Sirius & Company

# Fulfilling the promise of Retail Banking in the 21st Century

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It has been tough for the UK retail banks over the last decade – decline of market share, increasing competition from the non-banking companies, erosion of trust once the life blood of the retail banking industry, and lack of innovations. In addition, technological advances forced the retail banks to change the way they operate. Many have taken the opportunities of technological advances but at the expense of poor customer services. Today, retail banks in the UK are at a cross-road and their future success is far from certain. The industry finds itself in a position where bankers, once the trusted member of the society, are seen as greedy and self serving. But, it doesn't have to be like that since the opportunities for the UK retail banks in the 21st century are enormous. In order to capture the hearts and minds of the customers and to fulfill the promise, the UK retail banks need fundamental change to their operating models. Find out how?

Retail banks have experienced turbulent times for the past ten years. In year 2000, world-wide retail banking operations of commercial banks earned approximately £115 billion in net revenue from deposits, mortgages, and credit cards, representing more than 80 percent of their overall retail revenues. By 2002, revenue from these three products had fallen to £96 billion as interest rates dropped and the decrease in deposit revenue overshadowed revenue growth from the boom in mortgages. A big increase in mortgages in 2003, and then in deposits in 2004 and 2005, pushed total net revenue toward the £165 billion mark. At the middle of 2006, overall revenue for deposits, mortgages, and credit cards appeared to be headed above £182 billion, as moderately rising rates increased deposit income. But traditional bank deposits are running out of steam, as people have again begun ploughing cash into the stock market and into some high-interest alternatives that have emerged online.

There is no easy relief for near-term revenue stagnation in any of these areas. Even if the UK retail banks continue to implement measures to reduce costs by offshoring back-office functions in low-cost destinations, this won't be enough to counter the levelling-off of deposit revenues. For this year and in year 2008, those revenues are likely to be £28 billion to £56 billion lower than they would have been had deposits remained on their mid-2006 trajectory, and had consumers continued adding to the cash they have in banks instead of using that money in other ways. So, the challenge facing the UK's retail banks is significant by any measure.

At the heart of retail banking today lies a dilemma: while the success of retail banking is increasingly dependent on customer services, most banks' innovation processes remain focused toward products. Most retail banks are yet to establish ongoing research and development (R&D) processes to understand their customers' needs. Instead, their product managers developed products based on pseudo market research and gut feel.

## "Estate Agent" style marketing is damaging the reputation

At some point in its development, every industry can be considered a growth industry, based on the apparent superiority of its product. But in case after case, industries have fallen under the shadow of mismanagement. What usually gets emphasised in the UK retail banking is selling of products, not marketing of services. This is a mistake, because selling of products focuses on the needs of the bank, whereas marketing of services concentrates on the needs of the customer.

The history of every dead and dying 'growth' industry shows a self-deceiving cycle of bountiful expansion and undetected decay. The railways serve as an example of an industry whose failure to grow is due to a blinkered market view. Those behind the railways are in difficulty not because the need for passenger transportation has declined or even because cars, air travel, and other modes of transport have filled that need. Rather, the railway industry is failing because those behind it assumed they were in the railway business rather than the transportation business. They were railway oriented instead of transportation oriented, product oriented instead of customer oriented.

Today, the marketing drives in most of the UK retail banks are akin to estate agents trying to sell derelict properties as state-of-the-art penthouses. Consider the case of one of the largest banks in the UK. The bank's recent advertisement of "free cash withdrawal" on top of its ATMs gives an impression that the bank is doing a favour to its customers by proving free access to the cash, when the cash belongs to customers and not to the bank. Irritating and misleading practices that leave customers seething are not uncommon among the UK retail banks [1].

Instead of phoney advertising practices, the UK retail banks can increase marketing effectiveness, resulting in significant cost savings, by designing, building, and deploying a service oriented marketing capability. Despite abundant resources banks have so far made less progress in employing their understanding of return on marketing expenditures to unlock value than companies in other industries (see Figure 1). Even though banks now rank as one of the leading industries in terms of marketing spend, it lags behind other sectors, such as consumer packaged goods, in its ability to understand the link between effective marketing investment and results. This gap is more obvious than ever as marketing increases its profile within most banks.

For banks to ensure continued evolution, they must define their industries broadly to take advantage of growth opportunities. They must ascertain and act on their customers' needs and desires, not bank on the presumed longevity of their products. They must accept that they are privileged to serve profitable customers and not the other way round. In short, the best way for a bank to be successful is to make its own success by providing superior services with highest level of trust. Banks must learn to think of themselves not as manufacture of products but as doing the things that will make customers want to do business with them. And in every case, the CEO is responsible for creating an environment that reflects this culture.

## Greed isn't good

The leading high-street banks stand accused of using increases in interest rates in January 2007 to make huge profits totalling £1.5 billion from customers. A new research by Moneyfacts revealed that eight of the UK's 10 biggest banks have manipulated both their savings and borrowing schemes to boost profits from interest rate rises in the recent months [2]. The research found that, despite a 1.5 percent point rise in the base rate, savings rates have risen by an average of only 1.04 points, while mortgage rates typically rose by the full amount. For example, One of the

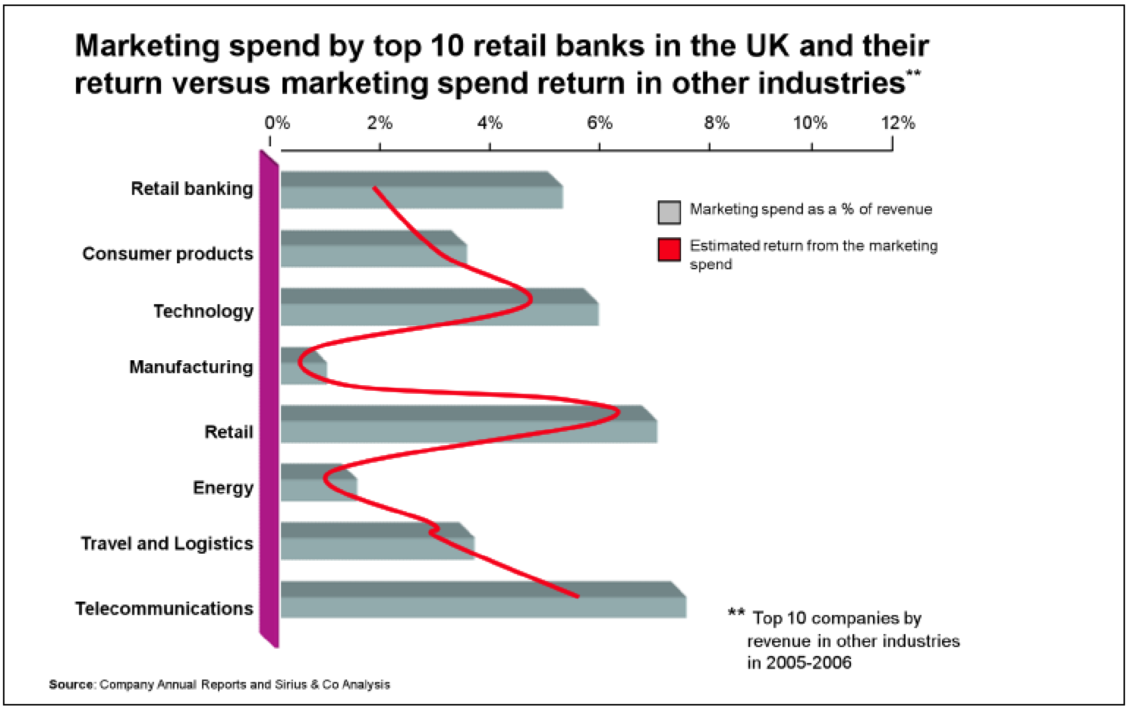


**Figure 1:** *Retail banks in the UK make less from marketing expenditures than companies in other industries.*

big UK banks has increased savings rates by an average of just 0.66 points while its mortgage rate increased by 1.76 points — more than the rise in the base rate. As a result, a saver with £50,000 has lost out on £445 annually, while a borrower with a £200,000 mortgage is paying £520 more. However, the banks claimed that they continued to offer competitive products to their customers, and that movement in the base rate was just one of the factors in pricing their products.

This is the unpleasant face of the UK retail banks today, which the customers believe make a living out of devising new ways of ripping them off. Since 2003, most of the large retail banks in the UK have cynically appropriated money from customers to the tune of £1.5 billion by taking advantage of interest rate rises. This is also the other face of the UK banks which pays fund-managers excessive amount of money to deliver a mediocre performance in the unit trusts, endowments and pensions that ordinary customers rely on. For example, two of the UK's biggest insurers have discovered billions in surplus cash in their orphan funds. Instead of returning it to endowment holders, who have suffered disastrous performances, they plan to give most of it to big institutional shareholders.

## Poor practices continue

Despite banks agreeing to speed up the clearing of electronic payments years ago, cheques still take at least three days to clear. However, banks describe the slow clearing process as a secondary issue as cheques are a declining means of payment. In a sense, banks are right – first, the issue is secondary to them but not to the customers, who want a rapid solution. Secondly, if banks continue to delay the clearing process, in a further decade or two, cheques will then really be a declining means of payment. Until then, banks will keep making profit from customers' inconvenience and fall well short of what customers deserve. The UK's clearing system has long irritated customers, who resent the £30 million which some banks make annually from sitting on the money over the three-day clearing period.

## Nice rate but shame about the catches

It has become common practice for the UK retail banks to try to grab customers from rivals by raising the rate on their current accounts. However, the headline grabbing rate lasts for only few months and customers have to stick with their banks to earn the higher rate. The little bit extra that customers can earn by switching to these accounts isn't worth it just for few months. In addition, there are many catches – for example, retail banks insist that customers pay at least £1,000 into the account each month. In any months that they don't, they often earn miserly 0.1 percent. Another catch is that customers can only earn the higher rate on balances up to £1,000. Above that, they earn a modest rate, often significantly less than the rate of inflation.

## Technology revolution – are customers being served better?

The lunch-time melee, at most of the UK retail banks' counters is one of the central challenges that extend beyond marketing hypes, such as "Express Banking", promoted by some of the of retail banks. Since the early 2000, retail banks in the UK are always trying to find a way to use fewer people to service and yet touch more customers. But, the result of their effort is mixed. The question remains: How do they have enough cashiers available at the counters to serve customers, but not so many that their wages bankrupt operations?

## Customer Relationship Management software is not enough

The UK retail banks have poured enormous amounts of money into customer relationship management (CRM) software, but in most cases the investment hasn't really paid off. That is because getting closer to customers isn't about building an information technology (IT) system based on CRM, when there is a clear absence of a single view of a customer across the bank's multiple functions and IT systems.

For most retail banks, it is a learning journey that begins with the creation of a companywide repository containing every customer interaction with the company, organised by customer. Communal coordination is what is called for at this stage, as each group contributes its information to the data pool separately from the others and then taps into it as needed. In the second stage, one-way serial coordination from centralised IT through analytical units and out to the operating units allows banks to go beyond just assembling data to drawing inferences. In stage three, banks shift their focus from past relationships to future behaviour. Through symbiotic coordination, information flows back and forth between central analytic units and various organisational units like marketing, sales, and operations, as together they seek answers to questions like "How can we prevent customers from switching to another bank?" and "Who would be most likely to buy a new service in the future?" In stage four, banks begin to move past discrete, formal initiatives and, through integral coordination, bring an increasingly sophisticated understanding of their customers to bear in all day-to-day operations.

## Innovation is rare

Retail banks, by and large, lags far behind most other retail industries in developing leading-edge products and services. As retail banks try to keep pace with rapid changes in technology and cope with changing business environments, their R&D departments have to do more than simply invent new products.  Consolidation in the retail banking industry has also stifled innovations. For example, to make any integration work smoothly, banks invariably cut costs, which translated into a degradation of service. Since, further consolidation among the UK retail banks will be subject of the regulatory approval means the growth by acquiring new customers will no longer be feasible. Instead, the only way for the UK retail banks to grow will be to strengthen relationships with their current customers, and to do that, banks will have to innovate their offerings.

Consistent innovation is the key to market leadership. Outstanding retail banks know that and build their success on it by co-opting customers as innovators. Retail banking product development is often difficult because what the customer needs reside with the customer, and how to satisfy those needs lies with the bank. Traditional ways (such as market research, gut feel of product mangers in the bank) of obtaining customers' needs are often complex, subtle, and fast changing.

But innovation is a real challenge in the UK retail banking. The industry has to contend with a tangle of regulations that can slow down product and service innovation. Internal structural problems also inhibit marketing and service innovation. Product-centric companies have R&D departments, but rare in the UK retail banks, where IT tends to drive R&D. Furthermore, departments within banking organisations are highly segregated from one another; the people who know what kind of technical innovations are needed are often completely isolated from those in a position to deliver the innovations. Cross-departmental teamwork is rare. In addition, the risk aversion, a culture so common among the UK retail banks, act as a barrier to innovate new offerings.

## Obsession with offshore outsourcing

The UK retail banks have made heavy use of offshore outsourcing of some IT functions and business processes, and such deals continue to receive positive coverage in the media. Yet our experience suggests that the rosy picture being painted by the vested parties hide the failure of many retail banks capturing much value from their offshore outsourcing efforts (see *Offshoring practices in European financial services companies* by Pal). Visible but isolated success on one side, regular information theft from offshore business process offshore (BPO) centres with complex and painful failure of offshoring deals on the other, leads to three conclusions: first, the industry has not stabilised to the point where offshoring any particular business function is a guaranteed safe choice; second, there is too much hype and myths around the safeness of offshoring – primarily because of the propaganda work of vested parties; third, much value can be captured from offshoring if it is done right, and there clearly is a safe way to do it. We also found that most retail banks don't worry about the behaviour of offshore providers when they enter into legal arrangements with them. These retail banks assume offshore service providers will always act in ways that maximise both parties interest. Unfortunately, that isn't a very sensible assumption to make. Like all supply chain partners, offshore service providers can, and do, have incentives to behave in ways that prohibit retail banks from capturing benefits from offshore outsourcing. For example, some offshore service providers stop investing in training or employ people who are nowhere as skilled as the agents they presented during the contract negotiations.

## Security breaches are not uncommon

Security breaches have become a greater threat to retail banks than external hacking. A recent survey found a drop in external IT attacks - less than a third had experienced an attack in the past 12 months, compared with 83 percent a year earlier [4]. However, security breaches inside organisations, for example employees planted by criminal gangs to collect information, more than doubled (see *Case for investment in information security* by Pal).

Some 35 percent of companies had suffered this kind of attack, compared with 14 percent the previous year. Retail banks in the UK had spent a great deal of effort and money making their IT systems secure, with firewalls and anti-virus programmes. In response, criminals had reverted to older forms of attack. The UK's Financial Services Authority warned of increasing evidence that criminals were placing staff inside banks. The survey found only 65 percent of banks trained employees to spot suspicious activities. Retail banks are also failing to keep control over the IT they outsource to suppliers. Almost 75 percent of the banks have outsourced at least one IT function, but 27 percent do not conduct regular assessments of compliance with security requirements.

## Over reliance on big IT vendors

The UK retail banks also need to take a more sophisticated approach to managing risks in their IT operations. Traditionally, most large retail banks have procured their technology and related services from large IT vendors, believing them the safest bet – but in today's business environment, that isn't necessarily true: just look at what happened to once mighty Digital Equipment, Sun Micro Systems and Compaq. Moreover, many large IT vendors – especially in the hardware sector – have become outsourcers, whose primary aim is to carve out technology and back-office functions from retail banks, lock them into long-term contracts, and subsequently make them pay over the odds when their business changes (see *How to select and create profitable relationships with IT suppliers?* by Pal). Many large retail banks have failed to recognise this new risk. Prudent CEOs need to steer their CIOs and supply chain organisations toward small and independent service providers, who are more likely to act in the true interests of their clients by helping them to deliver efficiency and operational excellence.

## Applying old formula to the new retail banking world

Most CEOs of retail banks are still relying on a set of formula that served them well in past. But, in today's intensely competitive retail banking industry, these formulae need to be revisited to return decent value to shareholders and good services to customers in equal measure. Specifically:-

- **Scale:** It is better to be deep and locally focused than big and shallow. Bigger is no longer better in the retail banking sector, and it is difficult to grow, and harder to manage. After a certain size, there are few economies of scale in retail banking.

- **Skills:** Instead of traditional economies of scale, it is the economies of skill that would make the difference. If, for example, one of the local branches can find a way to increase sales by 5 percent more than anybody else, then the retail bank can use that formula nationally.

- **Revenue growth:** The key to the bottom line is the top line. Don't just focus on cost and efficiency; focus on revenue growth and agility. If a branch or region is generating sufficient new revenue, then they must be doing something right with the customers.

- **Revenue enhancing merger and acquisitions:** Don't do traditional merger and acquisitions unless the revenue growth of the combined company will be faster than the sum of the two companies.

- **On cost-cutting merger and acquisitions:** What does a one-time saving of, say, £500 million do for a large UK retail bank? At best the share price may go up by 5 pence – but what's next? What about sustainability?

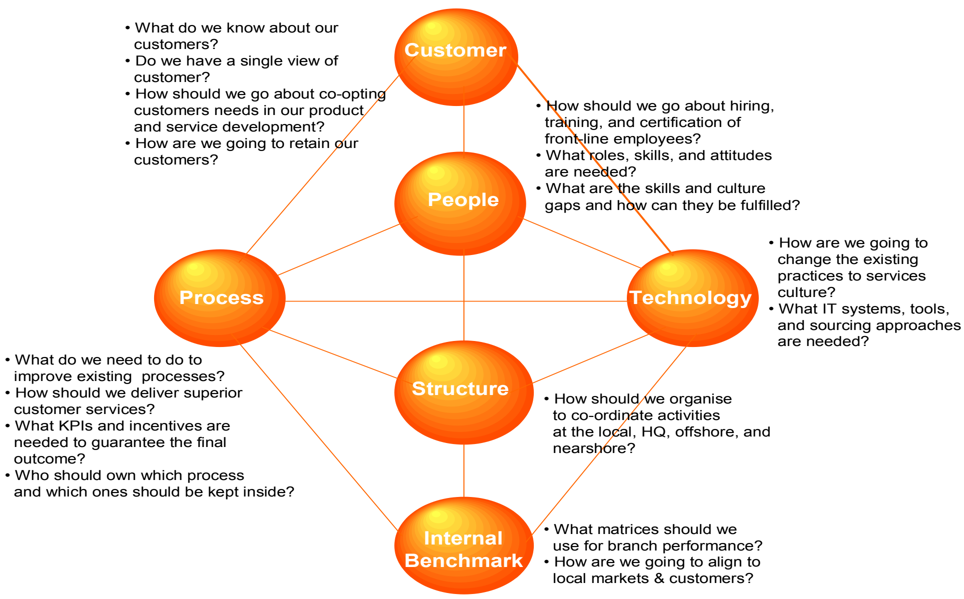


**Figure 2:** *A better operating model for the UK retail bank*

## Operating models for the 21st Century

Since the UK retail banks have similar products and capabilities, it will be the motivation and skills in execution that will make the difference. For the UK retail banks, there is only one proper measure of corporate success: remaining competitive and profitable over many years, through recession, technological change, and regulatory upheaval. Few retail banks achieve it. Those that do are alert to every change in their environment and know how to get the best out of their people. This does not mean employees never lose their jobs; sometimes it has to happen. But that means banks manage the move of non-core functions to lower-cost locations carefully, ensure customer service is not compromised, and maintain the morale of staff, who see their colleagues leave. A survey carried out in February 2005, found that while UK banks were making record profits, only 12 percent of customers thought their banks understood their needs [3]. That should tell us more about the UK retail banks' long-term prospects than any analyst's note.

By developing a better operating model for the 21st century, retail banks bring together the way customer, people; processes, technology, organisational structure and ownership interact to deliver performance based on highest skills that their competitors can only envy (see Figure 2).

The UK retail banks can capture significant benefits by rethinking all the components of the operating model, compared with laggard retail banks that focus on only one or two components, such as offshore outsourcing certain processes (without considering the need for superior interaction capability of customer facing employees), technology, and cosmetic process improvements.

## Interacting for competitive advantage

Although some retail banks in the UK have long tried to raise their productivity by automating production and some back-office functions, competitors can easily imitate such practices. But it may be harder to emulate efforts to boost the productivity of employees (such as employees behind the branch counters, call centre agents, branch managers, employees of supply-chain departments, etc) who mainly interact with customers, suppliers, and other employees - particularly now that so many of them undertake complex (or "tacit") interactions, such as managing supply chains, rather than routine ("transactional") ones.

Recent trend among the UK retail banks in offshoring business functions that involves tacit interactions with customers is unlikely to usher competitive advantage. Tacit interactions demand that employees make judgments based on experience and be comfortable with ambiguity, and call centre agents located in a country thousands of miles away with different cultural values are unlikely to be comfortable with the cultural ambiguity of the UK customers. Those who undertake these interactions command higher salaries and have a disproportionate impact on the bank. The UK retail banks that make these employees more effective and efficient stand to reap huge gains.

## Innovating services with real customers

Instead of product managers developing products based on pseudo market research and gut feel, banks can innovate new services using the real customers walking into their branches. Banks can turn their branches into laboratories where their research teams can conduct service experiments with actual customers during regular business hours, measures results precisely, and compares them with those of control branches, and identifies attractive innovations for broader rollout.  Successful bank innovation begins first by learning to look at things from the customer's point of view and then trying to solve a problem. Like many product companies, the UK retail banks have been better product engineers than marketers, better at engineering financial products than solving consumers' problems. It is, therefore, no surprise that most offerings of the UK retail banks are too complex for the average customer to understand.
If one looks at some consumer products, where there is a complexity dimension, such as a hi-fi system, typically the manufacturer will have a sales force to explain the different features and associated benefits. Today, the UK retail baking products are more like hi-fi systems — not easy to sell when so many similar products are on the market. But the UK retail banks have no sales forces to deal with customers. Nobody sells those products, and more importantly nobody really tries to educate customers. Even when a banking product can't be simplified, helping customers deal with the offering's complexity can create greater loyalty. Instead of having a better sales force, who can make a real difference to a bank's top-line, and superior after sales services, most of the UK banks embarked on cost reduction and offshoring initiatives that diminished the very capabilities required to make their offerings superior to competitors. However, despite their effort to reduce cost, the cost-to-income ratio of most of the UK retail banks remains between 45 to 65. What it means is that following fashionable practices, such as offshoring call centre or installing many ATMs and closing branch counters, have not produced the desired results so far.

## It is not the customer relationship software but customer experience that matters

Customer experience is the internal and subjective response customers express to any direct or indirect contact with a bank. Direct contact occurs in the course of visit to a branch for a service, by making a call to a call centre, opening an account, and is usually initiated by the customer. Indirect contacts involves receiving unsolicited information on a bank's products, services, or brands and takes the form of word-of-mouth recommendations or criticisms, advertising, news reports.

Most of the UK retail banks spent millions of pounds on CRM software, but may retail banking CEOs find their problem to be not a lack of customer information but a superfluity of it. Before investing more time and money on implementing CRM software, senior executives in many retail banks need to know how customer experience data are different and what their value is to a retail bank (see Figure 3). The difference is stark - CRM captures what a bank knows about a particular customer, whereas customer experience data captures what customers think about banks and relevance of offerings to their needs. The latter is far more important and drives the benefit that can be captured by the former. And, it is no surprise that product-centric retail banks rush to implement CRM software in the hope to increase their products sell – when they need to innovate products and services using the customer experience first. It is the "cart before the horse" mentality that typifies the current approach to the UK retail banking and widespread customer dissatisfaction with banks.

Although banks know a lot about customers' purchasing patterns, incomes, and other characteristics used to classify them, banks know little about the thoughts, emotions, and states of mind that customers' interactions with products, services, and brands induce. Without banks knowing and acting on these customer experiences and the role every function plays in shaping them, relevant offerings and customer satisfaction is more a marketing slogan than an attainable objective.

## Taking a better approach in technology adoption

Chief Information Officers (CIOs) in retail banks face demands for flexibility, resilience and value for money in a fiercely competitive and ever more heavily-regulated environment. The CIOs agenda is more demanding today than it has ever been. The churn in the CIO community reflects what a demanding job it has become. Banks were among the first organisations to invest heavily in IT. But a consequence of this early start is that many retail banks

**Customer Experience is to innovate products and services and Customer Relationship Management (CRM) is to sell more products, and they differ in their subject matter, timing, monitoring and purpose. One leads and the other follows.**

| | What? | When? | How Monitored ? | Who Uses? | Relevant to Whom? |
|---|---|---|---|---|---|
| Customer Experience To Innovate | Captures and distributes what a customer thinks about a bank | At points of customer interaction: "touch points" | Surveys, targeted studies, observational studies in the branch using it as a laboratory, "voice of customer" research | CEOs and CXOs to create offerings that matches customers expectations and experience | Proactive retail bankers who innovate offerings in the gap between customers expectations and experience |
| Customer Relationship To Manage | Captures and distributes what a bank knows about a customer | After there is a record of a customer interaction | Point-of sales data, market research, product managers "gut feel", website click | Customer facing groups, such as product marketing, customer services, call centre agents for efficient execution | Reactive retail bankers who push cross-selling of products not in demand bundling with ones that are |

Source: Sirius & Co Analysis and Christopher Meyer et al [5]

**Figure 3:** *Innovating products and services that customers want is in the core of retail banking*

are burdened with inefficient monolithic systems written in old computer languages such as COBOL and RPG that are costly to maintain and modify.

It typically takes a large retail bank between 12 and 15 months to bring a new product to market because of problems with the underlying technology. One UK retail bank was, in fact, forced to abandon plans to develop common account opening procedures for current accounts and savings products when it found 56 interfaces where the new system would have to link to its legacy systems. These interfaces, in turn, connected to other systems presenting the bank with an unacceptable risk of a big systems crash during implementation. While the system complexity (a function of duplicate applications, multiple customer databases, redundant and old infrastructure, poorly defined business processes) remains a major problem in many retail banks, they lack a central co-ordinating mechanism. It is not uncommon to find each business unit with duplicate business process, application, along with duplicate technology infrastructure.

Smart retail banks are well aware of the need to simplify their business models and corresponding operating models. Our work with clients over the last five years sheds further light on how the UK retail bank can adopt a better approach to technology to bring agility and accelerate business growth. Increasingly smart CIOs of retail banks are self-funding their IT investments using a layer of abstraction to legacy system deploying a technology platform that simplifies aggregation of data, servers, applications and processes. These CIOs find they are able to use the layer of abstraction to extend the life of legacy systems by bundling applications into services and simplifying the expensive integration with other systems. The new business process driven architectural simplification not only accelerates the IT system's ability to incorporate new changes, it can also do so while increasing system resilience and lowering costs.

The savings from technology simplification can be substantial. Our experience of working in this area suggests that maintenance costs can be reduced by 50 percent or more. New products can be launched in weeks rather than taking 12 to 15 months. Despite these benefits, many retail banks in the UK outsource their IT functions to large IT suppliers believing they will simplify their IT. But, the primary motive of large scale IT suppliers is not the technology simplification of banks but to carve out technology and back-office functions from banks. In adopting this practice, many banks loose control and flexibility and increase both the capital and operational expenditures.

Successful retail banks need to select IT suppliers who can respond to sudden changes in markets – and the monolithic size and scale of large IT suppliers and their outdated practices are often prohibitive to achieve this objective (see *How to select suppliers to mitigate risks?* by Pal and Evans). Agility is critical because in retail banking both demand and supply fluctuates rapidly. Large IT suppliers try to hide their lack of agility by playing up on their size, but independent and agile IT suppliers respond both quickly and cost-effectively. Smart retail banks also select IT suppliers who are capable of adapting to changes in their strategies. Long term outsourcing contracts and software lock-in by large IT suppliers are a hindrance to retail banks' achieving their operating objectives. Retail banks in the 21st century align their interests with that of the IT suppliers, but this is not easy as it involves change in sourcing practices and cultures in many of the UK retail banks.

## CIOs role in the 21st Century retail banking

Complexity in the UK retail banking is driven by misalignment between business needs and IT objectives. For example, in a retail bank, poorly planned product architecture drives fragmentation, complexity and high cost in the IT systems required to support the operating model. Management must understand that complexity is the result of both business drivers and IT drivers.

Most successful retail banks look for IT suppliers who understand their specific technology environment, offer ongoing independent advice, help them manage aggressive software upgrade cycles, and provide solutions for their most pressing business problems. To understand the failure of tradition list of "preferred IT suppliers" approach, which is cherished by so many retail banks, consider its underlying assumption: that retail banking executives can place big bets about their markets, future technologies, and suppliers' capabilities and motives with great deal of certainty. The truth is that they simply cannot. Today's retail banking is complex, unpredictable, and too turbulent. In spite of this, we have seen time and again senior executives sign five to ten year outsourcing contracts without considering that they often cannot predict, with confidence, how business conditions and regulatory requirements will change even in two years – let alone what technologies will be available then. They turn to external sourcing to gain access to the latest technology and low-cost labour with service level agreements (SLAs) without taking into account how an external service provider's motive to maximise its profits will impact the outcome.

Today, many retail banks in the UK prefer traditional sourcing models compared to the subscription-based pricing models. This is because retail banks are encouraged to institutionalise "best practices", freeze them into place, focus on execution, stick to their knitting, increase predictability and get processes under control. These approaches establish stability as the key to performance. As a result, the UK retail banks are built to support stable strategies and monolithic structures, not to change. Unfortunately, customers do change. They want new and different services and products, and they want to be able to get hold of them fast in new and different ways. So, sourcing methods have to change.

In the 21st century, smart retail banking CIOs primary objective should be to maximise flexibility, choice, and control so that they can pursue different options as they learn more or as their business circumstance changes(see *Sourcing versus Subscription* by Pal). And a subscription based sourcing method precisely does that - it helps to maximise competition, because a retail bank can see and compare the service bundle and its price offered by one provider with another provider, just like a customer can compare an item on a restaurant menu between two restaurants. For this reason, senior executives should not make a one-off decision whether to insource or outsource. Instead, they should create an environment in which potential suppliers – both external companies as well as internal departments, such as IT – are consistently competing to provide IT or business services on subscription based methods making services and associated charges completely transparent.

## What does all this mean?

The 20th century retail banking was shaped by developments of products. But the landscape of the UK retail banking has changed dramatically over the last decade. Increased competition from non-banking companies advances in IT and declining processing costs, the erosion of products, and less restrictive regulations have all played a role.  If the 20th century was defined by developments of retail banking products, the 21st century will be defined by developments of customer services. If the UK is to maintain its leadership in retail banking in the 21st century, important steps must be taken.

To fulfil the promise of retail banking opportunities, CEOs need to rebuild the trust, which was once at the core of banking success, by unashamedly reinventing their banks from shareholder-centric to customer-centric (see *Banks: Are they for shareholders or accountholders?* by Pal). This is because, loyal and profitable customers are invaluable to serve the interest of shareholders and not the other way round. They will need to drive their banks to innovate products and services that serve customers true needs. It is essential for the CEOs to recognise that poor practices that only benefit banks at the expense of customers inconvenience and irritations are not going to help reduce the cost-to-income ratio.

There are important and legitimate reasons for retail banking products to be aggregated into service bundles or packages. The logic comes from economics. Cost sharing in the production or delivery process can make providing a service bundle more efficient than providing individual products. For example, when a customer adopts internet banking, banks could use this electronic link to their customers to introduce new service bundles at lower cost.

The most crucial task for CEOs of the UK retail banks will be to establish a business and IT partnership to bring the IT organisation more closely in line with the rest of their organisations. From our research, we found that retail banks with better IT governance integrated with corporate governance have more than 25 percent higher profits than companies with poor governance given the same strategic objectives (see *Linking CEOs Corporate Governance agenda to CIOs agenda* by Pal). These top performing retail banks have custom designed IT governance for their strategies. Just as corporate governance aims to ensure quality decisions about all corporate assets, IT governance links IT decisions with company objectives and monitors performance and accountability. If IT projects are to be completed on time and within budget, and to have a real impact, the organisational structure and reporting relationships of the IT function will have to change within a retail banking organisation.

IT is in the core of the retail banking business and there is no escape from this fact. The better retail banks adopt and use IT, the better customers can do their banking. The smart retail banks, who harness the operating strategy with IT strategy properly, will be the banks that win (see Figure 4).

Many retail banks in the UK are yet to find a way to combine growth fueled by superior customer service with prudent cost controls. A better operating model, as described earlier, is designed precisely to achieve that objective. Smart CEOs recognise that complex banking products with "estate agent" style marketing do not bring prizes. Instead, services that retain customers' loyalty allow banks to win the heart, mind and majority-share of customers' wallets. Management of cost is a pre-requisite in any business, and retail banking is no exception. But, draconian cost

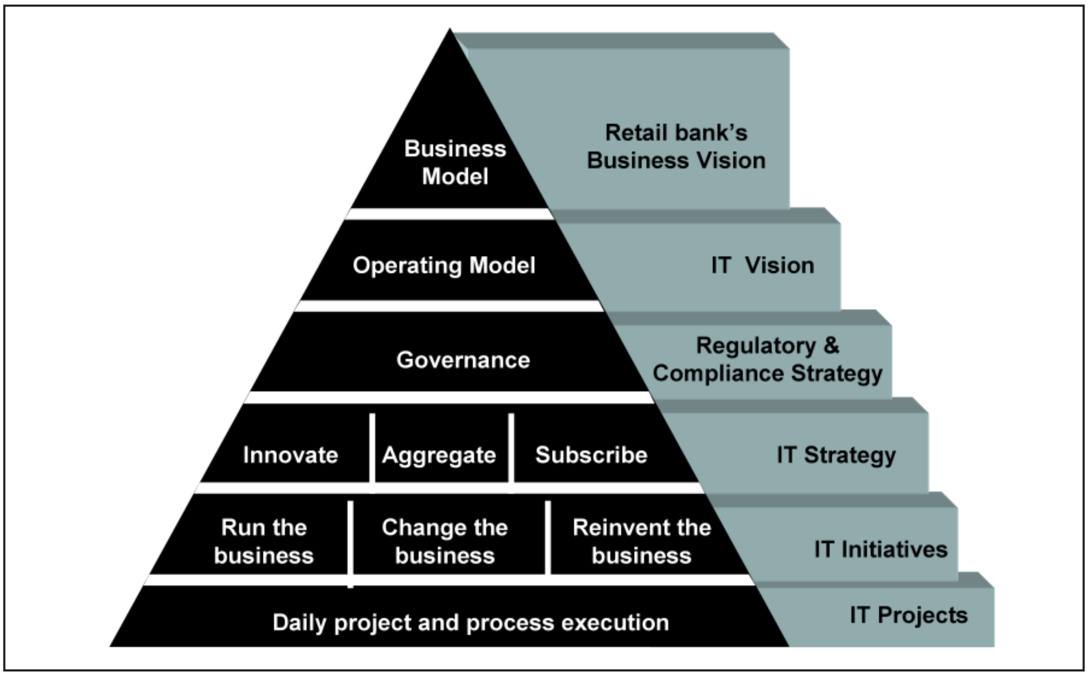


**Figure 4:** *Performance improves when IT strategy is properly harnessed with the operating strategy*

management at the expense of customer inconvenience is unlikely to improve either the efficiency or the performance. CEOs need to re-introduce the traditional banking value in their organisation - that it is a privilege to serve customers. Successful bankers are not bean counters – CEOs with foresight know that when customers are served well, the cost-to-income ratio improves.

For the UK retail banks the immediate opportunity lies in enhancing revenue and improving productivity. That means extracting every customer touch point more effectively and efficiently than the competition to capture a greater share of customer revenues. Taking advantage of this opportunity will require tough cultural changes and technology enhancements, such as implementing a layer of abstraction to legacy system by deploying a technology platform that simplifies aggregation of data, servers, applications, and processes. The good news is that banks that are willing to act now will put some distance between themselves and the competition.

In today's customer driven world of retail banking, value flows horizontally through a bank in the form of service chains, linking service bundles, pulled through by the customer. This is the reverse of banks trying to "make-and-sell" products by way of integration via vertically organised departmental functions or silos. The choice for the UK retail banks is simple: either a bank continues to flog products in the canny way and gradually experience loss of market-share, or become a customer-centric service oriented organisation that dominates its chosen markets, and keeps the competitions locked-out. The winners of the 21st century retail banking will be those who best bundle services to meet customers' real needs, not those who cling to the old way of manufacturing products and unfair institutional practices.

**NOTES**

1. "Surge in complaints over banks by public", Jane Croft, The Financial Times, May 1 2006.
2. "Banks make £1.5bn from rate rip-off", Clare Francis and Kathryn Cooper, The Sunday Times, January 21, 2007.
3. A survey for Proudfoot Consulting on the UK Retail Banks, *February 2005.*
4. The survey by Deloitte of the world's top 100 financial institutions, June 205.
5. "Understanding Customer Experience", Christopher Meyer and Andre Schwager, Harvard Business Review, February 2007.

About the author

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