



2010 Financial Services – Retail Banking Industry Perspective

The last 12 months have been tumultuous for the industry to say the least. Although more than 120 banks have failed this year, most executives are breathing a collective sigh of relief that the industry has survived the worst of it. That was not a foregone conclusion. Early in the year, in the wake of the government's takeover of Fannie Mae and Freddie Mac and the increasingly perilous financial conditions of Bank of America and Citigroup, there were serious discussions about nationalizing the banking system. That doomsday scenario was averted, thanks to massive and coordinated government efforts that drove down interest rates, relaxed mark-to-market accounting rules, pumped stimulus money into the system, and returned desperately needed liquidity.

The Industry's New Shape

As the worst of the financial crisis abates, strong banks have short-term opportunities but also face long-term challenges, which they must begin preparing for immediately.

In the short term some banks will have a chance to snap up rivals and consolidate positions. It's likely the FDIC will push weaker, smaller institutions, those with assets of roughly \$10 billion, to merge with regionals. And certain regionals may themselves become acquisition targets depending on their exposure to the faltering commercial real estate market. Just as mergers in 2008 redefined PNC, Wells Fargo, and JP Morgan Chase, most of the remaining superregionals will face defining merger moments in the first half of 2010.

Looking further out, the industry's challenges are more fundamental than who buys whom. Banks will face lower return on equity than in years past. Consumer demand will be weak, personal saving rates will remain higher, banks' balance sheets will shrink, profits from the shadow banking system will decline or cease, commercial real estate will falter, and tighter regulations of products such as credit cards and overdraft protection will restrict profits.

In this environment the focus of banks will shift from acquiring new customers to building deeper relationships with existing ones. Banks must

surgically identify and capture growth opportunities within their customer base. To do that, banks must significantly revamp their capabilities and evolve their organizations to: target the most attractive customer segments; harmonize the roles of segments, products, and channels; better align corporate strategy and risk; and pursue sustainable cost reduction, such as rationalizing the branch network.

Target Attractive Segments for Growth

The crisis of the last year has devastated the mass market. Most of these consumers have little or no home equity, their ability to access unsecured credit has been curtailed, and their job security is threatened. Banks will need to increase their focus on more affluent and emerging segments including:

- **Affluent and Retirees:** The affluent may have fewer assets than they did three years ago, but they still have more than most people and they remain a profitable segment. Meanwhile, retirees and retiring baby boomers need to save diligently and invest smart. Banks can build trust and market share with holistic offerings of products and services as long as these are transparent and low cost.
- **Small Business:** Small businesses were hit hard by the crisis when banks froze lending. By jumping in and grabbing market share now, banks could enjoy lending growth and capture business owners' personal accounts.
- **Gen Y:** By 2014, Gen Y will comprise the largest segment of the U.S. workforce and by 2025 will account for 60 percent to 70 percent of the employed population. Given its size, connecting with this generation is a must for banks. To do so, they will need to better integrate their channels and interact with customers through each customer's channel of choice. More than any previous generation, Gen Y is shaped by the Internet and ubiquitous connectivity.

Harmonize the Role of Segments, Products, and Channels

No matter which customer segment a bank targets, it must reorganize around that customer. We're well aware that customer centricity is one of the great bank catch phrases of the past 10 years. Millions of dollars have been invested in technology solutions to create 360 degree views of customers, but after all that talk and money the industry for the most part is still focused on products – mortgages, home equity loans, free checking – not customers.

Most banks remain siloed, with limited cross-product or cross-channel integration.

The roles of segments, products, and channels must change within the organization. Organizing around the customer is critical to getting more revenue from each one – an imperative in a low-growth environment characterized by little product differentiation. In a client centric model, each segment group develops its own customer value proposition, and is responsible for the customer experience and P&L for that segment. Customer centricity also demands that banks develop specific segment capabilities (people, process, and technology) to holistically understand specific customer needs along the customer lifecycle irrespective of products or channels. Product development groups should be focused on collaboratively and cost effectively finding solutions to fill “need gaps” that customers within segments have identified. Finally, the role of the channel must be to deliver the desired customer experience. Banks must create segment-specific channel capabilities to deliver solutions in a way that both meets segment preferences and balances cost (e.g., online channel for mass customers, small business branches).

This is a big change for banks, which commonly have overlapping roles for segment, product, and channel groups. Banks will need an all-hands-on-deck attitude to ensure every interaction among banking groups – from product development to pricing to customer-facing staff – serves the common purpose of delivering the targeted value proposition. Because these groups are commonly at odds with one another, the interactions among them must be clearly defined to ensure everyone is working together toward the same goals.

Better Align Corporate Strategy and Risk

Besides focusing on customer segments and realigning to create true customer centricity, banks must improve risk management. The global financial crisis demonstrated clearly that many banks lacked a proper understanding of their risk exposure and realized too late that it was out of kilter with their desired risk profile. Financial institutions need a comprehensive risk appetite framework in place to translate risk metrics and methods into strategic decisions, reporting, and day-to-day business decisions. After the financial crisis, regulators, rating agencies, and investors expect nothing less from institutions than a sophisticated, state-of-the-art enterprise risk management (ERM) program.

Pursue Sustainable Cost Reduction

Finally, to succeed long term banks must bring down operational costs – not just by capturing traditional back office savings but also by taking a hard look at distribution costs.

Booz & Company research shows that mass market customers prefer to conduct their banking at branches, accounting for 70 percent of traffic and resource consumption, yet they are half as profitable as mass affluent customers. The rise of Gen Y will only put further pressure on the traditional bank branch network, which banks may soon be unable to afford. Indeed, we expect that a major rationalization of the branch network will emphasize electronic channels and alternate formats. In the future, for example, branches may cater to specific customer segments, becoming “wealth” branches or “small business” branches, with fewer generic branches open to all.

We hope you find these insights helpful as you consider your organization’s strategy for 2010 and beyond, and we welcome the opportunity to further discuss them with you.

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