

## Optimizing distribution channels: The next generation of value creation

*Following a decade of above-market performance, retail banks are feeling the fallout from strategies that, while fueling growth, failed to leverage the rich potential of these institutions' customer-facing channels—fertile ground for growing and sustaining profitable, long-term relationships. By shifting their focus back to the customer, banks can set off a new wave of value creation.*



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# Optimizing distribution channels

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## Introduction

From 1994 through 2001, the S&P Banking Index grew at a compound annual rate of 12.7 percent – outperforming the S&P 500 over the same time period.<sup>1</sup> In driving this period of prosperity, banks pursued three key strategies: revenue diversification through wide institution of fees, consolidation through mergers and acquisitions, and risk reduction through asset securitization.

While these tactics allowed retail banks to create significant value for their shareholders, they came with a heavy price: weakened customer relationships. Today, with stabilization of noninterest income, slowing securitization and a lull in merger and acquisition (M&A) activity, banks are facing a sobering reality: While they were focusing on getting broader and bigger, their customers were becoming increasingly alienated by arbitrary fee hikes, inward-looking strategies and “one size fits all” service models.

In the face of a bruised and unsure economy and growing numbers of dissatisfied customers, retail banks are searching for new sources of sustainable revenue and earnings growth. To find them, they will have to shift their focus and learn to look from the outside in – from the customer’s point of view. This will require developing and deploying fulfillment strategies that map tightly to customers’ buying patterns and optimize a bank’s capabilities in the right way, at the right time, through the right channel – from the branch, to the call center, to the ATM and to the Web.

Firms that weathered the storm of merger activity were able to achieve unprecedented scale and scope. In the U.S. alone, assets per bank grew a full 187 percent between 1991 and 2001.<sup>3</sup>

### The past decade: How banks prospered

Over the course of the 1990s, banks relied on three strategies to create shareholder value:

**Revenue diversification**—Banks sought to diversify and grow their revenue base with additional sources of noninterest income. In just four years—from 1997 to 2001—noninterest income grew over 50 percent to US\$169 billion. A sizable amount of this incremental revenue was gleaned from service charges and fees from core deposit accounts.<sup>2</sup>

**Bank consolidation**—Banks sought to capture economies of scale and scope by acquiring other institutions. This wave of M&A activity took place in three stages:

- *Intra-regional*: During the period between 1990 and 1995, banks concentrated on consolidating within their traditional footprint. In reaction to a recessionary environment, firms used mergers to increase productivity—closing branches, laying off employees and generally relying on fewer physical assets to serve the combined customer base.
- *Inter-regional*: In the U.S., the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allowed banks to operate more easily across state lines. This, in turn, ushered in a wave of inter-regional mergers (from 1995 to 1998) during which banks sought to widen their footprint and accelerate their entry into new markets. By expanding their business across multiple marketplaces, banks were also able to diversify credit risk.
- *Cross-industry*: Thanks to the Gramm-Leach-Bliley Act of 1999, U.S. banks could offer a full complement of financial products and services. In their quest to provide “one-stop-shopping” to customers, retail banks acquired a string of brokerage firms and investment banks. Independent of the Gramm-Leach-Bliley Act, institutions also started to focus on global acquisitions as a way to secure new sources of revenue.

**Risk reduction through securitization**—In an attempt to diversify risk, improve their risk profile and clean up their balance sheets, banks securitized a greater number of the loans they originated, as well as assets sitting on their books.

Together, these measures have significantly impacted banks’ bottom lines and transformed the industry’s income statement (see Figure 1). Noninterest income rose dramatically from US\$63 billion in 1990 to US\$169 billion in 2001<sup>4</sup>—resulting in an 11 percent shift in the ratio of interest income to noninterest income. The effects of consolidation are evident in lower overhead costs, and asset securitization is partly responsible for the lower loan loss reserves.

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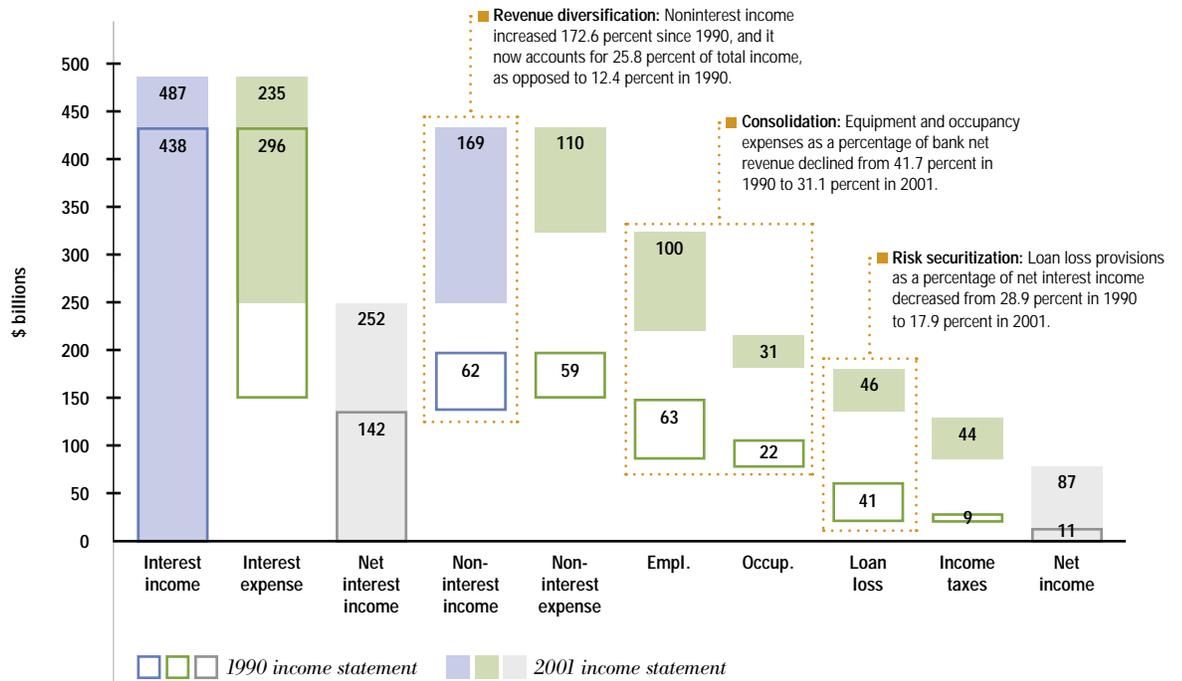


Figure 1. U.S. banking industry income statement, 1990 versus 2001.

Note: Total revenue was derived from adding net interest income to noninterest income.

Source: Federal Deposit Insurance Corporation (FDIC), IBM Institute for Business Value analysis.

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“The attention to bread-and-butter customers is the same formula that, along with shrewd acquisitions, propelled Seattle’s tiny Washington Mutual Inc. to a US\$275 billion national bank in a decade. Khaki-clad tellers still roam the floor asking customers what they want. The answer, obviously, has been more TLC, and less ATM.”<sup>6</sup>

### Facing the point of diminishing returns

Although the numbers are impressive, the returns on these strategies are leveling off. Growth in fee-related income appears to have stabilized. Less-attractive asking prices and the risks of integration have made banks more reluctant to pursue M&A ventures, and current portfolios reflect a more realistic mix of interest and noninterest earnings.

Banks imposed charges and fees totaling US\$26.5B in 2001.<sup>5</sup> Further increasing fees is a risky strategy that essentially penalizes consumers for remaining loyal and makes customer acquisition more difficult. It is not surprising that customers’ growing resentment at having to pay for services that were once free has become a major selling point for community banks across the nation.

The spate of mergers and acquisitions narrowed the playing field and left customers with fewer banks from which to choose. In the past decade (1991 - 2001), the U.S. banking industry witnessed a 33-percent decline in banking institutions.<sup>6,7</sup> Furthermore, the cost reductions realized from the integration process often came at the expense of customer service.

Even banks’ efforts to alleviate risk – securitizing and selling off assets – had negative consequences. By selling off consumer loans, banks lost an important link to many consumers’ financial activities – placing even more distance between themselves and their customers.

As banks chart their future, they will have to turn their attention to improving every customer encounter in a way that affords value to both the institution and the consumer. This will involve optimizing distribution channels by altering fulfillment strategies and current distribution networks.

## Optimizing distribution channels

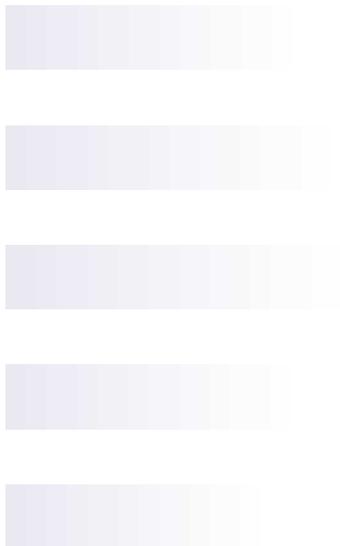
In the past, banks had more control over the manner and frequency of customer interactions, most of which took place within the confines of branch offices. Although customers have welcomed alternative channels like the Internet, ATMs and wireless technologies, they still rely heavily on the branch — a situation that offers more flexibility to consumers, but can increase the total cost to serve them.

### Unmet expectations for channel migration

Over the past 30 years, banks have invested heavily in the development of non-branch distribution channels, including ATMs, the Internet, call centers and, more recently, wireless technologies. The underlying assumption behind the alternative channel investment was that banks could reduce the costs to serve customers, as transactions — once consummated in the branch — were migrated to lower-cost sources of fulfillment. Banks further justified alternative channel development by hypothesizing that the availability of more channels would attract new customers and sources of revenue.

The latter portion of banks' investment rationale has been realized, as adoption of non-branch channels has been impressive to date. For example, in only six years, Internet banking uptake in the U.S. has already exceeded 25 percent of the retail customer base. Although the adoption curve for ATMs has plateaued during the past several years, approximately 65 percent of all banking customers in the U.S. interact through that channel.<sup>9</sup> It is anticipated that, over time, acceptance of online and wireless banking will reach their respective saturation points.

More troubling for banks is that the costs to serve customers have actually increased with the development of the non-branch distribution network. Customers have not exhibited the types of habits that banks had anticipated. Rather than replacing branch visits with lower-cost alternatives, most customers have increased the frequency and means with which they interact with their retail bank, resulting in higher overall service costs.



Maintaining a multichannel fulfillment infrastructure requires significant investment and strategic direction. Banks continue to invest in non-branch channels (spending as much as 62 percent of their IT delivery channel budgets on these alternatives<sup>10</sup>) to complement their core branch network. As banks seek to optimize their distribution strategies, they must consider three key trends shaping retail bank fulfillment:

### *Customers still rely heavily on the branch for most banking interactions*

The introduction of alternative channels – with their 24-hour availability and easy access – revealed an interesting customer dynamic: Not all customers are driven by convenience. In fact, the branch remains the focal point of the banking relationship for most customers. In a recent survey of U.S. customers' channel preferences, 92 percent used the branch in the last month, while 50 percent preferred the branch to other channels.<sup>11</sup> A similar study in four of Europe's leading banking markets – France, Spain, Germany and Italy – revealed that at least 80 percent of those surveyed favored face-to-face banking transactions over other available channels.<sup>12</sup> Not surprisingly, banks are stepping up their efforts to revitalize their branch operations. In the U.S. alone, retail banks are expected to increase general branch IT spending dramatically – from US\$2.9 billion in 2001 to US\$4.1 billion in 2005.<sup>13</sup>

### *Multichannel fulfillment has not produced the anticipated level of cost savings for retail banks*

Retail banks have invested considerable resource and funding to move customers out of the high-cost branch channel and into lower-cost distribution channels. Despite these efforts, the expected returns have not materialized. Instead of replacing their use of the branch, customers are simply increasing the frequency of interaction with their banks – adding to the overall number of banking transactions and raising the total cost to serve.

### *Customers' expectations have increased as retail fulfillment options have expanded*

As customers' options have grown, so have their expectations. Today's consumers – traditional and online alike – look to their branch as a source of numerous financial services, including tax preparation and financial planning. Online banking customers expect the customer service function to be integrated across all customer touchpoints. In fact, eight out of every ten online bank customers believe they should be able to resolve their online banking problems through any channel – phone, branch, e-mail or instant messaging.<sup>16</sup>

In the U.S., 20 percent of customers use four banking channels; 24 percent use three; only a third rely on a single channel. In the U.K., the number of retail banking customers using two to three channels has risen significantly — from 69 percent in 1997 to 80 percent in 2001.<sup>14</sup> And in a panel of more than 1500 U.S. Internet users, 16 percent made regular visits to the branch over the course of a year.<sup>15</sup>

## Optimizing distribution channels

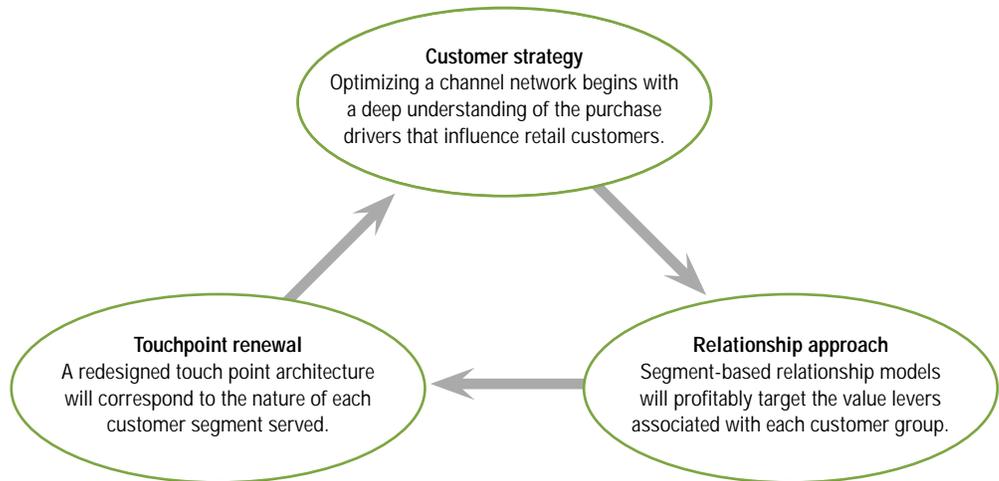
Traditional processes and strategies fail to address the needs and preferences of various customer sets and alter services accordingly— forfeiting the opportunity to gain valuable insight and provide an integrated, consistent customer experience across channels.

### What banks can do: A three-stage approach to channel optimization

Historically, retail banks have kept their product portfolios in “silos” – hampering their ability to cross-sell and serve customers consistently across financial product lines. Adding to this challenge is the fact that, over time, these vertical lines of business spawned their own channels, directly impacting institutions’ cost structures. In an effort to reduce fulfillment costs and improve service, many banks are attempting to consolidate these disparate channels. This is difficult, particularly when most banks have yet to fully integrate their business units. Although technology has made it possible to offer customers a horizontal, enterprisewide view of the company without combining business units, integrating channels alone is not a sufficient distribution strategy. By optimizing the distribution network, banks can create value from the fulfillment function – a function traditionally seen only as a cost center.

To optimize their distribution networks, banks must restructure their fulfillment strategies to better align with the requirements of individual customer segments and increase customer value. To do this, the IBM Institute for Business Value recommends a three-step process (see Figure 2):

1. Refine the customer strategy – Understand the drivers that influence retail financial purchases and segment customers accordingly.
2. Adopt a relationship approach – Develop a relationship model that influences the specific value levers associated with selected customer segments.
3. Renew touchpoints – Design distribution and fulfillment points based on the nature of the customer segment served. Consider the distinct preferences of each customer set, as well as the profitability associated with each group.



**Figure 2. Channel optimization initiatives must address three critical components.**

*Source: IBM Institute for Business Value*

### *Customer strategy*

Any exercise in optimizing the distribution network must start with a thorough understanding of the customer base and identification of the customers you most want to serve. The IBM Institute for Business Value sees three primary drivers of consumer financial product purchases: price, trust and convenience. These drivers should play a significant role in how banks sell and market offerings, manufacture and package products, and respond to customer demands. Segmenting customers by these purchase drivers can help banks to better acquire, serve and retain customers:

- *Price-minded* customers typically shop for the lowest fees and highest deposit rates, and are less inclined to develop long-term relationships with financial institutions. These consumers can make high demands, and they are hard to retain, given their propensity for seeking out the “best deal.”
- *“Trustees”* offer the best cross-selling opportunities for banks. These customers are open to building and maintaining a relationship with their bank; they tend to be older than price-conscious consumers, and generally buy a range of financial products. They seek advice and counsel, and act regularly on recommendations. Though not at the highest point on the income curve, they place a premium on the quality of their bank relationship and the service it affords.

- *Convenience seekers* are very loyal customers, but this loyalty is borne out of the high switching costs of banking relationships rather than affection for the institution. They like the proximity of a local branch, as well as the freedom and flexibility offered by other channels like the Web and the ATM. These customers appreciate banks' cross-selling efforts if the offer contains recognizable value to them and are happy to maintain a diverse portfolio from one provider.

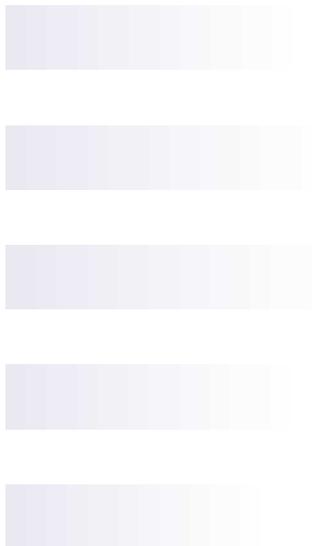
### *Relationship approach*

In this step, a bank lays out strategic objectives for each customer segment – specifically targeting the elements of customer value it plans to impact. The bank then shapes the components of its offerings (such as pricing, product selection and channel usage) into a cohesive relationship model that influences those levers. Three widely acknowledged levers of customer value map closely to the three core customer segments defined earlier:

*Reducing the cost to serve:* Migrating price-minded consumers to more-economical channels can significantly lower service costs. This will involve assessing how best to profitably fulfill these customers' requirements, given their attention to cost and their tendency to switch banks. By remaining watchful of account activity, banks can better anticipate customers' needs and remain proactive about presenting them with compelling value propositions.

*Increasing wallet share:* By assuming the role of advisor, banks can begin to cross-sell various financial products to “trustees.” At the same time, firms must develop a value proposition that underscores and elevates the role of the bank as a reliable source of advice.

*Improving customer retention:* Banks can justify higher prices and retain convenience-focused customers with innovative products and exceptional service. These customers will pay a premium for efficiency, and the more a bank can do for them, the harder it becomes for them to leave. To fulfill this strategy, institutions must first confirm what set of services best aligns with these customers' expectations.



## Optimizing distribution channels

By optimizing their distribution networks, banks can reap the returns of a more customer-focused enterprise—one that answers to a customer's needs with pricing, products and channels that increase overall value provided to—and obtained from—the customer.

### *Touchpoint renewal*

This step involves altering customer touchpoints to conform to the preferences and profit potential of each segment. When a firm enters a new market or establishes a brand new channel, designing segment-specific touchpoints is more straightforward. However, because most banks will not be “starting from scratch,” optimization generally involves rationalizing distribution channels across existing assets: the customer base, the channel infrastructure and the product portfolio.

Although product portfolios and channel infrastructures are largely fixed, their makeup can dictate the segments that a bank is most suited to serve. While focusing on only one customer group is certainly not advisable, it makes sense for a bank to target—and cater to—those segments that best align with its strengths, and make investments accordingly.

### **What banks are doing**

Using knowledge gleaned from extensive research, a large, Canadian-based bank divided its customer base into four groups. Given that the most profitable segment was highly dependent on the bank's branch locations, the institution created a service model that places trusted financial advisors in these environments and affords face-to-face interaction for the bank's key customers.

Confronted by declining business, a bank in the United Kingdom created a customer database to help it determine where best to concentrate retention efforts. After determining that its customers wanted fewer constraints and more options, the institution responded with a program that offers more freedom in performing self-service transactions.

A South African bank found a way to serve its country's previously untapped, low-income mass market. Given the segment's potential and cost to serve, the institution created a new brand in the form of an enriched ATM network comprising approximately 130 centers and more than 2.6 million accounts — and growing. In addition to providing opportunities for up-selling, the bank's automated brand is 40 percent less costly to run, and represents a win-win situation for everyone.

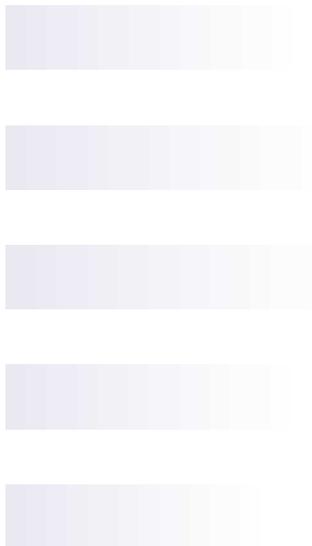
Located in the Northwest region of the United States, this bank serves consumers in locations across the country. Following two years of research, the bank confirmed that its customers preferred high-touch over high-tech. The bank created a special branch concept that uses a unique floor plan, specially trained staff (including onsite securities dealers) and customized offerings to create a “just for me” customer environment.

## Optimizing distribution channels

### Is your bank enhancing its value across channels?

If your bank is seeking to elevate customer satisfaction, increase channel profitability and serve customers in the most appropriate – and profitable – way, there are some fundamental considerations that must first be taken into account:

	Yes	No	Not sure
Has your institution examined its channel assets and prioritized whatever additional investments can and should be made in those areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Is your bank setting priorities in terms of where it will focus these efforts?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does your bank prioritize its channel strategies around key customer segments?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Do your bank's channels align with the preferences of your target segments?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does your IT infrastructure provide the necessary capabilities and afford the information access needed to identify and act upon purchase triggers?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Is your bank prepared to migrate customers dynamically to higher-value products and services?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Does your bank deliver a consistent and satisfying customer experience across its distribution channels?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Are all of your bank's channels fully integrated to afford consistent levels of information and functionality?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Do your customer-facing employees have access to the same information as your customers?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>



### Get started today

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The Financial Services Sector Team at the IBM Institute for Business Value created this executive brief based on their study entitled “Optimizing the Distribution Network: The Next Wave of Value Creation in Banking.” To learn more about this study and how these trends may impact your business, please contact Vik Lund at [vtlund@us.ibm.com](mailto:vtlund@us.ibm.com).

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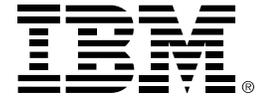
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