RISKQUEST

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The future of retail banking: the customers

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Retail banking was long referred to as a 3 – 6 – 3 business. The bank borrows money at a 3% interest rate at the capital market, lends the same money at a 6% interest rate to the customer and the banker finds himself on the golf course at 3 o'clock in the afternoon.

Those were the days. Apart from current interest rates being at all-time lows, today's retail bankers are confronted with various adverse forces. Increasing competition of new entrants with innovative proposals, margins that are under pressure and a negative perception, affect the market share. It is therefore time for change. Key question is what to focus on: customer or product?

Takeaways

- The business model of traditional retail banks seems no longer viable. There are adverse forces that put them under pressure.
- If banks want to become the train they have to act, if not they risk ending up as the track (the bank becomes a back office of which the customer is hardly aware, implying low margins).
- Rather than focusing on product, banks should focus on clients. While banks enjoy a good position to further cement their relationship with their customers, there is still much to be gained.
- If banks get to understand their customer's and their needs very well, they could add value by pro-actively advising them.
- Collecting information from various sources and applying big data type of analysis, should provide the required intelligence.
- While the change is needed, it poses a number of challenges including compliance with privacy legislation.

Introduction

Traditional retail banks are under attack by both temporary and strategic forces. The recent financial crisis has adversely affected the public opinion about banks. Meanwhile the flattening of the interest rate curve puts pressure on interest margins as retail banks traditionally borrow short money and lend money at the longer end of the curve.

There are however also more structural factors that threaten the business model:

- Banks face legacy systems implying a large cumbersome IT infrastructure.
- Banks are confronted with high costs of operations and human resources.
- Digitization changes customer requirements. As a consequence, banks are challenged to find the appropriate customer interaction.
- Legislation has increased significantly. Implementing the new legislation involves huge costs.
- Capital requirements for risky activities have strongly increased.

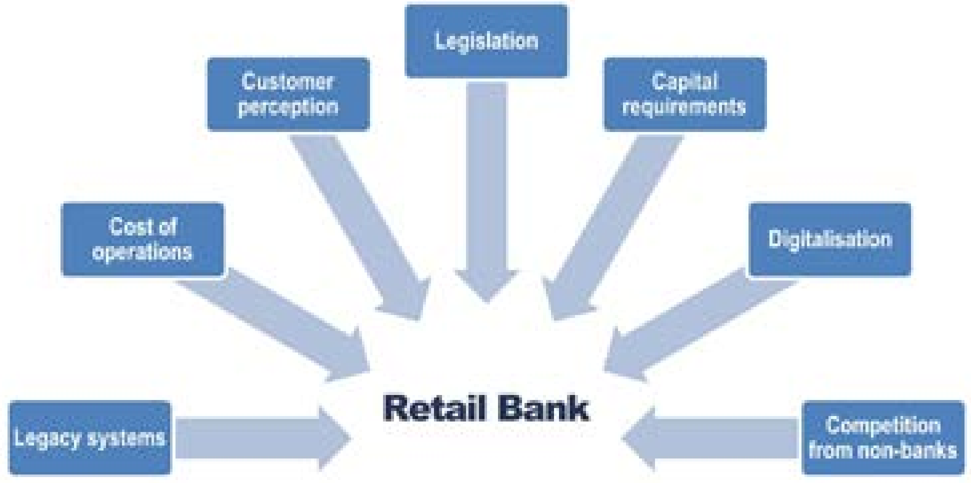

Figure 1: An illustrative representation of the pressure experienced by banks.

As a result of the above factors, competition becomes fierce as other financial institutions, with less regulatory restrictions, extend their banking activities (e.g. pension funds) and as Fintech enters the market. Continuing the traditional business model seems no option. If banks want to become the train rather than the track, action is required. How to accomplish this ?

What options do banks have

A business can either focus on the customer or on the product (say a mortgage loan). The table below considers the adverse forces for each alternative and the expected impact ("--" is very negative and "++" is very positive):

Negative force	Customer focus	Product focus	Remark
Legacy systems	++	--	Products depend strongly on existing systems. Customer relation management can make use of latest IT techniques.
Cost of operations	+	-	Operational efficiency cannot be improved easily. Client advisory can be implemented efficiently.
Customer perception	+	-	A good personal relationship with a representative outweighs the negative perception about the institution. The bank can get a second chance to prove its value added and duty of care.
Legislation	-	--	Product focus involves broader legislation and regulation. Client focus involves duty of care and privacy legislation.
Capital requirements	+	--	Taking on risks (as with product focus) involves high capital requirements. Fee based customer focus is capital efficient, in particular if risks are transferred (e.g. securitised)

Basically customer focus seems an attractive choice where banks have a number of advantages.

While banks have put customers in the center of attention, there is still much to be gained. Much of the interaction with clients is driven either by negative factors, i.e. clients missing payments, or by clients approaching the bank in case of a request or specific need. In both cases, the interaction is reactive and too late. At the same time, banks do not know much about their clients. What life events are on their agenda but also more trivial issues like what car do they drive, what sports do they practice, what holiday plans do they have and what is their net worth in terms of asset value? If banks are able to collect intelligence about their (prospect) customers, it may help them to pro-actively provide honest financial advice. This advice should be based on true customer needs and on finding the appropriate solution to satisfy these. Providing such advice would lead to income via origination fees and income from servicing. A positive by-effect is that if the bank does not take credit risk on its books, this involves no capital charges. This kind of advice can be seen as true value added advice.

Two aspect are important in providing quality advice:

- The customer may still be unaware of his or her financial needs (precognitive).
- The solution may, if more attractive, also be obtained from third parties. Think of credit card services, asset management solutions and insurance contracts.

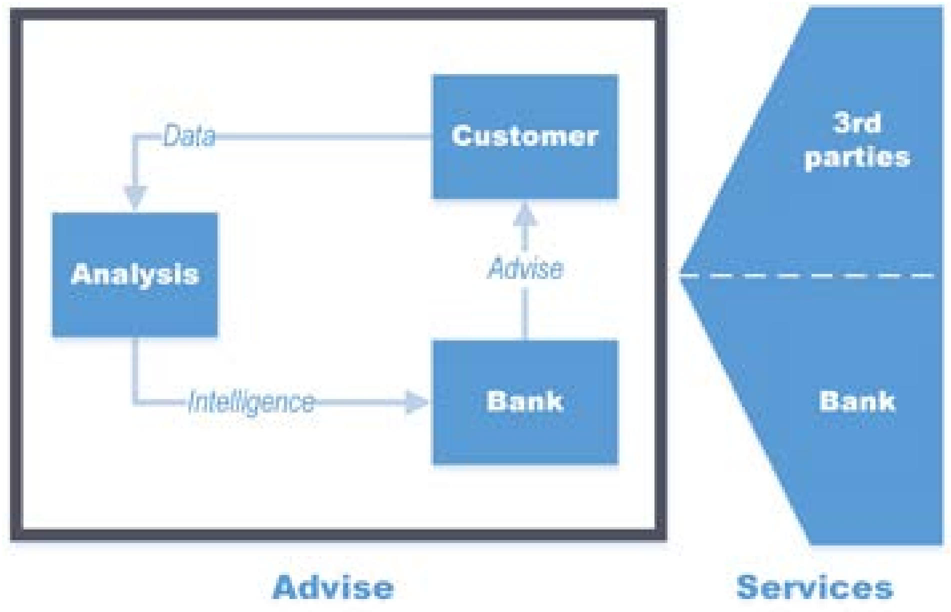

Figure 2: Banks should focus on advising the customer in using third-party services

The advantage that retail banks have

Compared to the new entrants banks have to profit from their (historical) knowledge. Banks have many existing customers and a large network. Moreover, banks have large amounts of data including payment data which can be considered extremely powerful (the latter is however threatened by the introduction of the new Directive on Payment Services). Furthermore, banks still enjoy a sufficient reputation that may serve as basis for further cementing the customer relationship. To strengthen their competition position banks should use their extended knowledge in terms of data analysis, customer protection and product offering. Banks are still well-positioned to provide useful advice. Also, banks have a network with local presence (this may be a useful, though somewhat cost inefficient, basis for customer advisory).

Example:

Past payment information is used to forecast the customers budget. It appears that the customer will face an overdraft in its current account in 3 weeks from now. As this involves high interest costs, the customer may be advised to take on a (cheaper) credit facility suiting his needs. The customer clearly benefits from the bank's advice.

Example:
Past payment information and knowledge about car depreciation and maintenance schemes has helped the bank to identify that this period is most optimal for the client (economically) to sell its car and buy a new one. Furthermore, the bank is aware of other clients looking for a similar car. It may approach car manufacturers to obtain an attractive offer (community buying), say an x% discount that the clients can realize.

How to get to know the customer better

The better the bank knows its customer, the better the quality of its advice. Getting to know the customer involves collection of relevant information and state of the art analytical skills. The following sources of information would serve the purpose:

Application Data	All information received from the client at any contact moment must be centrally stored. It provides useful basic information such as age, gender, marital status, income, etcetera. The data should be kept up-to-date.
Behavior	The way the customers behaves in relation to a product includes useful information. For example, does the customer pay installments in time? Are there past due situations?
Payment	Any payment made by the client provides powerful information. What products and services is money spent on, what sources of income are there, etcetera. Note that speed is of the essence as the new Payment Service Directive (PSD 2), which will be effective in 2017, enforces banks to provide payment information to third parties. Hence, payment information will no longer be proprietary to banks.
External scores	As not all payments by the customer may be known to a bank, payment behavior information from other sources (e.g. banks, telecom providers) may add value.
Social media	Social media may provide information about life events which are very relevant in relation to financial services. In addition, it provides information about leisure activities including holidays spent.
Housing information	Important property forms the financial basis of many households. Any large changes in the property or value of it, are highly informative to banks. Information can be obtained from residential real estate sites or via the land register.
Other sources	There are specialised firms collecting information from e.g. notary offices or the personal ads in newspapers. In addition, banks could be creative by for example offering clients to provide support in the annual tax declaration. This way the bank can obtain valuable information. Banks can also screen all communications by the client to the bank to gather information (e.g. based on key words).

Note that getting to know the customer better, may imply more effective risk management. This way banks:

1. can better profile and target clients,
2. apply early warning triggers,
3. can better fulfil their duty of care by not selling products that are inappropriate for a given client.

Challenges

The approach seems relatively easy. However, truly focusing on the retail customer is easier said than done. This approach involves a number of challenges of which the most important ones are:

Privacy legislation	Much information cannot be freely used because of stringent privacy legislation. Explicit customer approval for using the information is pivotal. The customer must therefore be convinced of the value added of the bank collecting such. Monetary or alternative incentives offered to the customer may help the process.
Communication	It is vital that the bank has the right intentions when using the intelligence for better advice to its clients and that this is clearly communicated. In doing so reference should be made to the banks duty of care for its clients.
Technical (info/ analysis)	Collecting data from various sources is intrinsically difficult. It poses many technical challenges to have an integrated client view which is consistent over time. New software and IT technology helps to store high quality data. The legacy systems must be avoided as far as feasible. Once the data is of sufficient quality, powerful types of mathematical analyses can be applied to get to know the customer and his needs in more detail. Such analysis not only involves the latest quantitative techniques but also common sense and business knowledge.
Interaction with client	A pro-active customer focused advisory relationship requires a different approach and also other types of accountmanagers. Sales staff needs to be trained in pro-actively approaching clients with privacy sensitive information.

Conclusion

RiskQuest believes that traditional retail banks are forced to change. A viable alternative is to focus on its existing customers (and prospect customers). Banks are in a good position to collect various kinds of information about their customers. Combining these may yield useful intelligence about customer profiles and needs. Such will lead to high value added advisory services. Data and analytical tools are crucial instruments. RiskQuest is familiar with data collection and big data types of analysis. In addition, our consultants are very much aware of the banking context. The latter is important to know upfront what kind of intelligence will be of most value added.

Example:

From social media data and payment data, a bank has intelligence that a private customer (household comprising a young recently married couple) is expecting a baby in 6 months from today. This household is a client of the bank. The relation is primarily based on a mortgage loan which was provided some years earlier for the acquisition of a one-bedroom apartment in the city center. Based on a house price valuation model and information from the land registry and previous application data for the mortgage loan, the bank has determined that the value of the house increased by 20% in the past years.

At the same time the mortgage loan was repaid by 10%. The current loan-to-value has therefore dropped below 70%. Analysis of payment information tells the bank that the household's monthly income has increased by 20% over the period since application. Furthermore, the client received annual dividend payments of 5,000 euro, implying an attractive asset portfolio. The customer has always served the mortgage loan instalments accurately and timely. The same holds for their credit card installments.

Finally, the customer is known to be part of a network comprising credit-worthy individuals. As the land registry has no information that the one-bed room apartment was expanded, the family may soon consider to move to a larger apartment (or house outside the city center). The bank can approach the customer with a detailed budget plan for the acquisition of a new residential property. In addition, it may offer appropriate financial arrangements such as a savings plan, insurance plans and pension related products.

RiskQuest is an Amsterdam based consultancy firm specialised in risk models for the financial sector. The importance of these models in measuring risk has strongly increased, supported by external regulations such as Basel II/III and Solvency II.

Advanced risk models form the basis of our service offer. These models may be employed in a frontoffice environment (acceptance, valuation & pricing) or in a mid-office context (risk management and measurement).

The business areas that we cover are lending, financial markets and insurance. In relation to the models, we provide advice on: Strategic issues; Model development; Model validation; Model use.

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