The future of retail banking; Relationship banking

Budućnost bankarskih poslova sa stanovništvom i odnosa sa klijentima

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The financial crisis and ensuing recession, coupled with regulatory changes related to fee income, have exerted enormous pressure on retail banks to develop profitable growth engines. Instead of relying on mergers, expansion and underwriting, banks must now derive greater value from existing customers. There are three primary ways this will happen: by driving product sales and fee income through up-selling and cross-selling; increasing retention of high-value customers; and mitigating losses with specific risk strategies based on the entire customer relationship. In short, banks must successfully take on the relationship banking challenge.

Keywords: Relationship banking, changes in banks, future of banking

Introduction

While most of the debate about the crisis has dealt with the banking industry as a whole and the stabilisation policies introduced by governments, especially central banks, this volume draws attention to the microeconomic specifics of banking. Ironically, the massive bailouts, subsidies and guarantees provided by national governments put competition policy at risk, just before it really started to become effective. With regard to consumer protection as a prerequisite for effective competition in financial retail markets, research is still evolving. This research is increasingly taking into account the psychological foundations of consumer decision-making – a promising perspective for better policy formulation in the future. In this area, policy-makers have just started to take policy advice (based on microeconomic analysis) more consistently into account. Just before the crisis, competition policy had received a lot of attention among policy-makers at conferences.
organised by various international institutions and in inquiries carried out by competition authorities into practices in the banking sector. With the financial turmoil, a more sceptical view about the alleged trade-off between competition and stability regained grounds. Moreover, virtually all empirical research suffers from the fact that it works with time periods in which a financial downturn like the current one was not an issue. To the contrary, financial markets were healthy and growing so that the critical impact of competition policy within a period of financial instability and thereafter is completely absent in the data.

This paper is organized as following. The following section reviews the theoretical foundations and develops the research model. Then we will describe an exploratory survey study, report and discuss the data analysis results. Implications to future research and practice are provided too. We conclude the paper by briefly present the contributions and limitations.

Rediscovering Relationship Banking

In short, banks must successfully take on the relationship banking challenge. Perhaps the biggest indicator of the shortfall is that the average cross-sell metric for the banks in our research stands at a relatively low 4.6 product categories per household (Broecker, 2008), against a theoretical maximum of 13 (Exhibit 1). Furthermore, more than 70 percent of the cross-sell total occurs at account opening, implying that the lifetime value of a consumer often remains untapped (Exhibit 2). Our work suggests that banks have been slow to adopt a relationship approach because of their causal nature. Most banks serve their customers through product-focused channels, oriented only to whether the customer needs a specific product. These efforts generally meet with limited success in generating either sales or greater customer satisfaction. Similarly, efforts to serve customers across product lines are often hampered by an inability to view the entire customer relationship. Banks must address the full range of customer needs across all financial products at all touch points. Only in this way will they reap the rewards of increased cross-selling, enhanced risk decision-making and customer retention.

The financial crisis and ensuing recession, coupled with regulatory changes related to fee income, have exerted enormous pressure on retail banks to develop profitable growth engines (Beck et al., 2004). Instead of relying on mergers, expansion and underwriting, banks must now derive greater value from existing customers. There are three primary ways this will happen: by driving product sales and fee income through up-selling and cross-selling; increasing retention of high-value customers; and mitigating losses with specific risk strategies based on the entire customer relationship. In short, banks must successfully take on the relationship banking challenge. Such success has been elusive. Perhaps the biggest indicator of the shortfall is that the average cross-sell metric for the banks in our research stands at a relatively low 4.6 product categories per household, against a theoretical maximum of 13 (Exhibit 1). Furthermore, more than 70 percent of the cross-sell total occurs at account opening, implying that the lifetime value of a consumer often remains untapped. In addition, only a few U.S. banks have taken initial steps toward developing a full customer relationship view – let alone incorporated it into their sales, service and risk strategies (Carletti et al., 2007).

Challenges

Five obstacles have accounted for the lackluster results in banking cross-sell performance to date:

- **Cross-selling.** Sales forces generally do not have the ability or incentive to offer a broad range of products. For example, few banks’ mortgage channels offer customers a checking account, even during refinancing, although the eventual value from a checking account can far exceed the value from the refinancing. This is due either to a lack of enablement (e.g., awareness, training or tools) or incentives.
- **The operational challenge.** Operationally integrating a single cross-sell campaign is difficult. U.S. banks have historically grown through acquisitions. Business units cobbled together often share different systems, operational platforms and processes. The result is that few banks can truly offer the full product suite at account opening, where, as previously mentioned, 70 percent of cross-selling occurs. Similarly, few banks can view a customer’s full range of products and total household profitability when making subsequent sales or servicing decisions.
- **Causal support functions.** Support functions such as risk, marketing or data support align to business units. This structure works well when banks need to make product decisions in silos. However, as customers aggregate their relationships, the arrangement no longer serves the bank well. For example, many banks cannot assess a customer’s real holistic risk profile or see sales opportunities based on gaps in what the customer has because they are constrained in knitting together data across the businesses (Stiroh et al., 2003).
- **Disconnected channels.** Different businesses often own different channels, which are typically not interconnected in a customer-friendly manner. As a result, at many banks, the branch may not fully service loan products (e.g., questions to a personal banker about credit cards require calling into a card call center).
- **Reliance on new customer driven growth.** Credit-driven growth in the run-up to the financial crisis resulted in a surge in new customer acquisitions. Cross-sell naturally became less important than selling the first product to a
new customer. In the wake of the recession, this scenario is changing, as new acquisitions have dropped sharply. Figure 1 and 2.

**The Challenges in Building Loyalty Programs**

In today’s world, so-called customer loyalty programs abound. Grocers, coffee shops, shoe stores, hotels, ice cream parlors, car washes, restaurants, and parking lots represent but a smattering of the merchants that regularly provide benefits to frequent and loyal consumers. The programs offered by these merchants are typically simple, relying on the principle that patrons will receive a purchase or service either gratis or at a discount after meeting a predetermined quota of purchases. Yet even in these relatively simple frequent-purchase programs merchants have considerable doubt as to the value of the

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**Figure 1.** Cross-sell effectiveness varies across banks
1. Product categories: DDA-related (DDA, debit card, direct deposit, online banking, bill pay, overdraft) and non-DDA-related (savings, MMA, CD, mortgage, home equity, credit card, investment account)
2 CRI: Client relationship index, a measure of the average number of product categories penetrated per DDA household
3 Average across all banks in survey; sample average product penetrations were used in 4 cases when a bank did not report data for 1 of the 13 products/services
Source: Federal Deposit Insurance Corporation

**Figure 2.** Account-opening is the single most important time for cross-sell
1 Includes all new personal/retail household (not just DDA HH) originated within the branch network during the first two months of the annual data sample analysed (Jan-Dec 2007); for purposes of this metric, direct deposit, online banking, bill pay, and overdraft were not counted as product accounts.
Other personal loans were added as a product account
2 Average product accounts per retail household as of December 2007
Source: Federal Deposit Insurance Corporation
Retail banks that are embarking upon or revamping a customer loyalty program should strongly consider incorporating a rewards system into their plans. Because retail banking is a relationship business, the institution needs to accept that a relationship is a two-way street and that a customer will maintain a relationship only if there is value in doing so. Fortunately, retail banks have a significant number of potential rewards they can use to promote and solidify customer loyalty. Having a range of potential rewards to offer is critical because not all customers place the same value on all the characteristics of a banking relationship. Just as consumers patronize merchants for a variety of reasons, including quality and selection of products or services, price, location, and staff quality, customers choose their banks for a host of reasons. To the extent that core processing systems and delivery channels allow, retail banks have a plethora of potential rewards they can offer to consumers as rewards for sustaining long-term, profitable relationships. Clearly, two integral aspects of negotiating value exchanges with customers are the ability to calculate the value of the total customer relationship and the ability to understand the real and perceived costs of each potential reward. Retail banks will be more successful in building loyal, profitable customer relationships when they pursue a value exchange approach to building loyalty programs.

**Real relationship banking**

Only by addressing these challenges will banks build deeper relationships with customers and increase cross-sell. Relationship banking will succeed only when customers feel that they are dealing with a single bank and not separate businesses. Customers must also see real value in the model; for example, their bank provides better advice based on a more complete view of their financial picture, or better prices based on the relationship's value, or more convenient service. To achieve this, banks must present themselves as a single entity across multiple channels and have a single view of the customer across the different products he or she uses. Finally, banks should focus on customers who offer the highest long-term relationship value. All of these imperatives have profound implications for sales, risk and operations. The rewards for banks that can crack the relationship banking nut are significant. Deepening relationships with existing customers clearly make for attractive economics. We have found, for example, that customers with two products are disproportionately more valuable in terms of revenue than the combination of two similar customers (each of whom own one of the products) (Degryse et al., 2009). This relationship multiplier – driven by higher balances and usage – can account for up to a 25 percent increase in revenues. There are also significant retention benefits depending on segment. Risk benefits also accrue from relationship

**Rewards on offer.** Consumers have many motivations for choosing a product or service provider: quality and variety of products and services, price, location convenience, and quality of customer service all factor into why a consumer chooses to patronize a particular merchant at a particular moment. Merchants that institute frequent-buyer loyalty programs are never sure what has motivated the consumer's purchase. The reward may play a role, or it may represent nothing more than forgone revenue (Schneider 2006).

Against this societal backdrop of near ubiquitous loyalty programs, retail banks have long recognized the importance of building and strengthening customer loyalty. Despite a lack of clarity of objectives in banks' loyalty rewards programs, the programs do exist and typically fall into three categories:

- **Points programs** reward consumers for maintaining a product or service with the bank.
- **Relationship packages** bundle products and services together and provide discounts or special pricing to consumers.
- **Recognition programs** are commonly date based, acknowledging the longevity of customers’ relationships with the bank or their personal milestones such as birthdays or anniversaries.

Such programs are simple and often inflexible in design in that they are designed for masses of customers and have very little customization capability. Programs that allow the consumer to redeem points from a catalogue with a broad spectrum of consumer goods or services represent an attempt to inject some customization into bank loyalty programs. Given the competition for loyalty awards that is common in the broader consumer market, it has often been difficult for banks to design programs and fund rewards that stand out not only from those of their banking competitors but from those of merchants as well. And so the challenges for banks in strengthening customer loyalty are actually threefold:

- How to construct loyalty programs that go beyond product loyalty to building relationships with customers,
- How to determine the appropriate combination of rewards for their customers, and
- How to measure the cause and effects of a loyalty program.

The primary challenge for retail bankers is determining the behaviours and attitudes that accurately reflect customer loyalty. Customer loyalty programs represent a long-term commitment on the part of the bank. Given that retail banks offer a multitude of products and services to consumers and spend considerable time and effort up selling and cross-selling the same, bankers should focus on the total relationship rather than on a single product or service. Communications with enrolled customers should reflect the tone and tenor of the loyalty program, regardless of the nature of the communication (e.g., notification of a branch closing, introduction of a new product).
banking. Our analysis has shown a 10 to 25 percent lower risk from customers that have deeper, multi-product relationships with a bank. And integrating operations to deliver a seamless customer experience can result in further savings of between 5 and 15 percent in the areas addressed. Typical drivers of these savings are better organizational spans and layers, fewer broken transactions, pooling benefits, duplication of platform or functions and, most importantly, sharing of best practices across the consolidated groups.

A systematic approach

Taken together, these benefits can significantly boost the profitability of a bank. To achieve these results, banks need to take a systematic approach that addresses the friction points outlined above:

- **Product design:** To bundle or not to bundle products has been an intense debate in the industry. Our research suggests that bundles can help drive higher cross-sell performance to some extent, but contrary to conventional wisdom, their impact is truly felt in non-demand deposit account (DDA) products rather than in DDA-related products. There is 9 percent higher cross-sell rate in non-DDA products among banks that bundle. (The lack of DDA impact may stem from sales forces offering DDA-related products as part of the customer discussion, regardless of whether they are bundled or not and not doing so for non-DDA products, which then require active bundling.) More broadly, U.S. retail banks have only recently started thinking about other innovations in product design that could encourage deeper relationships. For example, most bundles are fairly rigid combinations; banks should offer more flexible options through dynamic pricing, features or services. Banks could also bundle across product categories at the value proposition level. For example, Manulife offers a combined deposit and credit account (Levine, 2005). As Canada’s first flexible mortgage account, it combines a mortgage with checking and savings, using the net balance to calculate the client’s interest – which positions the account to serve as the client’s primary current account. Bundling does not need to be just product related – banks can bundle over time, allowing customers discounts for loyalty achievement across products, or bundle across people, offering rewards, services or discounts for family participation. The goal should be to craft the bundle based on customer needs. While companies in other industries have taken this to heart, only a select few banks offer products that can be configured based on customer preference. Too much flexibility can be confusing for customers and salespeople (not to mention expensive to implement), and too little results in inactive products or higher loss rates. But linking bundle design tightly to needs assessment helps overcome this. To do this, banks need to dramatically increase their emphasis on the frequency and quality of customer needs assessment. Our research found that only 40 percent of branches conduct a structured needs assessment the first time a customer enters the branch.

- **Relationship sales:** Banks configure and train sales forces in a generally causal manner, specializing by product. This means that customers interested in other products have to be referred to other channels or sales forces, a process that results in high leakage or customer dissatisfaction (e.g., from re-submitting basic information). A relationship sales approach would differ in several ways. First, a customer’s file is reviewed across products to determine metrics. This approach requires deep data-mining and validation. Second, high-potential targets are approached in a coordinated manner across products by a quarterback who always remains the common touch point. Third, formalized teams across business units (e.g., small business, retail and mortgage) must coordinate to address customers’ needs across unit boundaries. This helps create a name-face recognition between team members, minimizing referral leakage and ensuring that follow-ups are conducted. Fourth, periodic customer relationship reviews assess additional sales potential (e.g., reduce leakage) across all products and business units. Finally, retention programs are structured in a cross-product manner (e.g., a decline in DDA balances for a customer who also has a credit card triggers an alert in both business units). This work is not easy, especially when targeting mass customers (as opposed to high-net-worth customers) with limited sales capacity. Indeed, we have found that up to 40 percent of a bank’s mass customer base can be unprofitable. The important point therefore is to select customers who have high potential relationship value. Identifiers such as direct deposit or online bill pay sign-ups often flag this relationship potential, as do other pragmatic approaches to segmentation. Focusing on the truly valuable relationships and de-emphasizing less valuable relationships can help with capacity issues.

- **Service to sales:** Each service interaction with the bank is an opportunity to sell, and each sale should really be about serving the customer with a product. Our benchmarking shows that best-in-class banks sell 4 to 8 products per 100 calls through the call center. To offer the right product without referring the customer, an agent needs a broad knowledge of the product set. One regional bank has cross-trained 10 percent of its agents across nearly all the deposit and loan products it offers.

- **Relationship risk:** Banks should take a cross-product view of the customer when calculating risk. If they neglect to do this, they can misprice the true risk, which can result in lower approval rates for good risks and also limits banks’ ability to offer multi-product approvals or qualifications at account opening. An integrated view of risk, incorporating deposit and loan information, supports features such as a single risk score, joint decision-making and pre-qualification at account opening.
• **Relationship servicing:** Ninety days after the average customer opens an account, banks’ cross-sell drops off sharply and the rest of a customer’s tenure with the bank accounts for only 30 percent of the total products he or she buys. This large opportunity remains untapped due to two factors. First, banks typically service most of their retail customers in the same way without regard to their relationship value. Indeed, as we noted earlier, at one bank over 40 percent of the customer base was unprofitable on a fully allocated basis, while the small proportion of truly valuable relationship customers accounted for more than 80 percent of the bank’s profit. Second, servicing assets and processes are fragmented into product packs, leading to lost opportunities to deliver on the relationship promise. For example, valuable customers often need to call multiple service numbers for products they were sold in a bundle (Berger et al., 2009). Banks need to be able to recognize and serve their customers based on their relationship value, delivering superior cross-product service to the more valuable customers and channelling less valuable customers to self-serve options. This focus on customers with true relationship value should enable better cross-sell and retention, while reducing costs. The call center is the main venue for realizing this opportunity – customers with high relationship value should experience shorter service queues, receive service from more skilled agents, or be eligible for special offers. The same agents would also be superior at service-to-sales techniques. Relationship sales, risk and servicing efforts must be supported with organizational changes along the following lines:
  • **Product-line ownership:** Consolidating organizational ownership for products that customers typically buy jointly facilitates the development of well-integrated bundles and channel strategies. Several U.S. regional banks have recently consolidated lending business ownership.
  • **Operational sites:** Servicing assets is difficult without a single leader. One bank that wanted to integrate its call center onto a single platform first appointed a shared service owner to oversee its operation.
  • **Risk and marketing analytics:** An integrated risk or analytics function that spans businesses can help better coordinate customer data analysis and risk assessment across products (Dell’Ariccia et al., 2006).

**Retail banking trends**

For better or worse, the following trends influence consumer perceptions, behaviours, and expectations of retail banks. Re-evaluating these approaches may provide insight into how banks can demonstrate their friendship potential to consumers.

• **Trend 1:** Web innovations distance the customer relationship
  The manner in which traditional banks are innovating is not building positive relationships with customers, but may be distancing their relationships with customers. While the banks’ recent shift to digital customer interactions allows for self-service and ease of use for even complex transactions, it further distances customers from the banks by degrading their already weak “forced” relationships. Further, contributing to the demise of the customer relationship, is the subpar customer support provided by the bigger banks, calls that are often answered by an offshore call center representative, most likely unfamiliar with, and insensitive to, home market conditions. Over 50% of internet users, approximately 97.5 million, now engage in online banking, coupling an on-demand culture with the convergence of technology (Degryse et al., 2008). Retail banks’ new product and service extensions that enable online and mobile banking reflect this lifestyle change. Bank of America leads the way with online chat and e-alert initiatives that increase functionality and enable real-time communication with customers. Historically, many banking customers have reported that they are unable to complete their business with a single phone call, so diversifying communications channels is certainly a move in the right direction, but not enough to cultivate advocates. City Mobile SM supports the now indispensable mobile banking service, but falls short of garnering positive momentum for the company.

• **Trend 2:** Quality over quantity
  The rise of online banking provides fewer reasons to walk into a retail branch, yet over the past decade the total number of retail bank branches has increased nationally by 29% (Degryse et al., 2008). Additionally, banks are extending service hours into the weekend and offering supermarket and in-store locations. Bank of America and Wachovia continue to grow their retail footprints, providing consumers with increased convenience, a leading reason for switching banks (Degryse et al., 2008). However, our findings suggest that there is a negative correlation between strength of customer relationship and the size of the bank. Figure 3.

In other words, the larger the bank, the lower its advocacy score and the lower its rate of business growth. Indeed, the largest banks in our study, Bank of America and Citibank, have annual growth rates that are low to negative, at -0.7 % and -6.38%, respectively. Not surprisingly, our study found that Bank of America has negative momentum, indicative of an unstable relationship, one in which consumers are moving away from the brand.

Two banks are keeping retail banking relevant and fresh, taking innovation beyond products, services, and digital interactions, and giving the larger traditional banks a run for their money. ING and Umpqua are challenging the codes of retail banking and the customer experience through branch innovation. ING Café’s create an atmosphere of friendship and partnership, providing education on products and services through financial literacy workshops. The company’s customer experience strategy is more closely aligned with the hip, educational
environment of Apple stores and the café experience of Starbucks. Embedded within neighbourhoods, Umpqua is part internet café and part community center. Its branches have even been compared to stylish hotel lobbies where customers are tempted to hang out. “Daily Specials” highlight neighbourhood events and resources, as well as bank products and services. Umpqua’s Discover Local Music initiative supports community initiatives with an online music store, Umpquamusic.com that features local indie artists. By creating a service-oriented culture, versus a sales-oriented culture, and integrating customer experience at such a vital touch point as the local branch, it is not surprising that both ING and Umpqua are befriending consumers.

• **Trend 3**: Keeping secrets and providing unwanted surprises creates critics

With a total of 2,030 mergers among FDIC institutions, 2001 heralded an era of consolidation (Degryse et al., 2008). This has provided both opportunities and challenges for large traditional banks. Bank of America, which is nearing the government-mandated limit of holding 10% of total outstanding deposits, is seeing its revenue growth limited by its inability to acquire new business. This pressure has led the bank to move toward alternative revenue streams that extract more money out of existing customers. Today, over $20 billion, close to 50% of the industry’s annual revenue, is generated from “nuisance fees.” These hidden fees are resulting in a backlash by consumers who are migrating in droves to banks they consider more transparent. Bank of America is notorious for its lack of transparency for such things as overdrafts and late payment fees. These practices fall short of creating positive customer experiences. Rather, they are deemed by consumers as self-serving, and as a result, consumers perceive Bank of America to be the least *Honest and True* in the category based on their tenet index of 65, 35 points below the category average and a whopping 43 points below ING. The advocates are outnumbered by the critics, whose harsh words depict their acrimonious relationships on Rateitall.com: “Bank of America is the worst bank that I have had. I have never been so mistreated by any customer service as I have by them. They do NOT work for the customer, they work for themselves to put money in their own pockets.” It leads us to believe that Bank of America is not following through on its branding campaign, “Bank of Opportunity.” Wachovia scores low, too, at 81. They engage in collecting nuisance fees, not to mention accepting fees based on transactions conducted by companies using the bank’s account to engage in fraudulent activities. These activities stole as much as $400 million from unsuspecting victims. Wachovia looked the other way while collecting fees on the fraudulent transactions that were conducted. The perniciousness of Wachovia’s nuisance fees is illustrated by the comments of a Senior Attorney from the Consumers Union in San Francisco. “I have consumers tell me that they used their own debit card three times in one day and they got hit with three thirty dollar ($30) overdraft charges.” It’s no wonder that pursuing lower account fees is the third highest motivator for switching banks. Such hidden fees erode trust and detract from other customer-oriented initiatives such as the bank’s “Who Would You Thank Campaign?” which is meant to celebrate National Customer Service Week. Overall, these practices, common among the larger banks, are not befriending consumers nor setting the tone for future cross-sells or up-sells, but rather destabilizing their customer relationships. Indeed their negative True Momentum scores suggest that their customers are moving on: Bank of America, -31%; Citi, -
26%; WaMu, -6%; and Wachovia, -17%.

Concluding remarks

Organizational causal nature can be broken down in different ways: through organizational moves (e.g., a single-channel leader), through incentives or through workflow. This can be the trickiest part of any relationship banking strategy and must be carefully tailored to the individual bank, personalities and customer preferences.

The ideal of relationship banking has always been a sound one. It makes good sense for banks to deliver a unified experience to their customers and to cultivate loyalty from those customers that are most profitable. What has often been missing, however, are the sales, risk, operational and organizational capabilities to support this vision. Given today's pressures on profits, the time is ripe for banks to get relationship banking right.

While some retail banks have been successful in implementing loyalty programs based on products or services, the nature of retail banking is an argument for establishing relationship-based programs instead. In addition to providing assistance in meeting cross-selling goals, a relationship focus in loyalty programs can also preclude communication mistakes that result from one product group within the bank not knowing the true value of a customer's total relationship with the bank.

Our work suggests that banks have been slow to adopt a relationship approach. Most banks serve their customers through product-focused channels, oriented only to whether the customer needs a specific product. These efforts generally meet with limited success in generating either sales or greater customer satisfaction.

Similarly, efforts to serve customers across product lines are often hampered by an inability to view the entire customer relationship or by systems that cannot service multiple products. Banks must address the full range of customer needs across all financial products at all touch points. Only in this way will they reap the rewards of increased cross-selling, enhanced risk decision-making and customer retention.

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