

Opportunities for Action in Financial Services

## Banking's Changing Dynamics

THE BOSTON CONSULTING GROUP



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The banking industry, like many others, is changing fundamentally. Interest rates in some regions of the world are approaching 40-year lows, equity markets are far more unpredictable than in the bubble years of the 1990s, and the aging baby-boom generation is increasingly looking to accumulate secure assets.

Against the backdrop of these developments, three major dynamics pose formidable new challenges for financial institutions. Organizations that hope to control their own destiny in the years ahead must come to grips with these dynamics and devise the best ways to manage and profit from them—before their competitors do.

### **Dynamic 1: The Industry's Scarcest Resource Has Become Satisfied Customers**

The current climate of lower growth and higher uncertainty has put banking revenues and margins under greater pressure. Consumers have become more demanding and more financially sophisticated. Finding themselves in a buyer's market, they not only are more vocal in expressing dissatisfaction with their financial relationships but also feel empowered by favorable regulatory developments. Moreover, they are increasingly willing to switch institutions if they feel neglected, and they will keep switching until they are fully satisfied that their banking and financial-planning needs are being properly looked after.

Holding on to these customers is an increasingly critical driver of revenue and profit for financial institu-

tions—and losing them to competitors is becoming more and more costly. One European mortgage provider recently found, for example, that adding one year to the life of an average mortgage was worth an extra €450 in net present value. A life insurance company calculated that every percentage-point reduction in the lapse rate of a ten-year savings bond would increase the value of the total product book by 2 percent. It is becoming clear that strategies based on customer acquisition—which have been highly useful during a period when low interest rates encouraged people to borrow—must now take greater account of retention. Indeed, customers, many of whose levels of debt have risen sharply, are confident enough to move to other institutions that hold out the promise of better service.

In parallel, a major demographic shift is occurring, particularly in industrialized countries. Members of the baby-boom generation are approaching the end of their working life, and, because the fundamental social contract between government and citizens is changing in many countries, they are being required to finance an increasing portion of their retirement. This creates greater complexity because more of their income is now going into pension plans and investments than into traditional savings products.

These customers will be more difficult to retain than ever before. They need reliable advice and navigation through the wide and often confusing array of financial products, especially at a time when they are revising their expectations of long-term returns. Financial institutions therefore face an imperative to develop innovative products that address the needs of the expanding late-middle-aged group—along with the means to deliver and service those offerings. More-

over, the propensity of many financial customers to hold a variety of assets at the same time gives banks a growing opportunity to offer personal administration services, such as those they provide with some wrap accounts.

## **Dynamic 2: Value Creation Is Switching from “Stocks” to “Flows”**

As increasingly demanding and sophisticated consumers seek out better deals, they tend to hold products for shorter periods of time than they used to. Our research shows, for example, that banks in some regions must now sell three to four times as many mortgages in order to attain an annual profit similar to that of 15 years ago. In the United States, mortgage origination tripled in the five years between 1997 and 2002, owing largely to a refinancing surge driven by historically low borrowing rates. But revenues and profits from these flows have, in many cases, accrued to specialist providers and players in mortgage-backed securities markets, not to banks. When they have flowed to banks, the return on invested capital has been much lower.

Many regions have also witnessed significant growth in other forms of consumer credit, such as credit card debt, auto loans, and sales financing. Some markets have seen credit card spending triple since 1995. On the consumer-asset side, the upheaval in financial markets has driven large-scale flows out of mutual funds toward deposits. Even within the context of traditional, interest-bearing offerings, the change has been the rapidity and regularity with which funds move in and out of different types of products, and the volume of funds involved.

The implication for banks is that the playing field is tilting from one based on accumulating *stocks*, or assets that provide revenue (usually interest income) over a period of time, to one based on generating *flows*, or transactions that earn charges and fees at specific points in time. The economics in each case are very different. Institutions that take advantage of this trend can reduce their dependence on interest income during the current low-rate environment and may be rewarded by the market for earning high-value, fee-based annuity income.

Indeed, from a capital perspective, the operative trend is now one of “capital in motion.” Loans and mortgages are put together with the efficiency of an assembly line, each unit moving forward on a pre-defined path. Securitization has enabled banks to tie up less capital in these products and has encouraged credit-oriented institutions to focus on growth through improving origination. Moreover, in an environment based on flows, the nature of the capital that banks provide fundamentally changes. The emphasis, reinforced by Basel II, is on providing capital against operational risk, not just against credit risk, as with stocks of consumer debt.

Fees, of course, are harder to capture than interest income since they are subject to greater transparency and scrutiny by both consumers and regulators. Although banks in Australia have succeeded in introducing fees for transaction products (as have some U.S. banks with their “free checking” offers), the shift is more challenging in markets where personal banking has long been perceived as free. In an environment based on flows, banks also need IT systems that can efficiently handle a heavier level of traffic in accounts.

### **Dynamic 3: Value Is Moving from the “Back End” to the “Front End” of the Bank**

As more institutions sell not only proprietary offerings but also those manufactured by others, the architecture of the financial services industry is becoming increasingly open in areas such as savings and investments, life insurance, general insurance, mortgages, and even credit cards. For these products, which represent a significant proportion of the retail-banking range, value and emphasis are shifting toward the activities that are closest to the customer: sales and distribution.

This trend represents a fundamental shift in the traditional banking paradigm. What was once a bilateral relationship between customer and banker—who traditionally was both manufacturer and distributor—is giving way to tripartite arrangements among customers, manufacturers, and other players such as independent financial advisers (IFAs). This evolution will favor those providers that develop their distribution “front ends” to the fullest and that create a unique proposition in the minds of customers. This is a tough challenge because banks are competing not only against one another but also against IFAs and specialist brokers whose primary activity is distribution. Multilateral relationships are also expanding to broader customer segments and often include separate IT platform providers.

In addition, banks need to find ways to cut back-office costs as most of the value moves to the front end. In concentrated markets, we are witnessing a rise in new businesses and joint ventures aimed at sharing activities such as external sourcing, operations, and transaction processing. Such ventures can help institutions

gain scale as well as strip out costs in areas from which value is migrating.<sup>1</sup>

Just as significant, banks are being forced to share more revenue with third-party distributors. This development heralds the need for many institutions to determine whether they should continue to focus on both manufacturing and distribution—or perhaps on distribution only. The greatest source of advantage for most banks is their customer franchise, and they will need to find ways to deepen share of wallet, retain customers, and provide levels of service commensurate with the value that each customer brings.

## Seizing the Challenge

These dynamics—which are most pronounced in the United States, the United Kingdom, and Australia—pose great challenges for banks but great opportunities as well. Institutions that truly understand them and that respond vigorously will be best positioned to benefit. The banks that succeed will be those that focus on understanding their customers' needs (in order to enhance retention), develop smart products, formulate and execute an effective distribution strategy, and manage capital and costs well.

Some institutions have already adopted decisive measures to take advantage of the new landscape. In the United States, Commerce Bank is creating a more rewarding customer experience that has enabled it to rapidly take market share from entrenched banks.

1. For a thorough discussion of this and related issues, see “Banking à la Nike and Dell: Achieving Scale Without Acquisition Premiums,” BCG Opportunities for Action, May 2003.

Commerce has embraced a more “retail” approach in its branches, offering cheerful service and business hours oriented to customer convenience rather than expedience for the bank and its employees. It has also adopted efficiency measures to reduce waiting time, such as decreasing the number of teller keystrokes necessary to process transactions. Commerce believes that consumers will accept lower interest rates on deposits than might be available at other banks in exchange for qualities that are truly rare: consistent, reliable service and trustworthy advice. The bank’s success appears to be bearing out this philosophy.

Other organizations are taking advantage of today’s shorter product lives and the overall stocks-to-flows trend by developing revenue structures that capitalize on product churn and on the propensity of many consumers to take on certain kinds of debt. MBNA Corporation, which specializes in lending through credit cards, has been successful in targeting high-value consumers whose revolving-credit accounts maintain high average balances. MBNA has also enhanced its distribution capability by picking up on a growing trend: the desire of many consumers to have group identification on their cards, such as the logo of a sports team or university. The company has grown into the industry leader in so-called affinity marketing, or selling to groups with common interests. Outsourcing deals with large banks have further broadened MBNA’s access to consumers.

## **Showing the Way**

Competition in the financial services industry will only continue to intensify, consumers will become even more sophisticated, and products will have

shorter and shorter lives. As these dynamics take further hold, the most prescient, nimble institutions will likely triumph, while the slower, less thoughtful players will be left behind.

If your bank is trying to gain a more solid footing on the shifting financial-services landscape, we urge you to consider the following questions:

- Would your customers say the service you provide is a primary reason they continue to bank with you? Do you track how many accounts are lost to competitors each year and explore the reasons why? Do your loyalty programs and pricing structures encourage retention?
- Is your product-development process segment specific? Does it currently consider the needs of the baby-boom generation?
- Can you identify product areas and customer segments in which you could most effectively move toward fee generation? Does your management team understand the economic implications for your business of the general industry shift toward fees and, more broadly, of the transfer of value from the back end to the front end of the bank?
- In your role as distributor, do your customers see you as a trusted adviser who can help them navigate the confusing world of financial products? And are you doing all you can to ensure that customers make their choices through your channels, not those of your competitors?
- Is your IT system vigorous enough to master the “flows” environment?

- Can you identify areas of your business in which it is no longer economical to manufacture, and where you might source alternative products to generate the greatest value?

The answers to such questions won't provide a full set of solutions, but they *will* establish a useful starting point from which your bank can begin to chart the unfamiliar territory ahead. Truly understanding—and acting quickly upon—the changing dynamics of banking can help you do more than just keep pace with competitors. It can help you show them the way.

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