Challenges for Retail Banks

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Global Economy Outlook

According to the Conference Board's latest update on its Global Economic Outlook 2013[1] released last month, the global economy has yet to shake off the fallout from the 2008-2009 financial crisis after more than four years. For advanced economies comprising the US, Europe, Japan, Canada, Australia, South Korea, etc; the Outlook predicted 1.2% growth this year compared to 1.1% in 2012. The slight increase of 0.1% was attributed largely to Europe which is expected to return to very slow growth of 0.3% after the negative 0.2% contraction last year.

Other industry watchers are however not so optimistic. According to the Economist[2], while financial conditions have improved over the past nine months, Germany, the biggest economy in the euro area saw its GDP rose by just 0.1%. Forecasts from the European Commission in early May 2013 showed annual euro-zone GDP shrinking by 0.4% in 2013.

China, long held as the pillar of growth for the global economy has seen economists cutting back on their growth projections for the country after 4 months of disappointing data. A new survey by the Wall Street Journal[3] last month of 12 economists showed that the median forecast has fallen to 7.8% down from 8% forecasted in late 2012.

With these dismaying projections, what is the impact on the banking sector, in particularly retail banking?

Humps Ahead

For the banking industry, the financial crisis in 2008-2009 has spurred the creation of the most comprehensive sets of new regulations governing US financial institutions in the last 70 years. The slowing down of the global economy in advanced and emerging countries, market uncertainties, cost pressures, added regulatory compliances, increased capital requirements, squeezed margins and greater demands for consumer protection have become the backdrop that the retail banks have to operate within.

Against this global backdrop, retail banks are continually facing the need to improve productivity to drive cost efficiency while delivering more product choices and options for their customers. As product features become more complex, cost of implementation and maintenance escalate. All these while innovation in technologies such as rapid growth and adoption of the mobile devices and usage of social media has led to customers demanding different ways to interact with their banks (See the previous article; "Branchless Banking[4]" by this author).

According to Denise Montgomery, Research Director of Financial Services Technology at Ovum[5]; "… the mobile revolution will shape the innovation agenda in banks throughout 2013. Banks across the board view innovation in the mobile banking and payments space as a critical differentiator. Large and small banks are examining innovation initiatives and searching for best-practice lessons."

So what is the winning formula for retail banks to surmount these challenges?

People, Processes and Technologies

There are abundance of articles and researches on what is the most important component: People, Processes or Technology? While the debate continues; the majority seems to agree that People are the major driving force behind the Processes being implemented and operator of the Technologies deployed. Besides these three key pillars that form the foundation for successful companies; Product is the deliverable: the output of these core competencies that bring in the revenue for the organisations. However, if products are not designed to meet customers' needs or are complex and difficult to support; investment and operational costs will spiral wiping out the intended benefits that they are supposed to bring.

In this uncertain global environment, retail banks are at the cross roads of prioritizing what to invest so that over or under investing in one of these core building blocks will not be detrimental to their organisation growth or dampened its competitive advantage. For instance, if banks over-invest in one area (which normally is in technology) but neglect in training or hiring the right people to use the new tools, aligning the processes and put in place a governance framework, the outcome would not only be undesirable but lead to a possible drop in productivity too. On the other hand if banks want to invest in all three areas, it often end up not being good enough in any one of them unless the banks have the budgets approved at the highest level, unyielding management support, strong leaders, staff co-operation, the right strategy and implementation capabilities to deliver them.

In reality, banks like any organisations will not get all its desired budgets approved and there is always the need for trade-off. Where, when and how much to invest in the three areas then become an important strategic decision.

Based on the global backdrop that was outlined earlier, there is a pressing need to ensure compliance to regulatory requirements; e.g. the Basel Committee's recent guidance on data aggregation and reporting will require banks to fundamentally upgrade their capabilities in this area by early 2016 with supervisory assessments of compliance beginning in 2013. With the US government financial and political pressures on overseas banks to curb tax evasion of US citizens, the 1934 Swiss Bank Secrecy Law was repealed in mid-2012 and more banks and countries have since then agreed to co-operate with the US government to report tax evasion by citizens from the latter country.

Secondly, Montgomery's view earlier on why retail banks need to innovate in the mobile banking and payment areas means putting more stress on banks' existing technological platform. Thirdly, as customers become more demanding and competition put pressures on flexibility in product features coupled with the need to offer an integrated multi-channel service experience; front-to-back end technology changes become inevitable.

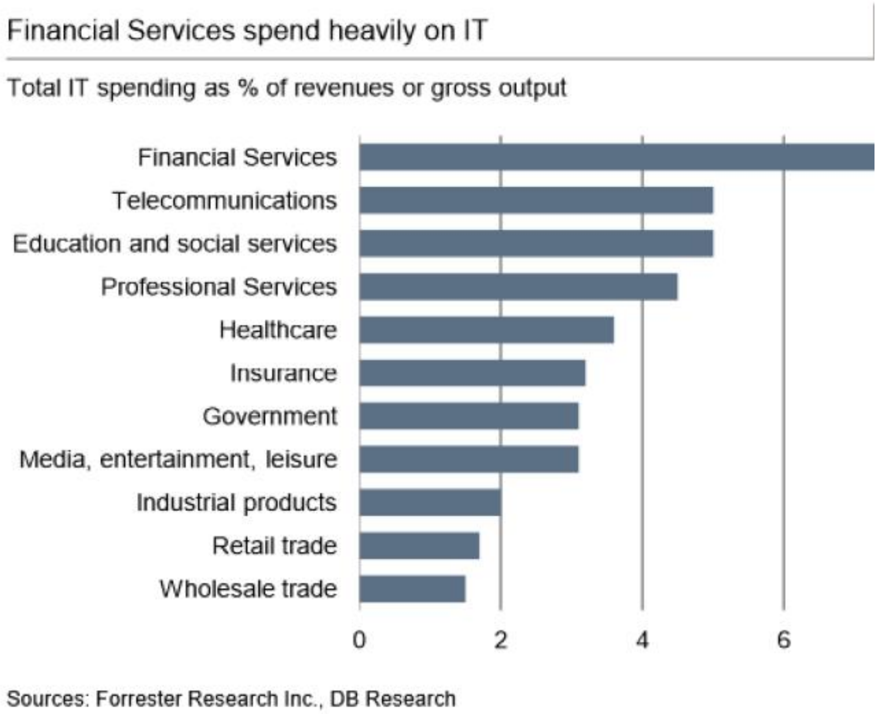
Supporting Investment in Technology

However given the uncertainties in the global market and the projected slow growth in most regional economies, CTOs and CIOs of the retail banks will face uphill challenges to secure buy-ins from stakeholders to approve sizeable investment in the technology for their banks during this period. The reason for "sizeable" investment is motivated by the experience of most industry practitioners that any form of incremental changes or piecemeal investments is not going to yield significant improvements that are needed.

So how do CTOs and CIOs support their IT investment plan?

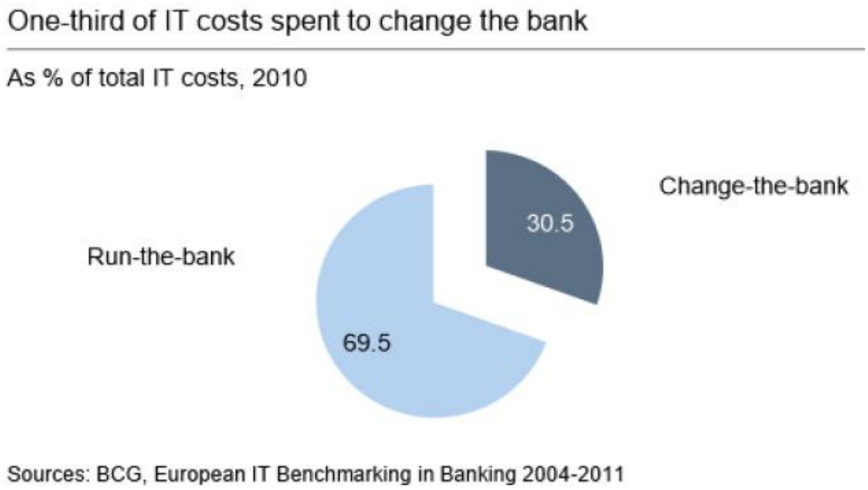
According to a survey done by Forrester Research Inc. and DB Research (Figure 1), banks spent more on IT than other industries do. For instance, banks' IT expenses (survey covering US, Europe and Asia) is about 7.3% of their revenue. On the other hand, IT costs for all other sectors are only about 3.7% of their revenue. In a separate study by McKinsey, it noted that banks' IT costs ranged from 4.7% to 9.4% of their operating income. The higher cost to operating income ratio is driven by several factors including the need to fulfill exacting regulatory requirements that do not contribute to the banks' bottom line and that banks have to rely on IT to support their back offices as well as their brick-and-mortar and electronic-based channels.

Figure 1



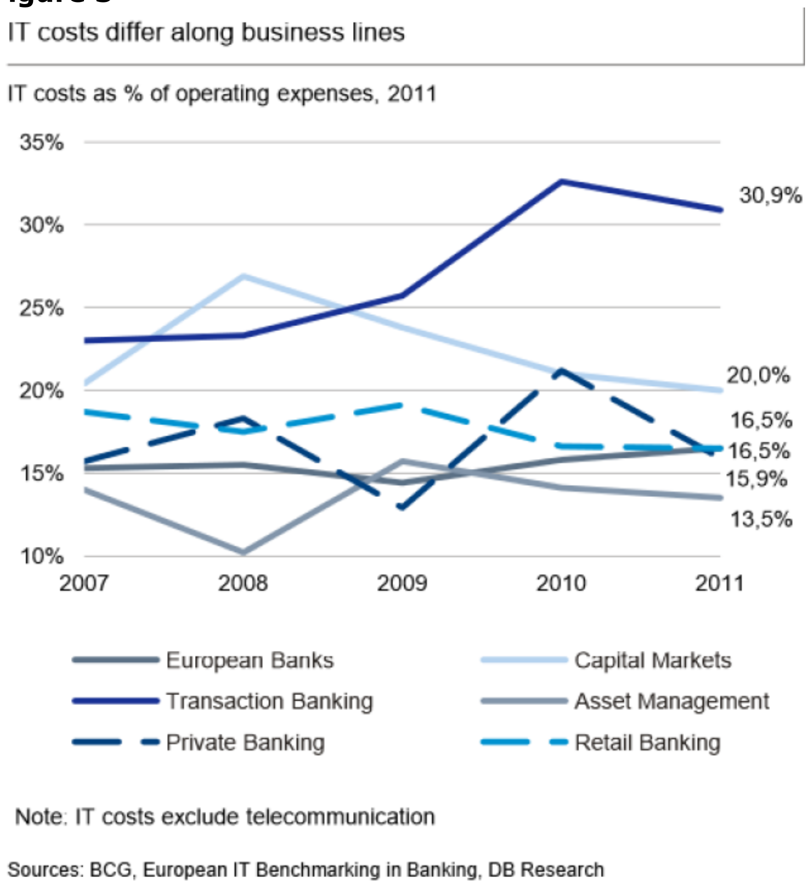
In a study by Boston Consulting Group (Figure 2) of European banks, it noted that nearly one-third of banks' IT budgets were in the "Change-the-bank" projects (typically referred to by industry players as "transformation" projects) with remaining 70% IT expenses allocated to the "Run-the-bank" costs ("keeping the lights on").

Figure 2



The BCG study (Figure 3) also noted that IT costs are influenced by the banks' different business lines. For instance, IT costs for retail banking in European banks account for 16.5% of operating expenses while a lower 15.9% in private banking.

Figure 3



Moving away from European banks, a research paper[6] published in Feb 2013 attempted to show the co-relationship between technology investments in five electronic services namely: POS, ATM, PIN Pad terminals, Online and SWIFT branches and three key banking performance indicators: Return on Assets (ROA), Return on Equities (ROE) and Operating Investment Return (OIR), Based on the study of 19 private and government banks in Iran from 2005 to 2010 using linear regression analysis and Value at Risk (VAR) techniques, the results showed that there were some weak and positive relationships between POS, PIN Pad and online businesses with ROA and ROE but relatively strong and positive relationship between these three independent variables and OIR. Though this study is somewhat limited in scope and coverage, it is an attempt to show scientifically the benefits of investment in electronic based services in banks.

With these references and equipped with detailed business cases developed internally, CIOs and CTOs of retail banks would be better prepared to put forth their recommendations to invest in technology in a meaningful manner to position their banks in this challenging market place.

Notes:

[1] Global Economic Outlook 2013, May 2013 Update, the Conference Board: http://www.conference-board.org/data/globaloutlook.cfm

[2] Taking Europe's Pulse, the Economist, 15 May 2013: http://www.economist.com/blogs/graphicdetail/2013/05/european-economy-guide

[3] Economists Trim China Growth Forecasts, the Wall Street Journal, 14 May 2013: http://online.wsj.com/article/SB10001424127887324031404578482373897417986.html

[4] Branchless Banking, 3 May 2013: http://www.innovar.com.sg/more.htm#Branchless_Banking

[5] Innovation and transformation will be the main drivers in retail banking technology in 2013, 22 Nov 2013, Ovum: http://ovum.com/press_releases/ovum-says-that-innovation-and-transformation-will-be-the-main-drivers-in-retail-banking-technology-in-2013/

[6] A study on relationship between IT facilities and performance of banking industry; Growing Science: http://growingscience.com/beta/msl/669-a-study-on-relationship-between-information-technology-facilities-and-performance-of-banking-industry.html

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