenues are recorded outside France. The results achieved by this group of entities are underpinned by a unique, integrated business model centered on the customer, based on the producer-distributor concept and cross-selling. This model fosters a cross-cutting approach between the division's various entities, which enables them to streamline their processes, share investment and multiply know-how and innovative ideas among the teams. Underpinned by a culture of responsibility and rigorous risk management, Retail Banking adopts a multi-local approach, efficiently combining local brands with the strength of the Group. This enables Retail Banking to work with clients over the longer term and make a real contribution to the development of local economies. Through the Retail Banking organization, BNP Paribas is a European leader in Private Banking, Consumer Credit, Cash Management and Equipment Financing	**A responsible bank committed to you.**	**Values** Responsiveness: • Speed in the assessment of new situations and developments, and in identifying opportunities and risks. • Efficiency in decision making and in action. Creativity: • Encouraging initiatives and new ideas. • Recognizing contributions. Commitment: • Commitment to the service of clients and collective accomplishment. • Exemplary behavior. Ambition: • Aspiration for challenge and leadership. • Desire to obtain team success in a competition where the referee is the client.

for Businesses. Retail Banking brings together BNP Paribas' retail banks and specialized financial services. It is based around several autonomous operating entities.

Unicredit (www.unicreditgroup.eu):
UniCredit is a leading European commercial bank with an international network spanning 50 markets, with more than 9,000 branches and over 148,000 employees. The Group operates in 17 European countries. UniCredit benefits from a strong European identity, extensive international presence and broad customer base. Its strategic position in Western and Eastern Europe gives the group one of the region's highest market shares.
The bank's identity is made up of the following elements: (1) Re-think our reason to be. Our mission is our company's fundamental purpose, what justifies its reason of being and its being different from the other companies on the market;
(2) Delineate how to achieve and maintain our customers' preference and loyalty. Working on a relevant and differentiating brand positioning – what does an organization want to be known for in the marketplace, and why it should be preferred by its customers and employees;
(3) Understanding the views, needs and expectations of our stakeholders and responding coherently and transparently

Mission:
We are committed to generating value for our customers. As a leading European bank, we are dedicated to the development of the communities in which we live, and to being a great place to work. We aim for excellence and we consistently strive to be easy to deal with. These commitments will allow us to create sustainable value for our shareholders.

Values:
We are the sum of different cultures and experiences which come from the banks and the companies that have joined our group. Diversity is key to UniCredit. Our set of values is based on integrity as a condition of sustainability …to transform profit into value…for all our stakeholders.

- Integrity. As a driver of social legitimacy, can produce sustainability; sustainability can be transformed into value for our colleagues, customers, investors, local communities and for the society as a whole, with each of which the UniCredit group maintains a positive relationship. This is the reason why we call our Values the Foundations of the Integrity Charter; they are thus the pillars that must lead the behavior of the UniCredit group's employees with respect to each of our stakeholders.
- Fairness. Ban discrimination on the grounds of sex, age, race, political opinion or trade-union activity. Practice respect and care towards people at all times. Ban favoritism in recruitment, promotion, and incentive policies.
- Transparency. Share your knowledge without monopolising it to your own advantage. Ensure transparency in career paths.
- Respect. Clearly define roles and responsibilities for everybody employed in the company. Listen and offer constant attention to people, respecting their values, feelings, moral stance; never use any form of undue pressure or offence.
- Reciprocity. It means to co-operate, sharing information and knowledge to generate value and find legitimation of our professional identity beyond organizational boundaries. We should care about an active listening to our colleagues' needs, trying to have a positive influence in our working environment.
- Freedom to act. Create the proper environment free of dissent and the freedom to say what one thinks.Offer everybody the chance to practice the values of entrepreneurship and develop her or his own professional personality.
- Trust. Keep your word, admitting the possibility of mistakes made in good faith.

Table A2.1 Continued

Banks and their profile in the EU market	Vision and mission	Key values and beliefs
ING (www.ingbank.com.tr): ING is a global financial institution of Dutch origin. [...] We draw on our experience and expertise, our commitment to excellent service and our global scale to meet the needs of a broad customer base, comprising individuals, families, small businesses, large corporations, institutions and governments. Our strengths include our relatively high customer satisfaction levels, solid financial position, multi-channel distribution strategy and international network. ING believes all sustainable progress is driven by people with the imagination and determination to improve their future and the futures of those around them. We empower people and organizations to realize their own vision for a better future – however modest or grand. {...} to stay a step ahead in life and in business. ING Bank's strategy aims to create a differentiating customer experience, enabled by simplifying and streamlining our organization, further striving for operational excellence, enhancing the performance culture within our company and expanding our lending capabilities.	To provide our customers with the most effective solutions to help them best manage their financial futures, while creating long lasting value for all stakeholders. Mission: To be the preferred bank of our customers through operational excellence and international service quality; and of our employees with the highest level of ethical and moral values.	Everybody needs trustworthy, determined, sensible and accessible banks that act wisely and ensure excellence in services. With these values, we will enrich our customers even further.

We will aim to become the primary bank for more customers through growing the share of payment accounts in retail banking and with anchor products such as lending and transaction services in commercial banking. ING Group's focus is on service to customers, generating capital, growing profitability and improving efficiency. Its strategy is about offering appealing and easy to understand products and services, multi-access distribution and efficient and effective operations in the 18 countries in which it is active.

Barclays (group.barclays.com):
Barclays is a major global financial services provider engaged in personal banking, credit cards, corporate and investment banking and wealth and investment management with an extensive international presence in Europe, the Americas, Africa and Asia. With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs 140,000 people. Barclays moves, lends, invests and protects money for customers and clients worldwide.

'Becoming the "Go-To" bank is our corporate goal. The pursuit of it will drive our thinking, our decisions and our actions.' – Antony Jenkins, Barclays Group Chief Executive.

Our common purpose is to help people achieve their ambitions – in the right way. We'll measure and reward our people, not just on commercial results, but on how they live our values and bring them to life every day. And we'll judge our 'Go-To' success on a balanced scorecard of impact.

Purpose
Helping people achieve their ambitions – in the right way.

Values and behaviors:
Respect, Integrity, Service, Excellence, and Stewardship.

Table A2.2 How do US banks define their retail business, vision, and mission?

Banks and their profile in the US market	Vision and mission	Key values and beliefs
Bank of America (www.bankofamerica.com) A global company with a local focus.	Bank of America is all about providing people, companies and institutional investors the financial products and services they need to help achieve their goals at every stage of their financial lives. Our deep experience, broad range of services and global capabilities allow us to deliver comprehensive solutions that help customers and clients succeed in today's market and prepare for the future.	To make financial lives better, through the power of every connection. To make financial lives better, we must: • Deliver together. We believe in the importance of treating each customer, client and teammate as an individual and treating every moment as one that matters. We strive to go the distance to deliver, with discipline and passion. We believe in connecting with people person-to-person, with empathy and understanding. We believe everything we do for customers, clients, teammates and the communities we serve is built on a solid business foundation that delivers for shareholders. • Act responsibly. We believe that integrity and the disciplined management of risk form the foundation of our business. We are aware that our decisions and actions affect people's lives every day. We believe in making decisions that are clear, fair, and grounded in the principles of shared success, responsible citizenship, and community building. • Realize the power of our people. We strive to help our employees reach their full potential. We believe that diverse backgrounds and experiences make us stronger. We respect every individual and value our differences – in thought, style, culture, ethnicity, and experience. • Trust the Team. We believe that the best outcomes are achieved when people work together across the entire company. We believe great teams are built on mutual trust, shared ownership and accountability. We act as one company and believe when we work together, we best meet the full needs of our customers and clients.

Citigroup (www.citibank.com)
Consumer Businesses. Proudly serving more than 100 million clients in 40 countries, Citi's Global Consumer Banking business is among the largest retail banks in the world. Primarily known as Citibank and strategically centered in the world's top cities, Global Consumer Banking uses its deep footprint to deliver a consistent and enhanced client-centric banking experience. Global Consumer Banking consists of five primary business units – Retail Banking, Citi Branded Cards, CitiMortgage, Citi Commercial Bank and Retail Services – that operate in our four key global regions: North America, Latin America, Europe, Middle East and Africa, and Asia Pacific.
Retail banking: Primarily known as Citibank and centered in the world's top cities, Citi's network of global retail banks consists of more than 4,600 branches across the globe and holds deposits exceeding $300 billion. Citibank offers checking and savings accounts, small business and wealth management among our financial services. In 2011, we opened state-of-the-art digitized Citi Smart Retail Banking branches in many places and continued renovating our entire branch network. We also opened innovative sales and service centers and Citi Express modules – 24-hour service units…

Citi's Mission: Enabling Progress
Citi works tirelessly to serve individuals, communities, institutions, and nations. With 200 years of experience meeting the world's toughest challenges and seizing its greatest opportunities, we strive to create the best outcomes for our clients and customers with financial solutions that are simple, creative, and responsible.

Citi's Principles: These are the values that guide us as we perform our mission.
- Common Purpose. One team, with one goal: serving our clients and stakeholders.
- Responsible Finance[SM.] Conduct that is transparent, prudent, and dependable.
- Ingenuity. Enhancing our clients' lives through innovation that harnesses the breadth and depth of our information, global network and world-class products.
- Leadership: Talented people with the best training who thrive in a diverse meritocracy that demands excellence, initiative, and courage.

Table A2.2 Continued

Banks and their profile in the US market	Vision and mission	Key values and beliefs
JPMorgan Chase (www.jpmorganchase.com): Retail Financial Services helps meet the financial needs of consumers and small businesses. We provide convenient consumer banking through the nation's second-largest ATM network and fourth-largest branch network. We are the second-largest home equity originator, the fourth-largest mortgage originator and servicer, the largest non-captive originator of automobile loans, and a top provider of loans for college students. We serve customers through more than 2,600 bank branches and 280 mortgage offices, and through relationships with 15,600 auto dealerships and 2,500 schools and universities. More than 11,000 branch salespeople assist customers with checking and savings accounts, mortgage and home equity loans, small business loans, investments, and insurance across our 17-state footprint from New York to Arizona. An additional 1,500 mortgage officers provide home loans throughout the country.		• Aspire to be the best: develop a world-class franchise in every business we operate; be field- and client-driven, consistently delivering the best products and services in a cost-effective way; innovate, test and learn; create powerful brands that carry a commitment to quality and integrity • Execute superbly: demand and maintain strong financial discipline, building for good times and bad; create and maintain a fortress balance sheet; design and maintain the best systems and operations; eliminate waste and bureaucracy; maintain a strong system of internal governance and controls; measure performance through a complete and balanced scorecard. • Build a great and winning culture: operate with the highest standards of integrity; train and retain great managers; be open and honest with ourselves, our colleagues, our shareholders and our communities; get incentives right; foster an environment of respect and inclusiveness; give back to our communities.

Wells Fargo & Co. (www.wellsfargo.com):
Wells Fargo & Company is a nationwide, diversified financial services company with $1.5 trillion in assets. Founded in 1852, Wells Fargo provides banking, insurance, investments, mortgage, and consumer and commercial finance through more than 9,000 locations, more than 12,500 ATMs, online (wellsfargo.com), and mobile devices.

Vision:
We want to satisfy all our customers' financial needs and help them succeed financially.
Our vision has nothing to do with transactions, pushing products or getting bigger for the sake of bigness. It's about building lifelong relationships one customer at a time. Each of our customers defines 'financial success' differently and very personally. This could include the desire for financial security and self-sufficiency or the desire to be financially literate. It could include the desire to be disciplined and focused on spending and
saving so customers can afford their own home, start or grow a business, save for education or prepare for retirement. Knowing what financial success means to each of our customers is the starting point for serving each of them well.
Our vision of financially satisfied, successful customers is based on a simple premise. We believe customers across all business segments can be better served, and save time and money, if they bring all their financial services to one trusted provider that knows them well, provides trusted guidance and advice, and can serve their full range of financial needs through a wide choice of products and services.

Values:
- People as a competitive advantage. We value and support our people as a competitive advantage. We strive to attract, develop, retain and motivate the most talented people we can find, people who care and who work together as partners across business units and functions. We provide them the tools and training they need to succeed in their work, and we want them to be responsible and accountable for their businesses and functions. We expect their best and thank them for their outstanding performance.
- We say 'team members' not 'employees' because our people are a treasured resource to be invested in, not expenses to be managed – and because teamwork is essential to our success in helping customers. We believe everyone on our team is important and deserves respect for who they are and how they can contribute to our work together.
- Products and technology don't fulfill the promise behind a brand, people do – people who are talented, motivated and energized. We believe our people will out-execute our competitors every time because they have the talent, motivation and energy to do so.When our people are in the right jobs, spending time on the right things, leading well, feeling good about their contributions, fully using their skills, learning new ones and having fun, they'll do what's right for the customer. When they're properly supported, incented, rewarded, encouraged and recognized, they're even more satisfied with their jobs, providing even better service for our customers. This generates more revenue, which results in greater profit, which fuels a higher stock price. (...)
- Our team members are our most important constituents because they're the single most important influence on our customers. We want all our team members to be our customers, too. Some people say loyalty to a company is a thing of the past. We don't believe that. People naturally aspire to a larger purpose beyond themselves. They want to believe in their company and the good it can do. Don't we all?

Table A2.2 Continued

Banks and their profile in the US market	Vision and mission	Key values and beliefs
Wells Fargo & Co.	We've made steady progress toward this goal. But we still have much to learn, teach and share and, as always, more of our customers' financial needs to satisfy. For example, our own customers still give about half their financial business to our competitors! Our job – central to our vision – is to make it easy for customers to bring more of their business to us so we can satisfy all their financial needs. Our Strategy Having a vision is not enough. You need a strategy to achieve that vision, along with a business model that can succeed in any economic cycle. You also need extraordinary execution. In fact, it's *all* about execution. A good strategy perfectly executed will beat a great strategy poorly executed every time. The customer value of cross-selling The core of our vision-based strategy is 'cross-selling' – the process of offering customers the products and services they need, when they need them, to help them succeed financially. The more we give our customers what they need, the more we know about them. The more we know about their financial needs, the easier it is for us to work together for them to bring us more of their business. The more business they do with us, the better value they receive and the more loyal they become. The longer they stay with us, the more opportunities we have to satisfy even more of their financial needs. That's the mutual benefit of cross-sell.	• Ethics. We strive for the highest ethical standards with team members, customers, our communities and shareholders. Honesty, trust and integrity are essential for meeting the highest standards of corporate governance. They're not just the responsibility of our senior leaders and our board of directors. We're all responsible. Our ethics are the sum of all the decisions each of us makes every day. If you want to find out how strong a company's ethics are, don't listen to what its people say. Watch what they do. This is even more important in our industry because everything we do is built on trust. It doesn't happen with one transaction, in one day on the job or in one quarter. It's earned relationship by relationship. (…) We have to earn that trust every day by behaving ethically; rewarding open, honest, two-way communication; and holding ourselves accountable for the decisions we make and actions we take. • What's right for customers. Our customers – external and internal – are our friends. We advocate for their best interests. We want them to feel as if they're part of Wells Fargo – that we're their company. We want to be approachable and caring, exceed their expectations, and invest in long-term relationships that last a lifetime. Our customers trust us to protect their confidential information. They trust us to use that information to provide them with products and services that can save them time and money. • Diversity and inclusion. We want to build and sustain a diverse and inclusive culture for all Wells Fargo team members – one where they feel valued and respected for who they are as well as for the skills and experiences they bring to our company. (…) It's a business imperative that lets us take advantage of the creativity and innovation that come from multiple perspectives and allows us to respond quickly and effectively to customer needs here at home and all across the globe. It also helps us understand our customers more fully, see business opportunities in new ways and succeed in serving the needs of our expanding customer segments.

Our promise to our customers is this: *We'll take the time to understand your complete financial picture. Together, we work with you, now and over time, to provide the best information and guidance about the products and services you'll need to help you reach your financial goals. We sum up our promise in two words: Working together.*
This promise is backed by two fundamental supporting characteristics, or brand pillars, that help differentiate Wells Fargo from our competitors:

• *Relationship*. We want to develop meaningful, long-term relationships with our customers that demonstrate our appreciation for their business and our commitment to their financial success.

• *Guidance*. We want customers to view us as knowledgeable experts who are ready and available to help them choose the right products and services for their financial needs, now and in the future.

• Leadership. We believe everyone can be a leader – that leadership is not the exclusive domain of senior managers. We're all called to be leaders – to be the link between the vision of Wells Fargo and our customers. We define leadership as the act of establishing, sharing, and communicating our vision and the art of motivating others to understand and embrace our vision.

Appendix 3

EU Retail Banking: An Overview

Retail banking – as defined in terms of banking services to consumers and small firms – is an important industry for the European economy as it provides three main services: saving, borrowing, and payment services. Despite growth and diversification in the financial services sector, retail banking remains the most important sub-sector of banking. According to an EU document (2007),[1] it represents over 50 percent of total banking activity in Western Europe. In addition, it is estimated that in 2004, retail banking activity in the EU generated gross income of €250–275 billion, equivalent to approximately 2 percent of total EU GDP. As a whole, the banking sector in the EU directly provides over three million jobs.

Before considering the EU perspective with regard to retail banking through the comprehension of both the financial services legislation and some relevant parts of the EU law applicable to the financial sector in the Member States, we intend to present a brief overview of the market structure from both supply and demand sides.

Market structure differs considerably across the EU in terms of the degree of market concentration as well as the identity of the main players. Some retail banks have specialized origins, for instance, as mortgage or online banks and, therefore, only offer a limited range of retail banking products and services. However, there is also a growing trend in Europe, particularly among large banks, to operate as a financial conglomerate in a range of financial services markets such as life assurance or asset management. Alongside differences in the scale and scope of banks' activities, there are also important variations in the constitutions of retail banks. While some banks are fully commercial institutions, others in some countries have significant levels of public ownership and board representation or are cooperatives.

Another aspect is market concentration: while in most Member States, it can be described as modest, some countries such as Belgium, the Netherlands, Finland, and Sweden have significantly higher concentration ratios. Retail banking in the Benelux and Nordic countries is also characterized by significantly more cross-border activity and, consequently, a higher degree of market integration. Countries such as Germany or Spain are dominated by savings or cooperative banks with a strong regional focus. Subsidiaries of foreign banks have a major market presence predominantly in the new Member States.

From the demand side characteristics, retail banking can result in less efficient market performance. Such inefficiencies arise from two principal factors: first, information asymmetry, where banking consumers lack full information, reduces the intensity of price competition; and second, high switching costs, where the level of informational and transactional costs of changing some banking products (notably current accounts), discourage consumers from leaving their current provider.

The combination of these two factors tends to reduce the mobility of customers in the market for products such as current accounts. Levels of mobility may also be artificially reduced by some banking practices, such as the tying of retail banking products and the imposition of high exit fees.

As regards customer relationship, customers tend to have fairly long relationships with their bank, especially in the EU15.[2] Consumers in the EU15 tend to hold their personal current account for roughly ten years on average, whereas SMEs hold their current account for just under nine years. Patterns of customer mobility in the new Member States are quite different. The average age of current accounts is markedly lower at six years for individuals and five years for SMEs.[3] In the majority of Member States, annual switching rates for current accounts are low and stable at five to ten percent per year. This suggests that the overall effects of information asymmetry and switching costs (whether intrinsic or artificial) are fairly similar across the EU, notwithstanding some differences between Member States. This observed low level of customer mobility has important consequences for the operation of retail banking markets in the EU and the intensity of competition because it seems to render market entry difficult. For example, it is a common industry view that, for full service retail banking, 'greenfield' entry into other Member State markets tends to be more risky and less successful than entry through merger and acquisition. Among other factors, low customer mobility appears to be one explanation. Because of the relative immobility of customers, greenfield operations find it difficult to win large numbers of customers through price competition and acquire significant scale in a commercially viable time frame.[4]

The European Commission (EC) has been undertaking sector inquiries in the financial services industry with regard to all these aspects, and the European Competition Authorities (ECAs) jointly published a report about the retail banking industry in 17 European countries. Many National Competition Authorities (NCAs), also have been carrying out their own studies and reports, especially focusing on payment systems and consumer mobility.

In June 2005, the EC initiated sector inquiries into retail banking, and as outlined in the EU document (2006),[5] European retail banking markets were characterized by the following main features:

- A high degree of international and national regulation;
- A traditionally high level of cooperation among banks (e.g., payment infrastructures);
- Significant market fragmentation and differences regarding market structures;
- Entry barriers due to regulatory or behavioral causes; and
- A fragmented demand side (individuals, small enterprises) characterized by information asymmetry, customer immobility, and very limited bargaining power.

At the same time, the Commission identified two areas, where carefully targeted, evidence-based initiatives were likely to bring benefits to the EU economy:

- Investment funds; and
- Retail financial services.

Referring to the second, the Commission believed that further action was needed to open up the fragmented retail financial services markets, and so it took a targeted

and consultative approach, involving all market participants at every stage of its policy making. The Commission decided that some retail areas merited further consideration, and in December 2005, the future strategy on financial services was presented in the White Paper Financial Services Policy 2005–2010, which identified as priorities the extension of better regulation principles into all policy making and the strengthening of competition among providers, particularly in retail business. This is because in the same paper the Commission had identified some competition concerns. Noteworthy findings include that consumer protection rules for retail banking still vary considerably across the Member States, which raises the cost of entering new markets and maintains market fragmentation. Also, the high level of cooperation among the supply side causes restricted access to networks and systems, discriminatory fee structures or higher fees for consumers. In addition, because the EU Commission has always paid the greatest attention to current accounts and related services as a major aspect of retail banking, it was also noted that several products, including current accounts, do not have very transparent prices. Areas of concern identified on the demand side were:

- High switching costs;
- Low levels of information; and
- Transactional costs of changing some banking products (notably current accounts), which discourage consumers from leaving their current provider.

The combination of these factors tends to reduce the mobility of customers in the market and this may also be artificially reduced by some bank practices, such as the practice of tying of some retail banking products and the imposition of high exit fees.[6] According to the White Paper, some initiatives were underway. The first was on consumer credit, with a modified proposal for a Directive, which was published on October 10, 2005, aimed at creating a genuine internal market for consumer credit and improving consumers' protection. A second legislative initiative referred to a Payments Services Directive, whose aim was to enhance competition and clarify rules for users' and providers' rights and obligations. This initiative was intended to facilitate and underpin the industry's effort to create a Single European Payment Area (SEPA) by 2010, and this is still ongoing.

In 2007, another inquiry looked at the EU retail banking sector. Again, a particular emphasis was placed on access to a bank account, as this is the important entry point for most consumers to financial services and markets, and increasingly important for citizens to participate in the market and in society. Undue barriers associated with all types of bank accounts (current, savings, securities accounts) were to be removed, consumer choice widened, and competition between service providers improved.[7] The Commission set up an expert group, consisting of industry and user representatives, to identify existing problems associated with information asymmetry, bundling and tying, user mobility (such as cross-border opening of accounts – including online – closing fees, and transfers between banks) and consider the usefulness of an optional standard bank account. With regard to information asymmetry and non-transparency of prices, the consumer experts claim that information on products and prices was not transparent and there were many types of charges. They also argued that information asymmetry, the complexity of products coupled with the limited

cognitive and computational skills of consumers resulted in consumers relying on imperfect proxies rather then prices and contract terms and conditions for identifying alternative products. On the other hand, the banking industry experts evaluated customers as possessing the skills and abilities to make correct choices, and proximity, branding, and reputations were not imperfect proxies. They defended the existence of many types of charges, stating that competitive markets result in diverging price structures. There were nine recommendations in the report to reduce information asymmetry and improve price transparency. The consumer experts further claimed that bundling and tying might reduce transparency, making it difficult for customers to compare offers and prices. It was also stated that such practices increased the reliance of consumers on their bank, making it difficult to exit contractual relationships since the costs were very high. The banking industry experts, however, saw bundling as a convenient tool for consumers that lowers costs for consumers. The recommendation of the consumer experts was that tying and pure bundling of products should be prohibited, whereas banking industry experts recommended leaving the issues of tying and bundling to competition between banks. Anyway, it is interesting to see that from a theoretical framework there is no univocal answer to the question whether integrated financial solutions are better than separate banking and insurance products. It showed that much depends on the type of consumer and what he or she thinks is important,[8] and therefore customer segmentation becomes needful.

On the issue of switching current accounts, the consumer experts stated that filling in the necessary forms for opening a new account, closing the old one, transferring balances, transferring direct debits, setting up payment instructions, informing customers about the new account number, and so on required time and effort from a consumer and thus was a complex operation. However, the banking experts stated that switching itself is not complex, but the consumers' perceptions regarding the issue made it difficult. Closing charges have been abolished by many EU Member States, but some countries still maintain them. In parallel with the activity of sector inquiries, the EC started developing its activity by legal means, as shown in Box A3.1.

In June 2008, a Flash Barometer survey on consumers' views regarding switching service providers was carried out. The survey collected policy relevant information about consumers' experiences regarding usage of services, comparability of offers, switching, reasons why consumers do not switch, reaction to potential facilitators that could increase mobility and perceptions of recent price developments. With respect to comparability of offers, it was found that 30 percent of the consumers surveyed found it difficult to compare offers. Although the proportion of consumers who had switched their service provider in the previous two years varies according to sector, it was determined that the financial sector shows the lowest rates with 9 percent for current accounts. With regard to consumers who did not try to switch because of their perceptions of this process being difficult, current bank account owners are one of the highest group with a rate of 4 percent. The most common reason given by consumers who did not switch providers was that 'the current provider offers the best value for money' (average of 39 percent of respondents for all services). The services where consumers considered that the savings that can be obtained from switching were too small were current account and savings or investments.

Box A3.1 An overview of the legal background relevant to this study

Directive 2005/29/EC aims to contribute to the proper functioning of the internal European market and intends to achieve a high level of consumer protection by approximating the laws, regulations, and administrative provisions of the Member States on unfair commercial practices harming consumers' economic interests. The Directive defines the unfair commercial practices that are prohibited in the European Union, as those which do not comply with the principle of professional diligence and those which may influence consumers' transactional decisions. All the necessary information for the consumer must be provided to him or her in a clear and comprehensible manner at a suitable time to enable him or her to make a transactional decision. If the opposite occurs, then this is deemed to be a misleading practice by omission. Misleading practices are defined as practices containing false or untrue information or likely to deceive the consumer, even though the information given may be correct. In particular, this information relates to:

- The existence or nature of the product; and
- The main characteristics of the product (such as its availability, benefits, composition, date of manufacture, geographical origin, results to be expected from its use, etc.)

Article 7 of the Directive states that a misleading omission can be the omission of material information that the average consumer needs, according to the context, to take an informed transactional decision. The Directive also defines a misleading omission as information that a trader hides or provides in an unclear, unintelligible, ambiguous or untimely manner, which causes or is likely to cause the average consumer to take a transactional decision that he would not have taken otherwise. In deciding whether information has been omitted, limitations of time or space imposed by the medium used to communicate the commercial practice and any measures taken by the trader to make information available by other means will be taken into account.

Directive 2007/64/EC lays down rules concerning transparency of conditions and information requirements for payment services, and the respective rights and obligations of payment service users and payment service providers in relation to the provision of payment services as a regular occupation or business activity. The information and conditions shall be given in easily understandable words and in a clear and comprehensible form, in an official language of the Member State where the payment service is offered or in any other language agreed between the parties.

These (along with the energy sector) are also the services with the lowest percentage of consumers that considered their current provider to be offering the best value for money. Financial services had the highest percentage of consumers saying that the cost and effort required to switch is too great, relative to the benefits. With regard to policy, the Commission called the European Banking Industry Committee (EBIC) to set up a switching service. This resulted

in the issuing of Common Principles on Bank Account Switching service in October 2008.

In September 2009, the Commission published a working document on the follow-up in retail financial services to the consumer-markets scoreboard. The findings of the document are noteworthy. With regards pre-contractual information, evidence showed that in many cases the information was incomprehensible, insufficient, and presented in too many different ways, making it difficult for consumers to compare different offers and to obtain the best deal. The Commission approach had been to promote the standardization of pre-contractual information obligations through the adoption of carefully designed and tested formats. Where product features allow this, a well-drafted set of standardized information disclosures facilitates clearly the comparability of offers, and helps ensure that consumers understand and could use information to make more informed decisions such as switching providers.

The analysis of bank fees revealed that the price structures of current accounts were often very opaque, making it almost impossible for consumers to know how much they are paying and to compare different offers. In addition, the market for current accounts was fragmented along national lines. Consumers in some Member States had to pay higher prices for current accounts than in others. A single market in this area where price differences were easy to detect and where consumers could have easily switched providers would have enabled consumers to shop for the best offer on current bank accounts. The possibility to switch providers is essential for consumers to obtain the best deal. However, the consumer Market Scoreboard 2009 showed that only 9 percent of consumers had switched their current bank account during the previous two years. The causes again relate among others to difficulties comparing offers on banking services and anticipated or experienced difficulties with the switching process. A first attempt to facilitate bank account switching was made with the self-regulatory Common Principles for Bank Account Switching of the European banking industry.[9]

In 2009, a study was commissioned by the Commission for data collection for prices of current accounts provided to customers in order to: determine the transparency of fees charged in the context of having and using a current bank account; compare prices for services linked to current accounts and analyze the underlying factors behind price differences within and across EU Member States. The report findings suggest that regarding transparency and comparability of prices as a whole, only a minority of financial institutions (34 percent) provide sufficiently clear public information. The report has described the price structures of current accounts as 'very opaque making it almost impossible for consumers to know how much they are paying and to compare different offers.' Austria, France, Italy, and Spain score poorly on transparency and are among the most expensive countries for bank accounts. The EU market is still fragmented, depriving consumers of the advantage of an EU Internal Market.

In March 2010, a Consumer Summit to push for more access, choice, and fairness in services was organized, and the outcomes were to be fed into reflection on future policy on consumer services. A lot of attention has gone into guiding the 27 national banking communities in introducing additional measures to enhance transparency and comparability, and this should serve consumers' needs. The principles stated at the EU level are intended to lead to

the enhancement, within each national market, and with the close involvement of consumer stakeholders, of harmonized tools: uniform terminology for the most common services within that market, glossaries to explain the terms used; a standardized general presentation on applicable fees, and individualized periodic reporting on fees paid.

Another study on fee transparency was also concluded in January 2012, and a mystery shopping study on consumers' experiences with bank account switching with reference to the Common Principles on Bank Account Switching was conducted upon the request of the EC. The overall task of the study was to monitor and evaluate the effectiveness for consumers of the implementation of the Common Principles (CP) on Bank Account Switching, in addition to understanding the consumer experience when attempting to switch a bank account. The study covered all 27 MS. As regards provision of information to consumers enquiring about switching their bank account, it was concluded that the level of information provided to consumers across the Member States of the EU is inconsistent in terms of whether information is provided at all and whether the information provides a clear and complete overview of the processes outlined in the CP. With regard to the extent to which new banks support the switching process, a significant number of banks across the Member States do not support the switching process outlined in the CP because information is generally not 'clear and complete' and because a significant number of shoppers were told that switching processes do not exist. The overriding conclusion was that a significant number of shoppers (81 percent) were unable to successfully open a bank account with a new bank and switch their standing order. In line with the fact that many of the banks assessed were unable to carry out the switch on behalf of the shopper, almost six in ten (56 percent) of those shoppers instructed to switch a standing order did not receive information from the staff about the step-by-step process of switching. The report concludes that where the CP are used in practice, the process is favorably viewed by consumers, in that they view the process as running smoothly.

This picture shows an environment of tighter regulation, higher public scrutiny, and more rigorous capital situations.

European retail banks and the financial crisis

Europe, and especially the UK, was hit hard by the financial crisis, and continental banks are still suffering from the debt crisis in the Eurozone, so many of the big banks are working on improving capital ratios in line with Basel III and national regulations.

The big, mature institutions will continue to adapt, but their preoccupations keep them from adopting cutting-edge strategies. At the moment, many European banks are focusing more on retail banking as a source of low-cost funding and low-risk lending. This is a marked shift for some of these banks. Strikingly, there is little effort to adopt a pan-European retail strategy. Santander is pursuing a niche retail strategy in Europe outside Spain but focuses its main efforts on Latin America, while BNP Paribas is still leveraging legacy franchises it has in the Low Countries.

Meanwhile, one of Europe's biggest banks, Deutsche Bank, is remarkably tight-lipped about its retail banking strategies, either in its home market or elsewhere,

and they are convinced that their universal banking model serves their clients most effectively, offering them an integrated range of products and services. Then there are the cooperative and savings banks in France, which are well-positioned to respond to the public's desire for banks and they are able to keep pace with retail client demands for 'more, better, faster.'

Appendix 4

US Retail Banking: An Overview

Since the beginning of the new millennium, retail banking has become a key area of strategic emphasis in the US banking industry, as evidenced by rising trends in retail loan and deposit shares on commercial bank balance sheets and a continuing increase in the number of bank branches. The US banking system as a whole, including the share of loans made to retail customers, has increased significantly since the early 1980s, though with noticeable fluctuations during this period. Much of the long-term increase is due to the growth of mortgage-related lending and, to a lesser extent, credit cards, particularly at larger institutions. This result reflects two developments: the decline, beginning in the mid-1980s, of the thrift industry, a traditional sector for mortgage lending, and technological changes that enabled large banks to realize scale economies in credit card and mortgage activities. The recent surge in retail banking is evident in the retail loan share, which has increased sharply since 2000. This increase has been led by growth in home equity lending and, to a somewhat lesser extent, in credit card loans and one-to-four-family mortgages. Along with growth in balance sheet positions, the number of bank branches has been going up. Bank branches per capita have been increasing since the mid-1990s, and this growth has accelerated since 2003. Furthermore, an increasing proportion of branches are held by a relatively small number of large banks. As of mid-2003, nearly 25 percent of US branches were held by bank and thrift holding companies with 1,000 or more branches, up from 11 percent in 1994.[1]

This renewed interest in retail banking can be experienced in terms of a growth in importance in the range of products and services provided to consumers and small businesses. Retail-related positions now account for larger shares of commercial bank balance sheets, and the number of bank branches continues to grow. But this 'return to retail' contrasts with the 1990s, when banks' attention turned to broadening products, diversifying revenues, substituting alternative delivery channels for branches, and offering a multitude of financial services to all types of retail, corporate, and wholesale customers. In other words, they were less focused on the retail market. This strategic shift might suggest that interest in retail banking fluctuated in predictable ways with the performance of non-retail banking and financial market activities.[2] The recent 'return to retail' episode may be more persistent than past cycles because it is being driven almost entirely by the very largest US banks, which have been building large branch networks and investing in other retail banking infrastructure. Branching deregulation in the 1990s enabled large banks to compete more effectively with smaller local institutions by establishing branch networks spanning large geographic areas. Indeed, this renewed focus seems to have been a key motivation behind a number of recent large bank mergers, such as Bank of America's acquisition of FleetBoston Financial and JPMorgan Chase's acquisition of Bank One.

Consistent with these developments, retail banking is a significant source of revenue and profit for many large banking organizations. Data from a sample of

large banks' annual reports and public financial statements suggest that between 50 and 75 percent of net operating revenue (net interest income plus non-interest income) is derived from retail banking activities at most of these institutions. This situation works for many large US banks such as Wells Fargo, Wachovia, Fleet, and others.

In addition, the US experimented with an increased attention to consumer protection, as in the EU. In fact, in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act created a new US federal agency, the Consumer Financial Protection Bureau, to improve the functioning of consumer financial services markets. Since then, US banks have faced a challenging scenario in the form of stringent regulations and consumers who have become averse to borrowing, compared with the pre-crisis days of profligate borrowing and spending. This will continue to put pressure on the industry's margins, just as complying with emerging regulations will push banks to make efficiencies.

The regulation, in fact, heightened consumer protection, focusing the law on reducing fees and increasing transparency, and brought new regulatory oversight costs, increased capital requirements, and direct fees to cover federal intervention. Many regulatory changes have accrued over the past three decades. The competitive landscape has shifted considerably in retail banking due to the liberalization of bank branching restrictions and the expansion of bank holding companies. In most areas, traditional community banks and thrift institutions now face competition from branches of large banks that operate in numerous locations across wide geographic areas.

For many years, retail banking in the US was considered a simple business that offered relatively few strategic options. According to a Morgan Stanley and Mercer Oliver Wyman Report (2004), retail banking was defined as the Cinderella of US financial services.[3] This situation seems to persist in the market, and this is in part due to the fact that it is precisely the big money-center banks, which could be expected to take the lead in retail, that are the most fragile in the wake of the financial crisis and new regulations. Such top banks as Citi and Bank of America still clearly carry the scars of the financial crisis and are preoccupied with restoring capital, shedding businesses, and retrenching. Many banks are still working off legacy mortgage loans, a capital-draining exercise.

Again, this preoccupation with the past keeps banks from devoting full attention to product innovation and growth. The appetite for mergers and acquisitions has diminished in favor of organic expansion. Some US banks in general have been caught in a pincer movement by regulators, mandated (by the Dodd-Frank financial reform law) to both toughen capital requirements and impose other restrictions, and a central bank that has pursued a most aggressive 'zero-bound' interest-rate policy – keeping its benchmark short-term rate near zero while flooding the system with central bank money through quantitative easing. This means US banks have seen compression in net interest rate margins even as they increase capital and take other costly steps to comply with new regulations. In short, the combination of regulatory and monetary policy has created a cautious environment for banks. At the same time, economic growth, while stronger than in Europe, has come in fits and starts, leaving consumers and businesses alike uncertain about the future. As a result, growth in lending has been slower than usual during an economic recovery, exacerbating the pressure on margins.

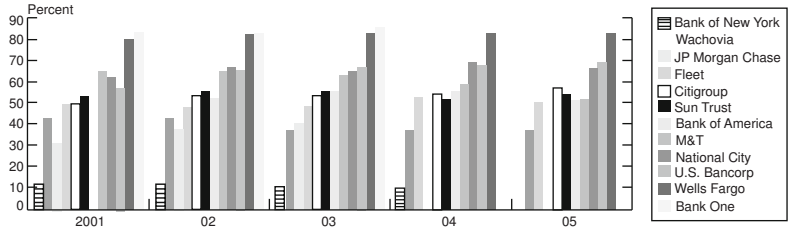


Figure A4.1 Retail revenue as a share of overall revenue: net interest income plus non-interest income

Source: Clark *et al*. (2007) 'The Role of Retail Banking in the U.S. Banking Industry: Risk, Return, and Industry Structure,' *FRBNY Economic Policy Review*, December, p.46.

Appendix 5

Retail Banking in the Rest of the World: An Overview

In this part, I would like to report some highlights on retail banking in areas such as Africa, Asia-Pacific, Latin America, and the Middle East.[1]

Africa

There is a big emphasis on pan-African banking as these relatively small institutions seek scale by leveraging the somewhat homogeneous situation in sub-Saharan Africa, which is marked by a high degree of interior migration.

South Africa's banks have been hit by many of the same problems as other industrial countries, such as squeezed margins, low demand, and a legacy of bad credit. They have in some cases sought links with emerging market banks in Africa or China, both for capital and expansion.

In central Africa, there is an emphasis on financial inclusion as technology now makes it possible to reach out to remote areas without building an expensive infrastructure. The technology of mobile banking provides the opportunity to leapfrog phases of evolution and reach out directly to underbanked populations in remote areas that have little other infrastructure. Use of third-party outlets and agents for payments and remittances, and other adaptations to this situation characterize this market. This is the promise that draws partners to the pan-African concept, as these newly banked customers will undoubtedly progress from payments transactions to loans, cards, and investments. For the same reason, these banks focus on microfinance, often in collaboration with government programs, as they seek to create wealth at a granular level and cultivate future customers. Focus on the classic SME segment also leads to the beginnings of wealth management and private banking.

Diaspora accounts for sending remittances and maintaining a link to home have become popular not only for migrants within Africa but for those outside the continent. African banks, in short, are quickly adapting new bank technologies to the special situations in this emerging market. Foreign currency accounts and credit cards are also part of this effort.

An interesting example is Ecobank, which goes so far as to promote a 'cashless society,' enabling electronic wallets so that most transactions can be carried out without cash.

Banks are cautious and planning on organic growth, but some consolidation seems inevitable as the various pan-African strategies cross paths across the continent. This could bring the scale that would accelerate progress.

In South Africa, a richer economy and client base enables the banks to operate sophisticated wealth management and private banking programs. While the banks are battling economic headwinds and face some restructuring challenges, they are well-positioned to grow with the South African economy and to branch out into sub-Saharan Africa. Nedbank, for instance, has concluded an alliance with Ecobank, creating a network that spans 36 countries, the largest banking

footprint on the continent. Nigeria's central bank abandoned the universal banking model, prompting banks there to transition to a holding company structure as banks were transformed into strictly commercial banks.

Asia-Pacific

Asia-Pacific is a sprawling region ranging from the sedate but highly mature market of Australia, through advanced economies like Japan and Singapore, to 'Wild East' markets like China and India.

Japanese as well as Chinese banks, Korean as well as Indian, often seem to take a scattergun approach to retail markets, if for somewhat different reasons. Japanese banks, of course, are still emerging from a long period of turmoil and government-backed reorganization, melding diverse cultures into new amalgam institutions with unfamiliar names. This poses multiple issues, from capital structure and IT platforms to branding. These banks are trying to map out a distinctive future in an economy that continues to languish and is subject to unpredictable shifts in government policy. On top of that, an aging Japanese population skews potential business toward retirement and insurance products.

Chinese and Indian banks are facing a different problem as the massive populations in these countries put these institutions into a different dimension altogether. Any one of their megabanks will open more new branches in a year than some of the Middle Eastern banks will ever have. There is nonetheless a lot of energy and enormous resources as these banks try to keep up both with the demands of a rapidly evolving society and a volatile global economic environment.

In Southeast Asia, Singapore banks, benefiting from a colonial tradition, are branching out into the populous neighboring countries of Malaysia and Indonesia to compete with domestic banks in these markets. These institutions are expanding their western banking operations but also laying heavy emphasis on Islamic banking and the development of Sharia-compliant banking services. Much of the focus here is on the potential afforded by the Asian Economic Community, which will enable the banks and their SME clients to operate on a regional basis as integration proceeds.

Australia remains a world apart in retail banking terms as the banks domiciled here focus on Australia, New Zealand, and the Pacific island nations. These banks are largely content to follow global trends in banking services for their relatively sophisticated and prosperous public.

Latin America

The Latin American banks considered here, dominated by Brazil, are in countries that enjoy a relatively high standard of living and a growing middle class. As a consequence, banks are able to offer the full range of retail banking services, including robust wealth management and private banking activities. In Brazil, especially, the legacy of a mixed economy with a strong government role still determines priorities in the banking business. The banks, particularly those that are state-owned, serve as agents of the government for everything from subsidized loans to retirement plans. To deepen its relations with customers, Banco do Brasil, for instance, launched its Bom Pra Todos (Good for Everyone) program, a set of measures that included financial advisory services, improved relations with customers, and lower interest rates on the principal credit lines intended

for individuals and small and micro-enterprises. In a region where credit cards have long been popular, there is a lot of activity in this sector including payroll cards, prepaid cards, co-branded cards, rewards cards, cards linked to merchant discounts, and multi-currency cards. They also have their own branded cards with different technologies applied to them.

Consumer finance, especially vehicle financing, continues to develop in line with economic growth in these countries. Most banks are active in insurance, both as a wealth management tool and consumer product, and many operate brokerage and securities businesses.

Financial inclusion and financial education, often in conjunction with government programs, are priorities for many of the region's banks. In addition to extending mobile banking and commercial agents into more remote areas, the banks use means such as the 18 truck-branches operated in Brazil by Caixa Economica Federal. In addition, banks are establishing or upgrading branches outside capital cities.

Middle East

In a market with much more money than people, the banks here are an odd mix of primitive and sophisticated. The banks are relatively small on an international scale, and many of their potential customers will have their main banking connection outside the region.

There is a focus on the needs of high net worth customers, including services for them in international capitals. In general, these banks are trying to provide comfort and convenience to support some local banking. Another focus is on Islamic banking, where there is some consolidation and expansion taking place. Again, however, there is a small customer base, and the biggest Islamic banks and most product innovation is taking place in Asia. Nonetheless, the banks, especially in the United Arab Emirates and Kuwait, are introducing the full suite of retail banking products – mobile banking, cards, consumer finance, wealth management, as well as deposits and loans – and are expanding physical distribution networks.

Appendix 6

The Net Interest Margin As the Key Root Value Driver for Retail Banks[1]

Net interest margin is defined as net investment income stated as a percentage of total interest-earning assets. Symbolically:

$$NIM = \frac{NII}{IA} = \frac{Y * IA - K * IL}{IA}$$

where Y = rate earned; IA = interest-earning assets; K = rate paid and IL= interest-bearing liabilities. As for a given level of interest-earning assets on the retail bank's balance sheet, growth in net interest income can be considered to be equivalent to growth in NIM. A central question now emerges – what are the determinants of growth in NIM? The answer to this question requires a further breakdown of the equation for NIM. After some simple algebra, we can show that:

$$NIM = (Y - K) + K * \left(1 - \frac{IL}{IA}\right)$$

The first term in the above formula is the part of NIM that is the difference between the yield on interest-earning assets and the cost of funding by interest-bearing liabilities. It is also called 'net interest spread' (NIS). The second part is the part of NIM that is funded by debt issuance and equity and is called 'endowment effect.' Typically, the endowment effect is small relative to the NIS. Following these definitions, we can give some examples and comments on this indicator. Consider the following information on NIM and NIS released by a given bank as part of its financial results for a given full year (see Table A6.1).

In Table A6.1, we present some calculations that would explain the data in the table and highlight the use of the formulas for NIM and NIS presented above.

Table A6.1 Example 1

Total interest income	€26,953 million
Total interest expense	€14,494 million
Average interest-earning assets	€879,601 million
Average interest-bearing liabilities	€853,303 million
Gross interest yield (such as asset yield)	3.06%
Gross interest rate paid (funding costs)	1.70%
NIS (Net Interest Spread)	1.36%
NIM (Net Interest Margin)	1.42%

1. Net Interest Income = €26,953 million–€14,494 million = €12,459 million. Hence, NIM = €12,459 million/€879,601 million = 1.42%
2. Gross interest rate paid (funding costs) = €14,494 million/€853,303 million = 1.70%
3. Gross interest yield (asset yield) = €26,953 million/€879,601 million = 3.06%. Hence, NIS = 3.06%–1.70% = 1.36%

The interesting point we have reached so far is that the most important root driver of profitability (as proxied by gross profit) is net interest income. But growth in net interest income, which has a direct positive impact on cost income ratio, is equivalent to growth in NIM, all else being equal. We also see that NIM is approximately the same as net interest spread. The key question is related to the choice of managerial actions to grow NIM. To answer this question, derive the total differential of NIM shown in Box A6.1.

Box A6.1 Example 2

Since NIM = NII / IA, and under the assumption that the gross yield on assets (Y) and cost of funding (K) are constant, we can write the total differential of NIM as follows:

$$\Delta NIM = (Y - NIM) * \frac{\Delta IA}{IA} - K * \frac{\Delta IL}{IL} = K * \frac{L}{A} * (\alpha - \beta); \text{ where}$$

$$\alpha = \frac{\Delta IA}{IA}; \beta = \frac{\Delta IL}{IL}$$

Clearly, α = percentage change of interest-yielding assets and β = percentage change of interest-bearing liabilities.

Consider the equation in Box A6.1, which was derived under the assumption that Y and K are both constant. If we assume that both the percentage change in IA and the percentage change in IL are equal, for example, we see that the change in NIM is zero. Essentially, if there are no incremental benefits from the spread (Y–K), just growing assets at the same rate as liabilities does not affect net interest margins (NIMs) and ultimately, profitability. Here is an illustration, using the data presented in Table A6.2.

Table A6.2 Example 3

Gross Asset Yield (Y)	3.06%
Funding Costs (K)	1.7%
Interest-yielding Assets (IA)	€879,601 million
Interest-bearing Liabilities (IL)	€853,303 million

Using the equation above for NIM, we obtain that

NIM = (Y–K) + K * (1–IL/IA)
= (0.0306–0.0170) +0.0170 * (1–853,303/879,601) = 1.42%,

as we obtained in Example 2. Now suppose that interest-funding assets are increased at the same rate as interest-bearing liabilities. Let this rate be 10%. The increased value for the interest-yielding assets is €967,561 million and €938,633 million for the level of interest-bearing liabilities. But then the interest-sensitive leverage ratio remains unchanged (equal change in the numerator and denominator), and hence there is no change in NIM, as predicted by the equation in Box A6.1.

Continuing in this vein, let us consider a case where ILR (Leverage Ratio) is positive. We assume that interest-yielding assets grow at 10% but interest-bearing liabilities grow at 5%. Based on these growth rates, we have €967,561 million for interest-yielding assets and €895,968 million for interest-bearing liabilities. The resulting NIM is 1.48%, which is just 4% higher than the current value of 1.42%. From this evidence the lesson learned can be the following: a very high percentage increase in interest-sensitive assets is required for even a relatively small increase in net interest margins.

Now we continue the discussion under different assumptions. To complete the analysis, we consider the case where both the yield (Y) on interest-yielding assets and cost of funding (K) may vary but ΔIA = ΔIL = 0. The algebraic computations are shown in Box A6.2.

Box A6.2 Example 4

Under the assumption that the current levels of IA and IL are maintained, but Y and K may vary, we derive:

$$\Delta NIM = \frac{\Delta NII}{A} - NIM * \frac{\Delta A}{A} = \Delta Y - \frac{IL}{IA} * \Delta K$$

To analyze the equation in the above, we define a new concept, which we call interest-sensitive leverage ratio (ILR). Definition:

$$\text{Interest-sensitive leverage ratio (ILR)} = \frac{(IA - IL)}{IA} = \frac{ISE}{IA} = \left(1 - \frac{IL}{IA}\right)$$

This definition is similar to the Basel III definition of leverage ratio (E/Total Assets), which has a minimum value of 3%. It is based on interest-yielding assets and interest-bearing liabilities. We define interest-sensitive equity, ISE, to be equal to IA–IL. Clearly, from our definition, we can write,

$$\frac{IL}{IA} = 1 - ILR$$

We can rewrite the final equation in Box A6.1 (example) as follows:

$$\Delta NIM = \Delta Y - (1 - ILR) * \Delta K$$

This presents an interesting managerial implication. To grow NIMs while keeping both interest-yielding assets and interest-bearing liabilities at their respective current levels, bank management can grow NIMs if the gross yield on interest-yielding assets (Y) is greater than (1–ILR) times the change in the cost of funding (K). And here there is a second lesson to learn, that the yield curve plays an important role in affecting NIMs. If the ILR is held unchanged and the change in the cost of funding is also unchanged, then NIM changes in the same direction and by the same magnitude as the change in gross asset yield. If both K and Y change by the same amount, X basis points, then NIM will change by the leverage ratio times X basis points (bps). Consider the following example where Y changes by 10 bps and K changes by 5 bps. Consider again the data in Example 3. Note the current ILR is 3%. The current value of the cost of funding is K = 1.7% and the gross asset yield is Y = 3.06% and NIM = 1.42%. We assume that the cost of funding is increased by 5 basis points to 1.75% and that the leverage ratio (ILR) is unchanged. Finally, if gross asset yield also increases by 10 basis points, then the increase in NIM = 10 bps–0.97 * 5 bps = 5.15 bps. This represents a percentage change in NIM of 5.15/142 = 3.6%.

To conclude this part, it is useful to underline that there are some important factors, which may affect bank margins and profits, and customers retention as well. Some of them are not under the banks' executive control.

A first case can be that of a change in the yield curve. If a bank pays depositors a rate above the benchmark rate; this could kill its NIM. Or if the bank pays depositors a rate below the benchmark rate, it earns a positive NIM but may lose customers.

Another example, which may have impact on the bank's NIM deals with the effect of monetary policy on the shape of the yield curve. If a bank decides to develop a bond program while a central bank aims at lowering long-term interest rate, hence to decrease borrowing costs for companies and consumers, so to restore the housing markets; there will be some important impact on its margins. If this is the situation, all else being equal, we know that bond prices and yields move in opposite directions. Hence, increased demand for long-dated bonds is expected to create higher bond prices and, consequently, lower yields. This will cause the yield curve to flatten. By contrast, the increased selling pressure of short-dated bonds is expected to reduce bond prices and hence, higher yields. This may even result in an inversion of the yield curve. In this situation, the yield curve is twisted with shrinking long-term yields and higher short-term yields. By reducing the spread between short- and long-term bond yields, the net interest margin of a given bank is reduced, and so profitability is hurt. In this case, again, an exogenous event has the potential of narrowing NIMs and hence eroding the bank's profitability.

A final example may demonstrate a different effect on the bank's profitability arising from the normal financial intermediation process whereby bank executives consciously mismatch duration for profitability. This would be the case of an upward-sloping yield curve where deposit rates are lower than the yields on longer duration loans. In this situation, there is potential for a liquidity problem. When rate increases, banks experienced a classic problem that arises from duration mismatch. The rate at which deposits are adjusted is called tracking speed, and the similar rate for assets such as loans is called repricing speed. The problem of duration mismatch is exacerbated in a period of rising short-term bank rates.

In this case, the tracking speed exceeds the repricing speed. Simply put, deposit rates are repriced faster relative to loans, which are slower to adjust upwards. This is clearly worse for fixed rate loans. The most obvious problem is a period of margin squeeze and reduced profitability until loan rates adjust. Also in this period, liquidity problems may arise if banks are slow to adjust their deposit rates to reflect rising bank rates since this may lead to a net outflow of funds. There is evidence that this margin squeeze may have some deleterious effects on the banking industry.

Duration mismatch has to be considered the core of the retail banking business. It is a main source of profits through NIMs. But when the tracking speed of deposits is higher that the repricing speed of loans, there is a potential for substantial margin squeeze and potential liquidity problems.

Appendix 7

Information Asymmetry in Retail Banking

To explain information asymmetry simply, we might imagine a scenario in which a customer is considering taking a loan from a retail bank and then applies for it. If the loan is granted, the customer will have legal obligations as a counterparty with the bank to a legal contract with typically binding terms and conditions. Before entering a contract, the customer may feel that he or she does not have full information about the contract's legal terms and conditions, as well the financial implications of missed payments or not paying on time or in full. In the end, the consumer may obtain the loan, but he or she may not have fully understood the terms and conditions of the contract. This is a case of information asymmetry where the consumer suffers information risk and may end up making a poor choice as a consequence of the lack of information.[1] We may also think about uncertainty from the perspective of the customer who views the bank officer's level of information as a reference point. The customer sees his or her own level of information as lower than this reference point. This difference in levels of information represents uncertainty from the customer's perspective. There is a large body of research based on information asymmetry and the consequent uncertainty facing the customer. Indeed, the presence of uncertainty can have a profound effect on the ability of savers (and lenders) to efficiently allocate funds at the disposal of investors (and borrowers). There are generally two manifestations of asymmetric information in the financial services industry. These are called 'adverse selection' and 'moral hazard.' We describe each of these concepts in detail.

1. *Adverse Selection* or simply 'incorrect' or 'bad choice' generally arises when one party to a transaction has hidden characteristics. For example, a borrower has concealed certain facts about his or her true financial position, and they remain hidden from the potential lender. This creates a problem for the supplier of funds in that it cannot unambiguously differentiate between good-quality and bad-quality borrowers. A 'lemons problem' can arise. Let us assume that a lender cannot easily differentiate good-quality borrowers from bad-quality borrowers. The lender decides to charge the same borrowing rate to all potential borrowers. This is an average rate between the rate that is charged for good-quality borrowers and the rate that is charged for bad-quality borrowers. But we now have a major problem. Good-quality borrowers will find the borrowing rate too expensive, while the bad-quality borrowers will see the borrowing rate as very attractive when compared to their true risk status (only known to them). Hence, good-quality borrowers will exit the market. The lender will be left with only bad-quality borrowers. This is called 'the lemons problem.' It is also called 'adverse selection.' If the customer has less information about the banking product than the bank official, then the customer may make an incorrect choice. Note that this problem may occur before the transaction actually takes place. We can summarize

as follows: if the customer has less information than the bank official, and this is information asymmetry, then the customer may choose incorrectly – adverse selection.

2. *Moral hazard* occurs after the transaction (such as the monitoring stage). This problem arises because, in the presence of asymmetric information, borrowers of capital may engage in risky behavior that puts the repayment of the borrowed funds in greater doubt than previously expected. This problem has another important implication for a lender. The lender may charge a rate on a loan that reflects the lender's estimation of the borrower's credit risk. But if the borrower hides his or her true risky behavior, then the actual risk will be higher than the expected risk. The lender will have charged a rate that is too low (ex post). The implication is that the market for loans would be very illiquid because of the problem of asymmetric information and its associated manifestations of adverse selection and moral hazard.

Key point to remember: adverse selection occurs where there is hidden information; moral hazard occurs when there is hidden action. The first problem presents a potential for high perceived purchasing risk for the customer. The second problem creates a situation where the bank may incur a higher level of risk than previously anticipated.

In addition to all the characteristics we have been discussing previously, there are some others that can occur for many financial transactions; they involve incomplete contracts, in which their value is determined in large part by the behavior of the supplier after the point of purchase.[2] This leads to the possibility of opportunistic behavior on the part of the financial firm, i.e., behavior that is in the institution's interest but clearly against the interest of the investor. These characteristics lead to a consideration of consumer transaction costs. These are the costs the consumer incurs in making purchases and the actions taken to validate the nature of the contracts purchased or entered into. They can be divided in three categories:

- Search and information costs are costs such as those incurred in determining that the required good is available on the market, where the lowest price can be found, and so on;
- Bargaining costs are the costs required to come to an acceptable agreement with the other party to the transaction, drawing up an appropriate contract

Table A7.1 Transaction costs in financial services: some remarks

Information asymmetry	
Adverse selection	**Moral hazard**
It occurs before the transaction and is the result of poor information. And this may increase consumer's risk to buy something as being perceived too risky for him or her.	It occurs after the transaction and can be developed because of actions which might increase the level of risk for the bank than previously anticipated.

and so on. On asset markets and in market microstructure, the transaction cost is a function of the distance between the bid and ask; and
- Policing and enforcement costs, are the costs of making sure the other party sticks to the terms of the contract, and taking appropriate action (often through the legal system) if this turns out not to be the case.

Although purchases and transactions in all goods and services involve some transaction costs, the characteristics of different types of goods and services will largely dictate the nature and extent of these costs. They generally arise as we move from *search* through *experience* to *credence* goods.

More formally, transaction costs can be divided into:[3]

- Search costs (information needed in order to search alternative products and their suitability);
- Bargaining and decision costs (involved in agreeing precise contract terms);
- Monitoring costs (the costs involved in monitoring post-contract behavior to the extent that it is relevant in determining the ultimate value of a contract);
- Enforcement costs (ensuring that contracting parties deliver on the contract);
- Verification costs (ascertaining the characteristics of the product and whether, for instance, disclosed information is accurate and complete); and finally, where relevant,
- Redress costs (costs involved in securing redress in the event of a contract failure of one sort or another).

For customers, these costs may be both monetary and non-monetary. This means they may pay for getting some information, but they can also invest their time and develop new competences in searching, collecting, and interpreting information by themselves.

In any case, it is clear that the higher the transaction costs, the more the consumer is likely to be deterred from making a purchase, and the more the consumer would value mechanisms to reduce transaction costs. This in turn introduces the concept of bounded rationality, which refers to the limits on the capacity of individual consumers to collect and process information and to deal with complexity. This suggests that investors will seek to devise mechanisms to simplify the problem and reduce the number of alternative choices. This may mean that because the costs prior to making a transaction may be high in some financial products (complex personal pensions arrangements, for example), the consumer may not in fact 'shop around' for the best value. Bounded rationality also suggests that it is costly for individuals to contemplate and assess every contingency that could arise over the maturity of the contract.

These considerations are relevant to the analysis of financial services in particular from a regulatory point of view; in fact, they want to reduce these costs, and so enhance welfare through a more nearly optimal purchase of financial products.

All the previous characteristics mean that, in practice, the transaction costs for the consumer in verifying the value of contracts (even when this can be done at

all) are high. Because of the nature of the products and contracts, producers can easily mislead the consumer, and this may not be detected for many years, and sometimes not until the contract matures, by which time irreparable damage may have been done. In these circumstances, it may not be sufficient to rely on the reputation of the supplier.[4]

In this regard, many financial products and contracts are credence goods, with the additional complication compared with most credence goods that the behavior of suppliers after the product has been sold determines the value of the contract.

Benston (1998) argues that, as with other products and services, the main protection for consumers of financial services lies in a combination of competition, information disclosure, reputation, and legal redress, and all of them are necessary but sufficient ingredients of consumer protection. And this is no different from other industries.

Notes

1 Introduction: From Banking to Retail Banking

1. J.A. DiVanna (2004) *The Future of Retail Banking*, Palgrave Macmillan, p.8.
2. 'Acceptance credits worked in this way: during the eighteenth century it became an established practice for smaller merchants finding their way into international trade to ask the established houses to endorse their trade bills so as to make them acceptable without questions to foreign exporters, or to bankers at home and abroad.' S. Chapman (1984) *The Rise of Merchant Banking*, George Allen and Unwin Publishers Ltd.
3. J.A. DiVanna (2004), p.17.
4. B. Hammond (1985) *Banks and Politics in America: From the Revolution to the Civil War*, Princeton University Press, p.4.
5. R. Glenn Hubbard (2002) *Money, the Financial System, and the Economy*, Fourth Edition, Addison Wesley, Boston.
6. R. Glenn Hubbard (2002), p.365. 'As a result, borrowers pay more for issuing new securities than they would if competition from banks were allowed.' On the other hand, 'Opponents of breaking down the wall between commercial and investment banking point out that commercial banks have a cost advantage in obtaining funds because bank deposits are generally insured by the FDIC. Securities firms have no such insurance and pay a higher cost for funds, usually in the form of loans from banks themselves. Allowing commercial banks to participate in risky broker-dealer and investment activities exposes the FDIC to additional risk.'
7. E. Gardener & P. Molyneux (1990) *Changes in Western European Banking*, Unwin & Hyman.
8. E. Gardener *et al*. (1999) 'The New Retail Banking Revolution,' *The Service Industries Journal*, Vol.19, No.2, pp.84–85.
9. See European Commission (1997) Credit Institutions and Banking, Subseries II: Impact on Services, Volume 3, *The Single Market Review*, Brussels: Kogan Page. See also X.F. Frei *et al*. (1999) 'Hunter Innovation in Retail Banking', Financial Institutions Center Wharton, 97–48-B.
10. E. Gardener *et al*. (1999), p.89.
11. P.D. Clarke *et al*. (1988) 'The Genesis of Strategic Marketing Control in British Retail Banking,' *The International Journal of Banking Marketing*, Vol.6, No.2, pp.5–19.
12. L.A.A Van den Berghe *et al*. (1999) *Convergence in the Financial Services Industry*, Report Commissioned by the OECD, p.9: 'Most researchers have referred to this phenomenon by the term "bancassurance," but other terms like "assurfinance," "assurbanque," "allfinanz," "all finance," and "financial conglomerates" have been used to identify the phenomenon of financial convergence. Little uniformity can be found, however, in the definition they attach to each of these terms.'

13. For a broad review of this topic, see *Convergence in the Financial Services Industry*, Report Commissioned by the OECD.
14. Lafferty (1991) applied to insurance companies entering the banking industry, some of the outcomes from the typology of Herring and Santomero (1990), based on the corporate structure of the financial conglomerates, which is based on differences in legal and operational separateness. See also Hoschka (1994) for the degree of integration. And also: Van den Berghe *et al*. (1999).
15. X.F. Frances *et al*. (1998) *Innovation in Retail Banking*, Wharton Working Papers, 97–48-B, pp.4–5. Furthermore: 'One major explanation for this industry's consolidation is the desire to have sufficient size to exploit scale economies in transaction processing, and scope economies in cross-selling multiple financial products to a household.'
16. R.J. Keith (1966) 'The Marketing Revolution,' *Journal of Marketing*, January, pp.36–37.
17. E. Gardener *et al*. (1999), p.87.
18. Ibid., pp.87–88.
19. D.T. Llewellyn (1999) 'The Economic Rationale for Financial Regulation,' Financial Services Authority, p.2.
20. D.T. Llewellyn (1999), p.39.
21. J.A. DiVanna, (2004), p.20.
22. Ibid., p.22.
23. R.K. Pond (2009) *Retail Banking*, Global Professional Publishing, p.82.
24. R.K. Pond (2009), p.78.
25. Ibid., p.82.
26. A. Omarini (2011) 'Retail Banking and Banks: Re-Start from a Service Perspective Management to Increase Profitability, Stability and Customer Retention,' *Economia & Management*, No.6, pp.82–106.
27. B. Nalebuff (2003) 'Bundling, Tying and Portfolio Effects,' DTI Economics paper.
28. This definition comes from the European Commission (2006) Interim Report on current accounts and related services, p.96.
29. European Commission (2007) *Report on the Retail Banking Sector Inquiry,* p.77.
30. European Commission (2006) *Report on the Retail Banking Sector Inquiry*, p.22. Some evidence can be seen also in Omarini (2005) where this aspect was analyzed for Italian bank customers.
31. Switching costs comprise direct switching costs such as closing charges for current accounts as well as indirect costs resulting from the search for alternative suppliers and the necessity to inform all parties receiving money from or paying to the consumer.
32. See also A. Di Giuli *et al*. (2007) 'Il cliente, il mutuo e la banca. Esigenze e aspettative delle famiglie italiane tra percezioni, consulenza e comunicazione' for a survey of the Italian market.

2 The History Lesson and the Need to Turnaround

1. E. Liikanen (2012) *High-level Expert Group on Reforming the Structure of the EU Banking Sector*, Final Report, Brussels, October.

2. E. Liikanen (2012), p.3: 'In March 2012, loans to non-financial corporations and households only make up 28 per cent, and deposits of non-MFIs make up 30 per cent of the aggregate balance sheet of EU MFIs. There are however significant differences between Member States.' And also p.12.
3. P. Alessandri & A.G. Haldane (2009) 'Banking on the State,' *BIS Review*, Vol.139, pp.1–20; G. Wehinger (2008) 'Lessons from the Financial Market Turmoil – Challenges ahead for the Financial Industry and Policy Makers,' *OECD Journal: Financial Market Trends*, No. 95.
4. D.T. Llewellyn (2010) 'The Global Banking Crisis and the Post-Crisis Banking and Regulatory Scenario,' *Topics in Corporate Finance*, Amsterdam Centre for Corporate Finance, University of Amsterdam, October.
5. During the years 2003–2004, a widespread discussion of retail banking activities took place. The annual reports of large banks, analyst presentations, and press releases highlighted retail as a core source of stable, predictable earnings in times when other sources of revenue were comparatively weak. Standard and Poor's (2004), for example, identified retail banking as 'an island of stability in the last cycle' while Moody's (2003) highlighted the 'low correlation to the lending business, creating earnings diversity' as a key benefit from retail activities. Standard and Poor's (2004) also pointed out the relative volatility associated with non-retail activities such as large corporate lending, investment banking, and emerging market activities.
6. Boston Consulting Group, The (2010) Retail banking. Winning Strategies and Business Models Revisited, January, p.1.
7. For further evidence see European Banking Federation (2012).
8. Office of the Comptroller of the Currency (1988) *Bank Failure. An Evaluation of the Factors Contributing to the Failure of National Banks*, Washington, DC, June, p.1.
9. European Commission, (2007) *Report on the Retail Banking Sector Inquiry*, Commission Staff Working Document, SEC 106, 31 January, p.21.
10. This part is taken from A. Rahman (2012) *Operational Leadership in Retail Banking. The Last Frontier for Profits*, Lafferty Ltd Publication, London.
11. T. Clark *et al*. (2007) 'The Role of Retail Banking in the U.S. Banking Industry: Risk, Return, and Industry Structure,' from http://www.newyorkfed.org/research/epr/07v13n3/0712hirt.pdf
12. A. Burger & J. Moorman (2008) 'Productivity in Banks: Myths and Truths of the Cost-income Ratio,' *Journal of Banks and Bank Systems*, Vol.3, No.2, pp.92–101.
13. A. Demirguc-Kunt & H. Huizinga (2001) 'Financial Structure and Bank Profitability,' in A. Demirguc-Kunt & R. Levine (eds) *Financial Structure and Economic Growth: A Cross-country Comparison of Banks, Markets, and Development*, MIT Press, Cambridge, MA, pp.243–262.
14. In order to get a full picture of whether diversified financial institutions outperform or not, see: Saunders & Walters (1994); Reichert & Wall (2000); DeYoung & Roland (2001); Stiroh (2004); and Goetz (2012). All provide detailed reviews of the literature.
15. K.J. Stiroh (2002) 'Diversification in Banking Is Noninterest Income the Answer?' In Federal Reserve Bank of New York, Staff Report, November 14, No.154, pp.2–3.

16. Actually, 'If non-interest income lowers the volatility of bank profits and reduces risk, for example, it might be reasonable to reduce capital requirements for banks with a diversified revenue portfolio and for supervisors to reallocate their scarce resources. Similarly, the costs of bank supervision are tied to the perceived riskiness of the institution, so banks have additional incentives to reduce risk.' K.J. Stiroh (2002), p.4.
17. K.J. Stiroh (2002), p.27.
18. K.J. Stiroh (2002), p.21.
19. In fact, 'The cross-sectional correlation between net interest income growth and non-interest income growth across banks in each year has steadily increased from 0.32 in 1979 to 0.66 in 2000.' K.J. Stiroh (2002), p.5.
20. 'Looking at individual banks over time, the median bank-specific correlation between net interest income growth and non-interest income growth for over 14,000 banks is 0.16 and only one-third of the banks show the negative correlation needed for strong diversification benefits.' K.J. Stiroh (2002), p.5.
21. At this time, one of the main issues for regulators is customers' financial literacy, but consumer protection is also becoming relevant; both have seen development since the end of 1990s, in Europe with the delivery of special Directives and laws in other countries.
22. '... Bank of America deal, for example, was driven by the potential growth and geographic expansion of the branch network (*Wall Street Journal* 2003), while the JPMorgan deal highlighted the stability of retail activities (Deutsche Bank Securities 2004). Similarly, Citigroup's sale of its Travelers Life and Annuity business to MetLife was viewed as part of a larger strategy to renew focus on consumer banking and abandon the financial supermarket model (*American Banker* 2005; *BusinessWeek* 2005).' T. Clark *et al*. (2007).
23. C. Mollen & J. Hechinger (2003) 'Branching Out: Bank of America Bets on Consumers,' *Wall Street Journal*, October 28, A1, 2003.
24. K.J. Stiroh, (2006), p.2158.
25. K.J. Stiroh, (2006), pp.2158–2159. Some more alternative interpretations are the following: 'One is that FHC managers are more interested in expected returns than in the volatility. If FHC managers are large equity-holders, for example, they might take risk beyond what debt-holders and supervisors would prefer. This could be exacerbated by any implicit government guarantee (e.g., a firm considered "too-big-to-fail"), that reduces the incentives for debt-holders to monitor and discipline managers. This is especially true for the largest FHCs, which have in fact shifted the most into the highly volatile activities. Another reason for excess risk taking is the standard principal-agent explanation: traders, brokers, and underwriters (agents) like volatility more than FHC shareholders (principals) do. Short-run phenomenon may have also contributed to the unprofitable shift toward non-interest income. For example, FHC managers may have over-reacted to the lending problems of the late 1980s and early 1990s by shifting too far toward new activities. This desire to avoid earlier problem areas like real estate lending, coupled with financial innovation and deregulation that opened new markets and products, may have led the FHCs to push too far into these new activities.'
26. European Commission, 2006, Interim Report II, Current Accounts and Related Services, Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, 17 July, p.95.

27. This information is from the Reports of Condition and Income, also known as 'Call Reports,' for individual FDIC insured institutions and can be found on the FDIC's Reports of Condition and Income and Thrift Financial Reports Web site.
28. K.J. Stiroh (2002), p.6.
29. E. Gardener *et al*. (1999) 'The New Retail Banking Revolution,' *The Service Industries Journal*, Vol.19, No.2, p.88.
30. The FSA is, therefore, keen to encourage consumers to shop around and has introduced a number of measures designed to achieve this, including a recent consumer leaflet, comparative information tables on a number of key products and disclosure requirements for firms to give information to consumers. 'It pays to shop around,' FSA consumer leaflet (2002). See also: M. Cook *et al*. (2002) 'Losing Interest: How Much Can Consumers Save by Shopping around for Financial Products?' FSA – Financial Services Authority, Occasional Paper Series, n.19, October, p.13.
31. BCG (2010), p.11.
32. D. Vitolo (2012) 'L'importanza della loyalty per lo sviluppo del mercato,' Intervento al Convegno ABI – Dimensione cliente, Rome, 2 April. This refers to retail customers, that is to say, families and individuals. And A. Omarini (2012) 'Il business retail delle banche: sfide e opportunità da cogliere,' *Bancaria*, Nos.7–8, pp.64–74.
33. Office of Fair Trading (2010) 'Review of Barriers to Entry, Expansion and Exit in Retail Banking,' November, pp.125–126.
34. T. Clark *et al*. (2007).
35. CapGemini, *World Retail Banking*, 2011, p.6 and 2013, p.6.
36. For more detail on this issue see, Office of Fair Trading (2010).

3 The Customer-Centric Perspective and How to Get It

1. V.A. Zeithaml *et al*. (2006) *Services Marketing: Integrating Customer Focus across the Firm*, McGraw Hill International Edition, Singapore, p.4: 'The University of Michigan's American Customer Satisfaction Index has shown consistently lower scores for services when compared to other products.'
2. V.A. Zeithaml *et al*. (2006), pp.4–6.
3. S.L. Vargo & R.F. Lusch (2004) 'Evolving to a New Dominant Logic for Marketing,' *Journal of Marketing*, Vol.68, January, pp.1–2: 'Over the past several decades, new perspectives have emerged that have a revised logic focused on intangible resources, the co-creation of value, and relationships. The Authors believe that the new perspectives are converging to form a new dominant logic for marketing, one in which service provision rather than goods is fundamental to economic exchange.'
4. This is in regard to a situation where the economic foundation is good dominant logic, and as a consequence most countries use an economic classification system centered on the good (or more generally, units of output–manufactured goods, agricultural commodities, minerals, and so on). This classification system(s) in the US was historically based on the Standard Industrial Classification (SIC), now supplanted by the North American Industrial Classification System (NAICS).

5. A. Rahman (2013) *Operational Leadership in Retail Banking: The Last Frontier for Profits*, Lafferty Management Report, London, p.76.
6. This could be also extended to marketers, who also serve as selling agents, enabling a customer to exchange his or her skills in the marketplace This position would enable the marketer not only to evaluate the skills (services) the customer needs, but also to advise the customer about which skills (services) he or she can best specialize in and exchange in the marketplace, and the services (intangible or provided through goods) that might be acquired to leverage his or her own service provision and exchange processes.
7. To get a more in-depth knowledge on service blueprinting see: Shostack (1984) 'Designing Services That Deliver,' *Harvard Business Review*, January/February, No.84115; and V.A. Zeithaml *et al*. (2006), p.267ff.
8. V.A Zeithaml *et al*. (2006), pp.52–53.
9. S. McKechnie (1992) 'Consumer Buying Behaviour in Financial Services: An Overview,' *International Journal of Bank Marketing*, Vol.10, No.5, pp.4–12.
10. C.T. Ennew & N. Waite (2007) *Financial Services Marketing: An International Guide to Principles and Practice*, Elsevier, Oxford, p.130.
11. V.A. Zeithaml (1981) 'How Consumer Evaluation Process Differ between Goods and Services,' cited in Ennew and Waite (2007), p.131.
12. Beckett (2000) cited in O. Lindholm (2008) *The Influence of Sales Promotion on Consumer Behaviour in Financial Services*, Master's thesis. Helsinki School of Economics. Downloaded from http://hsepubl.lib.hse.fi/FI/ethesis/pdf/12006/hse_Ethesis_12006.pdf on 12.07.2010, p.12.
13. M. Darby & E. Karni (1973) 'Free Competition and the Optimal Amount of Fraud,' *Journal of Law and Economics*, Vol.16, pp.67–88.
14. D.T. Llewellyn (1999) 'The Economic Rationale for Financial Regulation,' *Financial Services Authority,* Occasional Paper Series No.1, p.37.
15. A. Omarini (2011) 'Retail Banking and Banks: Re-start from a Service Perspective Management to Increase Profitability, Stability and Customer Retention,' *Economia & Management*, No.6, p.82.
16. J.P. Macintosh, 'Resilience' from www.Palgraveconnect.com, p.3.
17. B. Chakravarthy & P. Lorange (2010) *Profit or Growth? Why You Don't Have to Choose*, IMD, Switzerland.
18. C.N. Pitelis & V. Vasilaros (2010) 'The Determinants of Value and Wealth Creation at the Firm, Industry, and National Levels: A Conceptual Framework and Evidence,' *Contributions to Political Economy,* Vol.29, pp.33–58.
19. M.E. Porter & M.R. Kramer (2011) 'Creating Shared Value: How to Reinvent Capitalism – and Unleash a Wave of Innovation and Growth,' *Harvard Business Review*, January/February, pp.1–17.
20. R.F. Lusch *et al*. (2007) 'Competing through Service: Insights from Service-dominant Logic,' *Journal of Retailing*, Vol.83, No.1, p.5.
21. L. Berry (1999) *Discovering the Soul of Service: The Nine Drivers of Sustainable Business Success*, The Free Press, New York; R. Frey, M. Popp and S. Weber (2008) 'An Approximation for Credit Portfolio Losses,' *The Journal of Credit Risk*, Vol.4, No.1, pp.3–20.
22. Federal Trade Commission (June 3, 1998) 'The Effect of Consolidation on the State of Competition in the Financial Services Industry,' from http://commdocs.house.gov/committees/judiciary/hju58805.000/hju58805_0f.htm, p.9.

23. 'Empowering consumers means providing a robust framework of principles and tools that enable them to drive a smart, sustainable and inclusive economy. Empowered consumers who can rely on a robust framework ensuring their safety, information, education, rights, means of redress, and enforcement, can actively participate in the market and make it work for them by exercising their power of choice and by having their rights properly enforced. In line with the Treaty (Article 12 TFEU) and the Charter of Fundamental Rights (Article 38), the Agenda develops a systematic approach to integrating consumer interests into all relevant policies and puts a special emphasis on tackling problems faced by today's consumers in the food chain, energy, transport, digital, and *Financial Services Sectors* [emphasis added].' 'The New European Consumer Agenda,' DG for Health and Consumers website, http://ec.europa.eu/consumers/strategy/index_En.htm.
24. J. Kareken & N. Wallace (1978) 'On the Indeterminacy of Equilibrium Exchange Rates,' *The Quarterly Journal of Economics*, Vol.96, No.2, pp.207–222.
25. The New European Consumer Agenda, DG for Health and Consumers website, http://ec.europa.eu/consumers/strategy/index_En.htm.
26. R. Ayadi *et al.* (2012) 'Regulation of European Banks and Business Models: Towards a New Paradigm?' Centre for European Policy Studies, Brussels, p.27.
27. A. Omarini (2014) 'Strategy and Business Models in Retail Banking: Why They also MATTER to Supervisors,' *Journal of Financial Transformation*, Vol.39, pp.47–58.
28. R. Ayadi *et al.* (2012), p.21: 'For example, investment-oriented banks report much more information on performance-related indicators than do some retail banks.' See also p.81.
29. G. Hamel & C.K. Prahalad (1994) *Competing for the Future*, Harvard Business School Publishing, Boston, Mass, p.202.
30. R.R. Nelson & S.G. Winter (1982) *An Evolutionary Theory of Economic Change*, The Belknap Press of Harvard University Press, Cambridge, Massachusetts; K. Polanyi (1966) *Dahomey and the Slave Trade: An Analysis of an Archaic Economy*, Seattle, London.
31. J.M. Hunt & J.R. Weintraub (2000) *The Coaching Manager. Developing Top Talent in Business*. 2nd edn, USA: Sage Publications Ltd, p.24.
32. D. Teece & G. Pisano (1994) 'The Dynamic Capabilities of Firms: An Introduction,' Working Paper, Laxenburg: International Institute for Applied Systems Analysis, p.537.
33. G. Hamel & C.K. Prahalad (1994), pp.202–204.
34. C.K. Prahalad & G. Hamel (1990) 'The Core Competence of the Corporation,' *Harvard Business Review*, May–June, p.82.
35. S.L. Vargo & R.F. Lusch (2004), p.7.
36. M.K. Lewis (1991) 'Theory and Practice of the Banking Firm,' in C.J. Green & D.T. Llewellyn (eds) *Surveys in Monetary Economics*, Vol.2: Financial.
37. The most quoted references include Benston & Smith (1976) on transaction costs, Leland & Pyle (1977); Campbell & Kracaw (1980); Diamond (1984); and Fama (1980, 1985) on asymmetric information and signaling, and Diamond and Dybvig (1983) on liquidity insurance.
38. For those who are seeking a more complete list please refer to comprehensive reviews by Baltensperger (1980) and Santomero (1984).

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40. Z. Bareisis (2013) *The Rise of the New Bank Account? The Quest for Transactional Account Primacy*, Celent, London, p.11. And the same can be done for bank accounts for SMEs, such as the interesting and well-known example of PayPal, which has enabled many small businesses accept cards online and recently also at the POS via PayPal.
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45. Also, J.K. Galbraith (1975) *Money: Whence It Came, Where It Went*, Houghton Mifflin Co., Boston, MA, pp.18–19: 'The process by which banks create money is so simple that the mind is repelled. Where something so important is involved, a deeper mystery seems only decent.'
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47. Front-line providers have direct personal contact with retail customers. Traditionally these were mainly banks and post offices, but recently at least six other categories of providers have emerged; building societies, insurance companies, supermarket chains, major retailers, and other services-based conglomerates. Channel providers include a wide range of organizations, which could be information providers (credit rating agencies), payment organizations (specialist software houses dealing in transaction expertise), or IT service suppliers (computer and multi-media companies). These organizations are not directly supervised by the authorities. Gateway providers comprise Internet, ATM, smart cards and call-center management specialists. A. Lowe & J. Kuusisto (1999), p.178.
48. See S. Singh (2012) *New Mega Trends: Implications for our Future Lives*, Palgrave Macmillan, London.
49. S. Singh (2012), p.141.
50. Ibid.
51. A. Lowe & J. Kuusisto (1999), p.177.

4 Winning the War for the Modern Customer

1. With the kind permission of my publisher Nick Dale-Harris at Management Books 2000, I bring to life many of the observations discussed throughout this chapter with the aid of two case studies from my book, *The Art of Being Chosen: Secrets of Success from the Giants of Retail,* Management Books 2000 Ltd, Oxford, 2010. www.mb2000.com.
2. M. Butler (2005) *People Don't Buy What You Sell, They Buy What You Stand For*, Management Books 2000 Ltd, Oxford. www.mb2000.com.
3. Case study 1 taken from *The art of being chosen* (2010).
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5 The Modern Bank Customer

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2. Ernst & Young (2012) 'The Customer takes Control,' Global Consumer Banking Survey.
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4. Such as the Banking and Business Banking codes, which are recognized internationally as leading examples of self-regulation for the retail banking industry. Through these codes, the banks commit to act fairly and reasonably, and deal with things that go wrong quickly and sympathetically.
5. The National Consumer Council is now known as Consumer Futures. This is the operating name for the new National Consumer Council. It is a statutory organization (a non-departmental public body) created through the merger of Energywatch, Postwatch, and the National Consumer Council (including the Scottish and Welsh Consumer Councils) by the Consumers, Estate Agents and Redress (CEAR) Act 2007. It is sponsored by the Department for Business, Innovation and Skills (BIS) and from October 2008 to May 2013 operated as Consumer Focus.
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8. European Commission (2012) press release on The Final Report on Consumer Market Study on the Consumers' Experiences with Bank Account Switching with Reference to the Common Principles on Bank Account Switching, GfK, February. And European Commission (2012b), Special Eurobarometer 373 – Report, March downloadable: http://europa.eu/rapid/press-release_IP-12–164_En.htm.
9. European Commission (2012b), p.119.
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11. Nordic Competition Authorities (2006) Report on Competition in Nordic Retail Banking, No.1 p.79. See also surveys by CapGemini (2011, 2012, 2013) and Ernst & Young (2012).
12. J. DiVanna (2004) The Future of Retail Banking: Delivering Value to Global Customers, Palgrave Macmillan, Basingstoke, p.22.
13. Also known as the Millennial Generation, they are the demographic cohort following Generation X. Researchers and commentators agree that they are those who were born between the early 1980s to the early 2000s.
14. They were born between 2000 and 2009.
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32. Cram (1994), p.44, cited in Murphy 1996, p.75.
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6 Business Transformation, Strategy, and Organization: The Issue is in the Execution

1. See also M. Baravelli & A. Omarini (2005) *Le Strategie Competitive nel Retail Banking: segmentazione della clientela, modelli organizzativi e politiche commerciali*, Bancaria Editrice, Rome, pp.216ff.
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10. J.M. Groeneveld & J.M. Wagemakers (2004), pp.3–4: 'Co-sourcing is the joint establishment of back-office platforms together with another bank. Insourcing means carrying out back-office operations for other parties in order to realize sufficient scale. Outsourcing is the disposal of activities and buying them back from other companies. White labelling implies the production of products for other, mostly non-financial parties without a label. (…) Within organizations, scale economies can be attained by establishing shared service centers. Shared service centers implies the merging of back-office activities of the various subsidiaries. They can be seen as internal core insourcing initiatives.'
11. See also C. Grönroos (1990) *Service Management and Marketing: Managing the Moment of Truth in Service Competition*, Free Press/Lexington Books, Lexington, MA.
12. KYC is the process used by a businesses to verify the identity of their clients. The term is also used to refer to the bank regulation that governs these activities. Know your customer processes are also employed by companies of all sizes for the purpose of ensuring their proposed agents', consultants' or distributors' anti-bribery compliance. Banks, insurers, and export credit agencies are increasingly demanding that customers provide detailed anti-corruption due diligence information, to verify their probity and integrity. Know your customer policies are becoming increasingly important globally to prevent identity theft, financial fraud, money laundering, and so on.
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14. E. Liikaneen (2012), p.51. 'A number of other concerns have been expressed in relation to the corporate governance of banks that go beyond the ownership structure and degree of external monitoring. This includes the concern (i) that boards are not fully representative of a banks stakeholder base; (ii) that CEOs May be too powerful also vis-à-vis the chairman and the risk and control senior officers (CFO, CRO, etc.); (iii) that there may not be sufficient

reporting by individual business units and limited visibility of intragroup subsidies and transfer pricing; (iv) that "fit and proper tests" are inadequate; and (v) that sanctions are insufficiently punitive, etc.'

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18. CapGemini (2014) *World Retail Banking Report*, pp.13–14.
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22. G. Saloner, A. Shepard & J. Podolny (2001) *Strategic Management*, John Wiley & Sons, New York.
23. J.C. Collins (2001) *Good to Great*, Random House Business.
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Conclusions and Recommendations

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Appendix 1

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Appendix 3

1. European Commission (2007a) Report on the retail banking sector inquiry, Commission, Staff Working Document accompanying the Communication from the Commission – Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report), SEC(2007) 106, January 31, p.7.
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3. European Commission (2006) Interim Report II, Current Accounts and Related Services, Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, July 17, p.8.
4. European Commission (2007c) Green Paper on Retail Financial Services in the Single Market, Brussels, p.15.
5. European Commission (2006), p.7.
6. http://ec.europa.eu/competition/sectors/financial_services/inquiries/sec_2007_106.pdf.
7. European Commission (2005), White Paper: Financial Services Policy 2005–2010, p.14.
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9. European Commission (2009a) Working Document on the Follow Up in Retail Financial Services to the Consumer Market Scoreboard, September 22, Brussels.

Appendix 4

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Appendix 5

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Appendix 6

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Appendix 7

1. This part is taken from A. Rahman (2013), pp.77–79.C.E. Shannon & M. Weaver (1949) *The Theory of Communication*, University of Illinois Press, Urbana, Illinois.
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