

Rewriting the rules: Succeeding in the new retail banking landscape

Global Banking February 2019

Authored by:

Vaibhav Gujral

Nick Malik

Zubin Taraporevala

Rewriting the rules: Succeeding in the new retail banking landscape

Retail banks have long competed on distribution, realizing economies of scale through network effects and investments in brand and infrastructure. But even those scale economies had limits above a certain size. As a result, in most retail banking markets, a few large institutions, operating at similar efficiency ratios, dominate market share. Changes to the retail banking business model have mostly come in response to regulatory shifts, as opposed to a purposeful reimagining of what the winning bank of the future will look like.

Retail banks have also not kept pace with the improvements in customer experience seen in other consumer industries. Few banks stand out for innovation in customer interaction models or branch formats. Marketing investments have traditionally focused on brand building and

increasing loyalty: a reputable brand stood for trust and security and became a moat, providing protection against new entrants to the sector. Finally, most banks offer similar products, with limited innovation in features.

Today, the moats that banks have built are more likely to restrict their own progress than protect them from attackers. Four shifts are reshaping the global retail banking landscape to the point where banks need to fundamentally rethink what it takes to compete and win. This should be an urgent priority for banks. The pace of change will likely accelerate, with a select set of large-scale winners emerging in the next three to five years that will gain share in their core markets and begin to compete across borders, leaving many sub-scale institutions scrambling for relevance.

Four shifts are reshaping retail banking

Four secular shifts are changing the way retail banks will compete in the coming years:

- The traditional distribution-led growth formula is losing relevance, with a breakdown in the relationship between branch footprint and growth.
- Banks are now competing on customer experience, with leaders growing faster than their competitors.
- Scale economics are back—banks that excel at deploying new technologies (e.g., automation and machine learning) and those with a more digital-centric channel mix will have a structural cost advantage.
- The retail banking relationship is getting unbundled along product lines, fueled by digitization and, increasingly, by regulation—and the biggest profit pools are under attack. A few banks will be able to temper and reverse this trend, using superior data and analytics capabilities to build deeper and broader relationships with their customers.

In the near term, these shifts will combine to intensify competition as new entrants and incumbents seek to push past traditional boundaries. More than 100 digital attacker banks have launched in the last few years globally—including N26, Monzo and Revolut in Europe; WeBank, Digibank, Jenius in Asia; SoFi, Marcus, Moven in the US; Nubank in South America—while many incumbents have launched or are considering launching digital-first models.

Over the next three to five years, we expect a few players to emerge from this competitive scrum to gain dominant share in their core markets and possibly beyond. These firms will have taken bold and decisive actions to capitalize on the shifts that are reshaping the

industry. In some cases, these winners will be incumbents that build on an already significant share; in others, they will be institutions newer to the banking industry, which use their agility, strategic aggressiveness, and sharp execution to attract customers.

1. The traditional distribution-led growth formula no longer applies

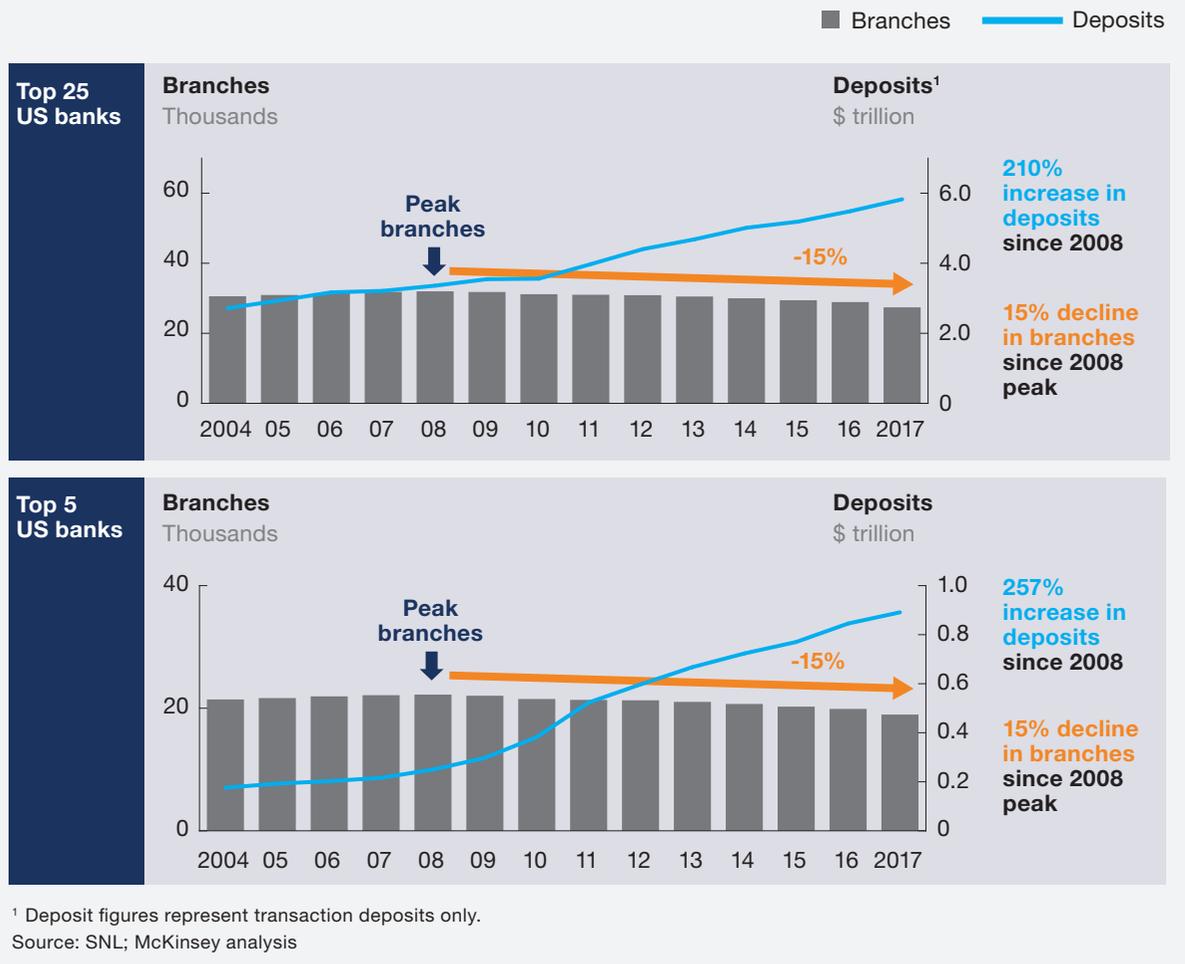
Until the financial crisis in 2007, a retail bank's total share of deposits was tightly linked to the size of its branch network. Even as internet use grew rapidly, customers still visited branches for account servicing and to learn about and purchase new products. The physical branch created a sense of security and trust. Banks with higher branch density benefited from a network effect—the more branches, the higher the likelihood of acquiring and retaining customers.

Over the past decade, this relationship between deposit growth and branch density has weakened. Deposits at the 25 largest US retail banks have doubled over the past decade, while their combined branch footprint shrank by 15 percent over the same period. This reverse correlation is even sharper for the top five US banks—while reducing branches by 15 percent, they increased deposits by 2.6 times (Exhibit 1). While there have been previous periods of branch contraction, they were clearly tied to economic downturns; this most recent wave of retrenchment commenced about a decade ago and has persisted through a period of robust economic growth.

Retail banking branch networks are contracting across North America, the UK, and Europe (Exhibit 2, page 4), although the pace of change varies considerably between regions. Those that are ahead of the curve have reduced branches by as much as 71 percent (Netherlands). Banks in North America and Southern Europe are

Exhibit 1

The correlation between branch scale and deposit growth has weakened for US retail banks.



reducing branches and growing digital sales at a more gradual rate. In many Asian, African, and Latin American countries, branch reduction is not so apparent—only because retail banks in these markets leapfrogged branch distribution to go directly to digital sales.

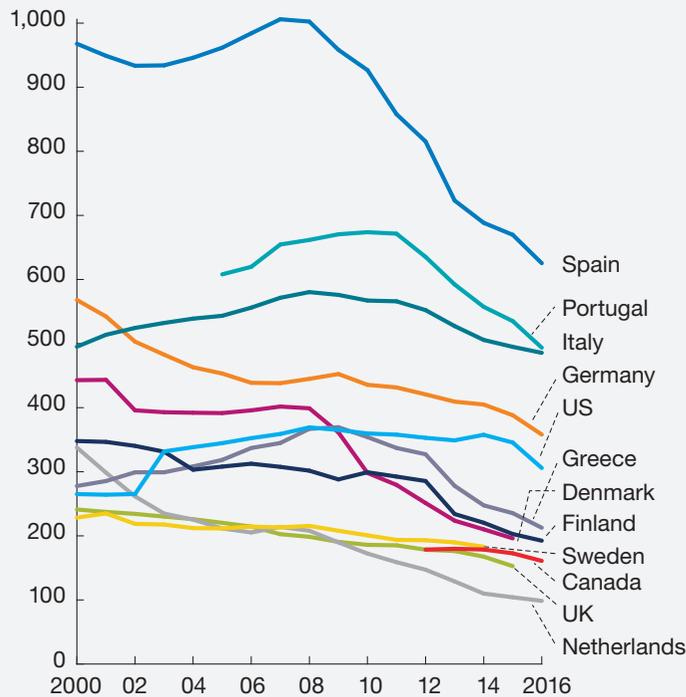
The rate of branch reduction is often tied to customer willingness to purchase banking products online or on mobile devices. Eighty to

ninety percent of banking customers in the Nordics, for example, are open to digital product purchases for most financial products, compared to 50 to 60 percent in North America and Southern Europe (Exhibit 3, page 5). While customer willingness to purchase products via digital channels varies, however, the common thread is that in all markets this readiness is far ahead of actual digital sales and will require banks to catch up to consumer needs and expectations.

Exhibit 2

The number of branches per million people is declining in North America, the UK, and Europe.

Bank branches per million people¹



Branches per million people² **Peak-to-trough reduction**

Spain	625	↓ 38%
Portugal	494	↓ 27%
Italy	486	↓ 16%
Germany	358	↓ 37%
US	306	↓ 17%
Greece	213	↓ 42%
Denmark	196	↓ 56%
Finland	192	↓ 45%
Sweden	183	↓ 22%
Canada	161	↓ 11%
UK	153	↓ 37%
Netherlands	99	↓ 71%

¹ Represents bank branch density per million people in the country.

² Based on 2016 or latest year available.

Source: McKinsey World Banking Intelligence database; McKinsey analysis

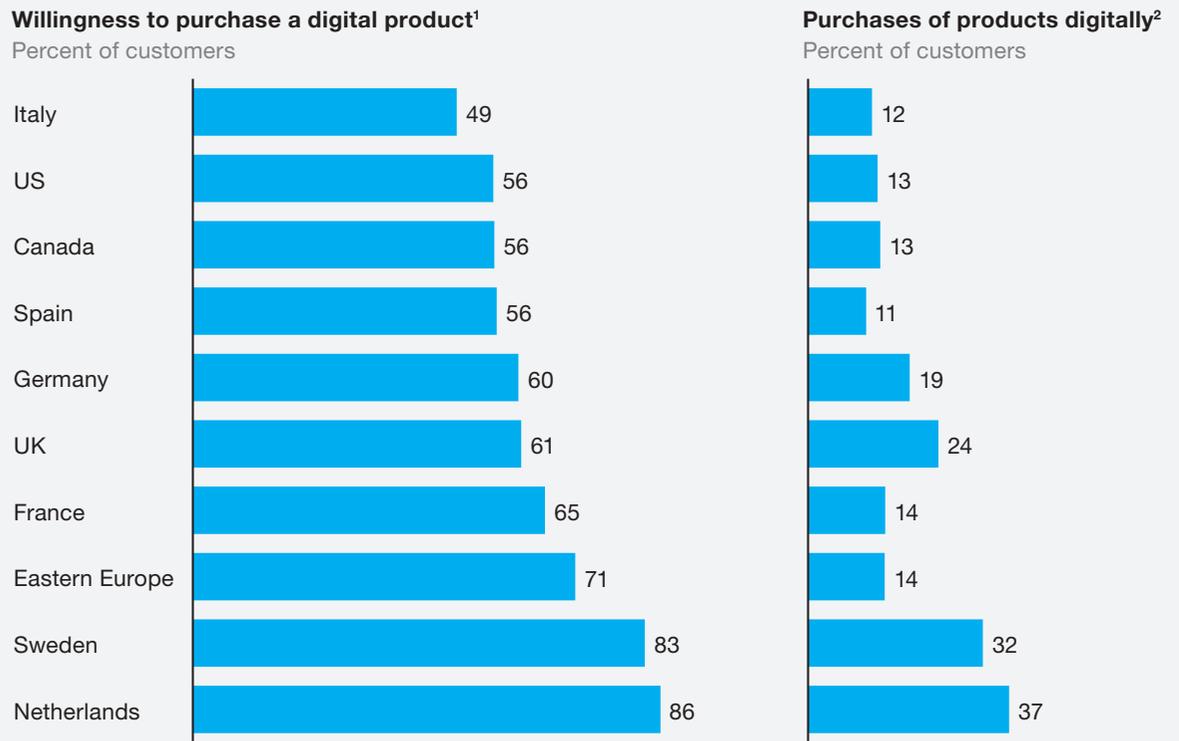
Within any specific market, of course, there are banks that have acted swiftly to adopt digital and remote as their main channel for interactions, and those that have lagged behind (Exhibit 4, page 6). One UK bank makes more than 50 percent of sales through digital channels, well ahead of market peers. Even in the historically branch-dependent small business segment, a range of banks and fintechs are finding that remote value propositions delivered digitally (e.g., remote relationship managers at Nordic banks) are attractive to small businesses.

Banks that are ahead of the curve in terms of capitalizing on this shift are pulling away from the pack and have taken decisive actions on several fronts:

- *Set a bold aspiration for sales/service channel mix.* Banks must do more than react to shifts in consumer preferences—they need to set aspirational targets for sales and service across channels. Some customers will self-select into digital channels, but banks can do

Exhibit 3

Northern European banking customers lead the way in terms digital preferences.



¹ Represents customers that would be interested in purchasing their core banking product (e.g., checking account) digitally — via internet, tablet or mobile.
² Percentage of customers that acquired their core banking product (e.g., checking account) digitally—from among customers that acquired a new product in the last 2 years.
Source: McKinsey Consumer Multichannel Survey (n=12,000)

more to encourage less motivated customers to make the shift. Banks in markets like the Nordics and UK have reduced the number of customers using branches by up to 60 percent by focusing on how to serve the heaviest branch users effectively through other channels.

- *Use advanced analytics to reshape the physical footprint.* Optimizing the branch network requires a deep understanding of consumer

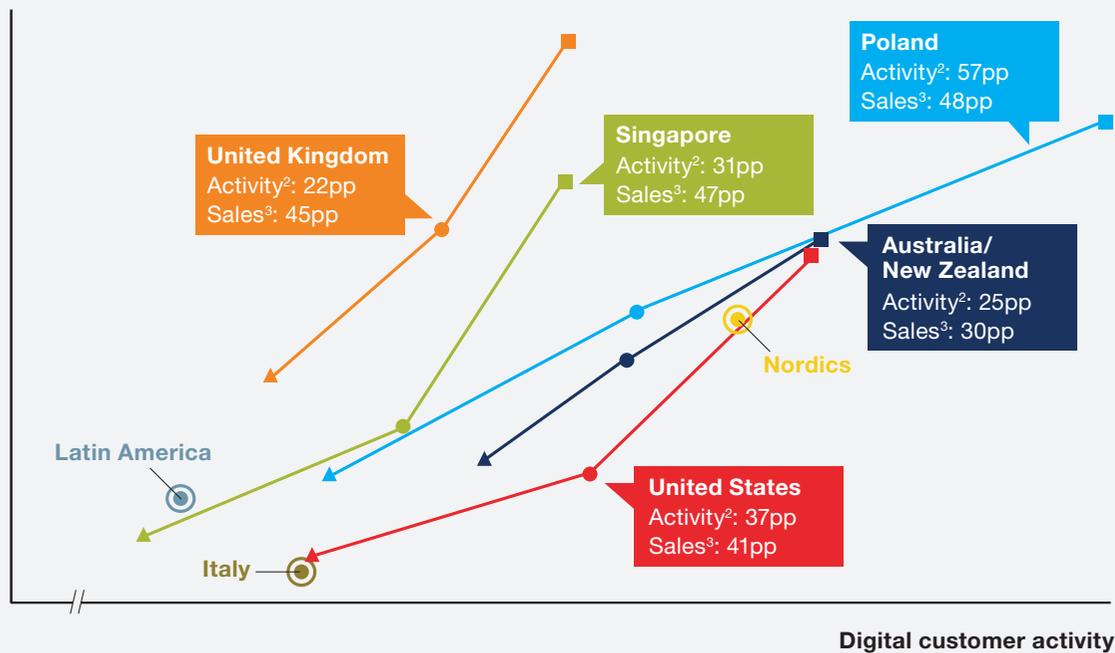
preferences in every micro-market, and of the economics of making changes at the branch level. Leading institutions are using combinatorial optimization algorithms to optimize the net present value (NPV) of the network based on granular customer data on characteristics such as digital propensity, willingness to travel, needs based on transaction patterns and branch usage, and the size and space/format of branches. A European bank recently used this approach to identify 25

Exhibit 4

In most markets, there are wide gaps between banks in terms of digital performance.

Digital sales penetration

July 2017 – June 2018



Note: For Latin America, Italy, and the Nordics, only average shown.

¹ Lowest/highest observed for each metric in given market - not necessarily the same bank

² Activity = difference between highest and lowest observed digital customer activity

³ Sales = difference between highest and lowest observed digital sales penetration

Source: McKinsey

- percent of branches that could be closed, and 35 percent of FTEs that could be redeployed.

 - Develop cutting-edge digital sales capabilities.* Achieving meaningfully higher levels of digital sales requires a sophisticated approach to digital marketing and an understanding of how to optimize each stage of the funnel. Most consumers already seek information on financial products on digital channels (e.g., bank websites, price comparison sites), but

few institutions are highly effective at converting these inquiries into digital sales. Leading banks use first- and third-party data (e.g., geospatial, browsing behavior), a robust marketing technology stack (360-degree view of customer, omnichannel campaigns), and an agile operating model (e.g., cross-functional marketing war rooms). With these elements in place, progress can be rapid; a North American institution tripled annual online product sales in 12 months.

2. Customer experience is beginning to generate meaningful separation in growth

Across all retail businesses—including banks—customers now expect interactions to be simple, intuitive, and seamlessly connected across physical and digital touchpoints.

Banks are investing in meeting these expectations but have struggled to keep pace—focusing on the less-than-lofty goal of making the experience “less bad” for customers, rather than “outstanding.” Many banks are hampered by legacy IT infrastructures and siloed data. As a result, few banks are true leaders in terms of customer experience. Even for leading institutions, typically only one-half to two-thirds of customers rate their experience as excellent. This holds true across product categories, including those such as cards and deposits that have higher digital adoption rates.

The impact of this less-than-stellar performance is measurable. For example, McKinsey analysis shows that in the US, top-quartile banks in terms of experience have had meaningfully higher deposit growth over the past three years (Exhibit 5, page 8). Simply being good does not move the needle; customer impact really shows when banks offer outstanding experiences. The few “experience leaders” emerging in retail banking are generating higher growth than their peers by attracting new customers and deepening relationships with their existing customer base. Highly satisfied customers are two-and-a-half times more likely to open new accounts/products with their existing bank than those who are merely satisfied; they are also less price sensitive and generate positive word of mouth.

These experience leaders are adopting tactics pioneered by digital-native companies in other sectors such as ecommerce, travel, and

entertainment: setting a “north star” based on proven markers of differentiated experience (e.g., UX design, carrying context across channels), redesigning journeys that matter most for digital-first customers and not just digital-only customers, and establishing integrated real-time measurement that cuts across products, channels, and employees. These banks know that customer experience is not just about the front-end look and feel, but that it requires discipline, focus, and investment in the following actions:

- *Focus on the journeys and sub-journeys that matter:* The relative contribution of sub-journeys (e.g., *app downloading; activating account*) in determining overall customer experience varies considerably. In fact, ten to fifteen sub-journeys have the biggest customer satisfaction impact for most products and should thus be the first priority. For instance, when opening a new deposit account, the *researching options* sub-journey has eight times the impact on customer satisfaction than other account-opening sub-journeys, on average (Exhibit 6, page 9). For banks, the key is to prioritize these high-impact sub-journeys and systematically redesign them from scratch—a process that can take about three to four months and result in at least a 15 to 20 percent lift in customer satisfaction.
- *Change the way you engage with customers.* Experience leaders understand that digitization is not just about creating a cutting-edge online and mobile experience, and that satisfaction is shaped by customer experience across channels.¹ The experience should be seamless, especially on journeys that are more likely to take place over multiple channels, such as *new account opening, financial*

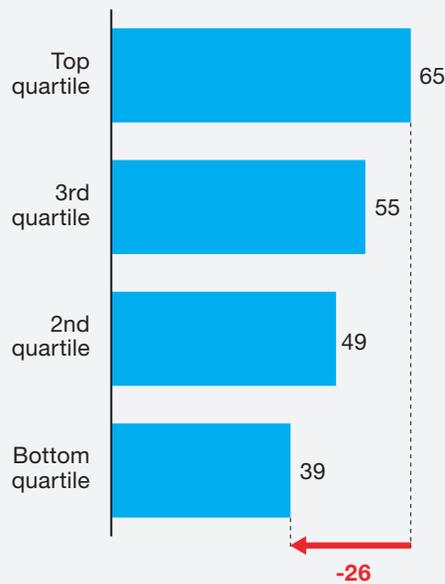
¹ Walter Rizzi and Zubin Taraporevala, “The balancing act: Omnichannel excellence in retail banking,” McKinsey.com, January 2019.

Exhibit 5

US retail banks with better customer experience are growing deposits faster.

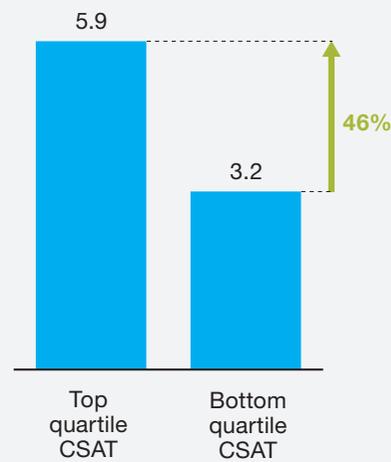
Real differences in customer satisfaction¹

CSAT (Percent of customers rating 9 or 10)



Leaders in customer experience are growing faster

Deposit CAGR (2014-17)



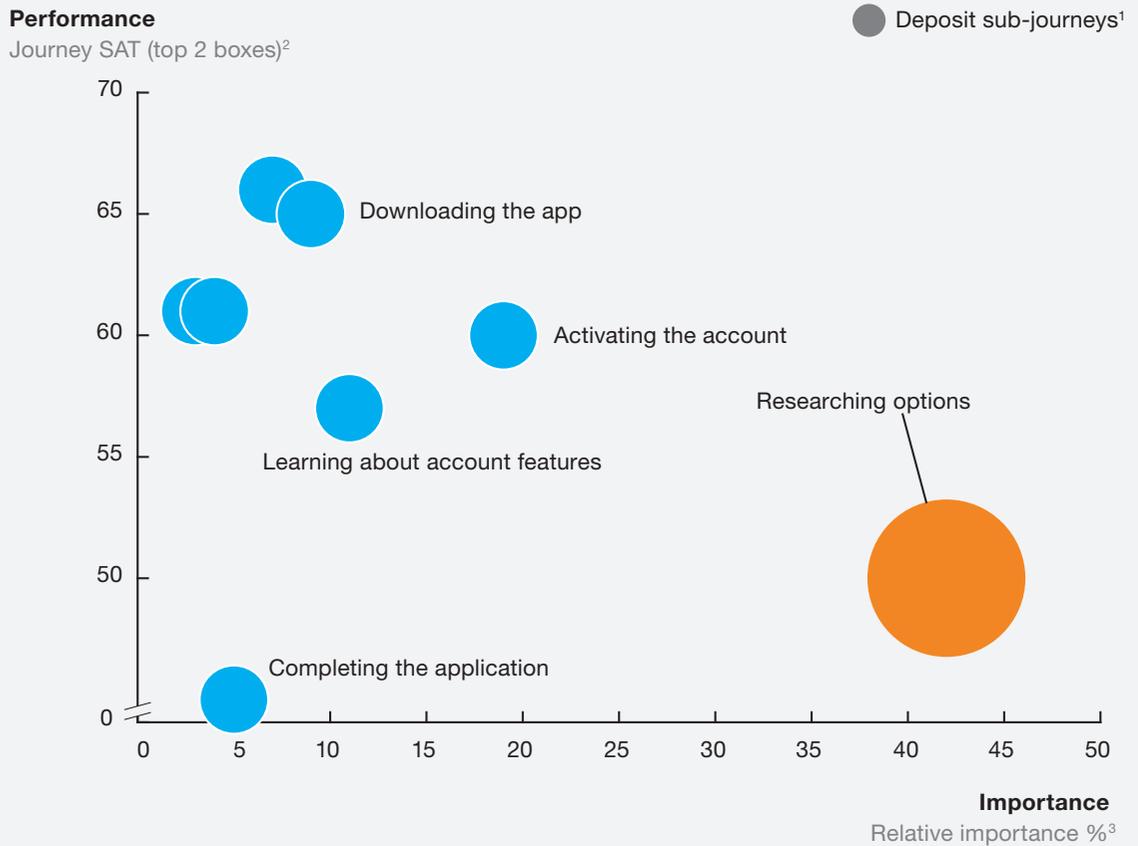
¹ Percentage of respondents that selected a 9 or 10 on a 10-point customer satisfaction scale. Question: "We would like to understand your experience with [product] with [Bank]. Overall, how satisfied or dissatisfied are you with [product] with [Bank]?" Source: McKinsey 2018 Retail Banking Customer Experience Benchmark Survey.

advice, or issue resolution. One wealth manager equipped its front-line relationship managers with robo-advice algorithms that are in sync with what customers see on the self-directed channel—and provided the RMs with daily and weekly next-best-action recommendations to nudge their clients. Banks need to deploy these tools broadly and empower their front-line staff to play a more consultative role that blends human and digital recommendations. They will also need to revisit how these employees are incentivized, shifting to a longer-term view of relationships and profitability rather than just product sales.

- *Translate data into personalized products and real-time offers.* The amount of data available on individual customers or prospects has exploded in recent years. The challenge is to convert this data into actionable nudges and highly relevant offers for customers that are delivered at the right moment. Credit card companies have long offered discounts on specific spending categories or with specific retailers. Today, however, they can improve loyalty and share of spending by providing location-specific offers right when a customer enters a coffee shop, movie theater, or car dealership. South

Exhibit 6

Banks should prioritize the sub-journeys the have the most impact on customer experience.



¹ Deposit example journeys shown; trend also holds true for credit card and mortgage account-opening sub-journeys.

² Customer satisfaction with individual sub-journeys. Represents percentage of customers that rated the sub-journey 9 or 10 (on 10-point scale).

³ Relative importance is the amount that any individual sub-journey impacts the total journey score; calculated using a variance decomposition approach.

Source: McKinsey 2018 North American Retail Banking Journey Benchmarks

Africa's Discovery, as an example, is launching a bank with product features that are informed by behavioral science and incentive design research (e.g., dynamic interest rates for savings and credit products that are tied to healthy financial behavior).

3. Productivity gains and returns to scale are back

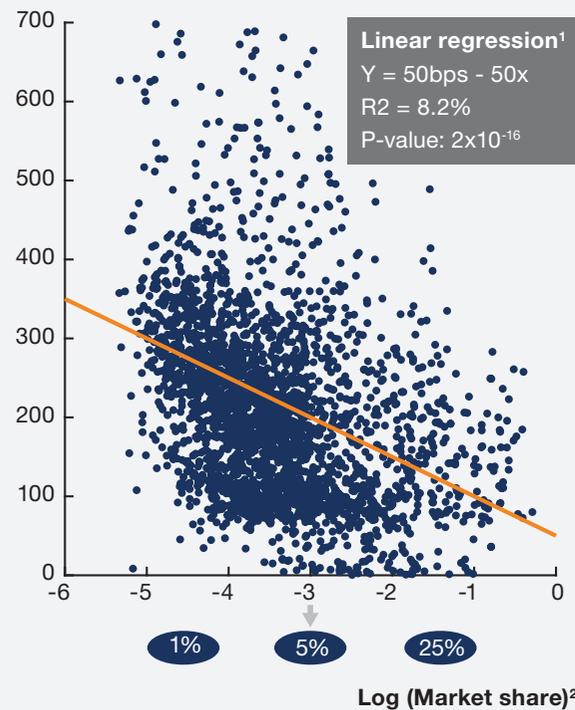
Larger retail banks have historically tended to be more efficient than their smaller competitors, benefiting from distribution network effects and the shared overhead for IT, infrastructure, and other shared services. Our analysis of over 3,000

Exhibit 7

The efficiency advantage for large retail banks holds true on a global level.

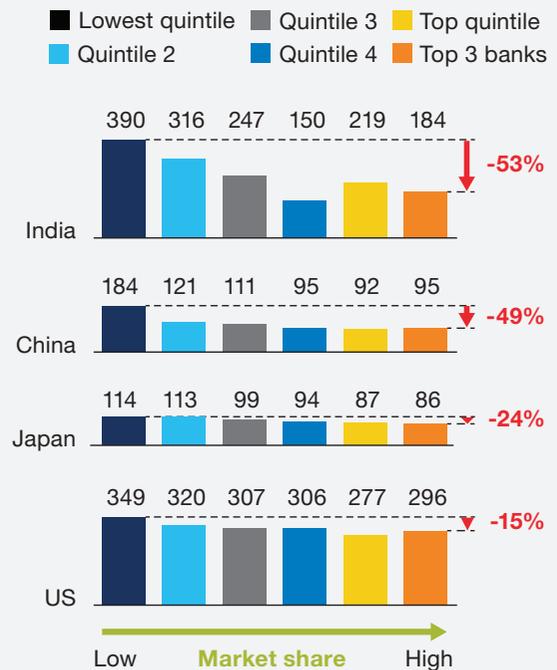
Average cost to assets

2015-2017 C/A, bps



Country examples³

2015-17 C/A, bps



¹ Linear regression based on sample of ~3000 banks (all countries included with a sample size larger than 30).

² Market share defined as bank's asset size divided by total assets of banks from the specific country.

³ Quintiles based on market share.

Source: S&P Global Market Intelligence; McKinsey Panorama

banks around the globe shows that while there is variation across countries, larger institutions tend to be more efficient both in terms of cost-to-asset (Exhibit 7) and cost-to-income ratios. However, beyond a certain point, even larger institutions struggle to eke out efficiencies or realize benefits from scale. For example, even after several years of cost-cutting after the most recent financial crisis, large US retail banks have not made material improvements in productivity over the past decade (Exhibit 8).

We expect this paradigm to change over the next few years, as structural improvements in efficiency ratios and increasing returns to scale enable some large banks to become even more efficient. The reason is two-fold: first, advances in technologies such as robotic process automation, machine learning, and cognitive artificial intelligence—many of which are now mainstream and commercially viable—are unleashing a new wave of productivity improvements for financial institutions. Deployed effectively, these tools can reduce costs by as

Exhibit 8

Most large US retail banks have struggled to improve productivity beyond a narrow efficiency band.

Evolution of cost/income ratio for leading banks¹

Cost/income ratio



¹ Top 25 US banks by deposits in transaction accounts.
Source: SNL; McKinsey analysis

much as 30 to 40 percent in customer-facing, middle-, and back-office activities, and fundamentally change how work is done. Dramatic change has already taken place in banking sectors such as capital markets, where algorithmic trading and automation are radically changing the talent profile and making a significant portion of existing jobs redundant.

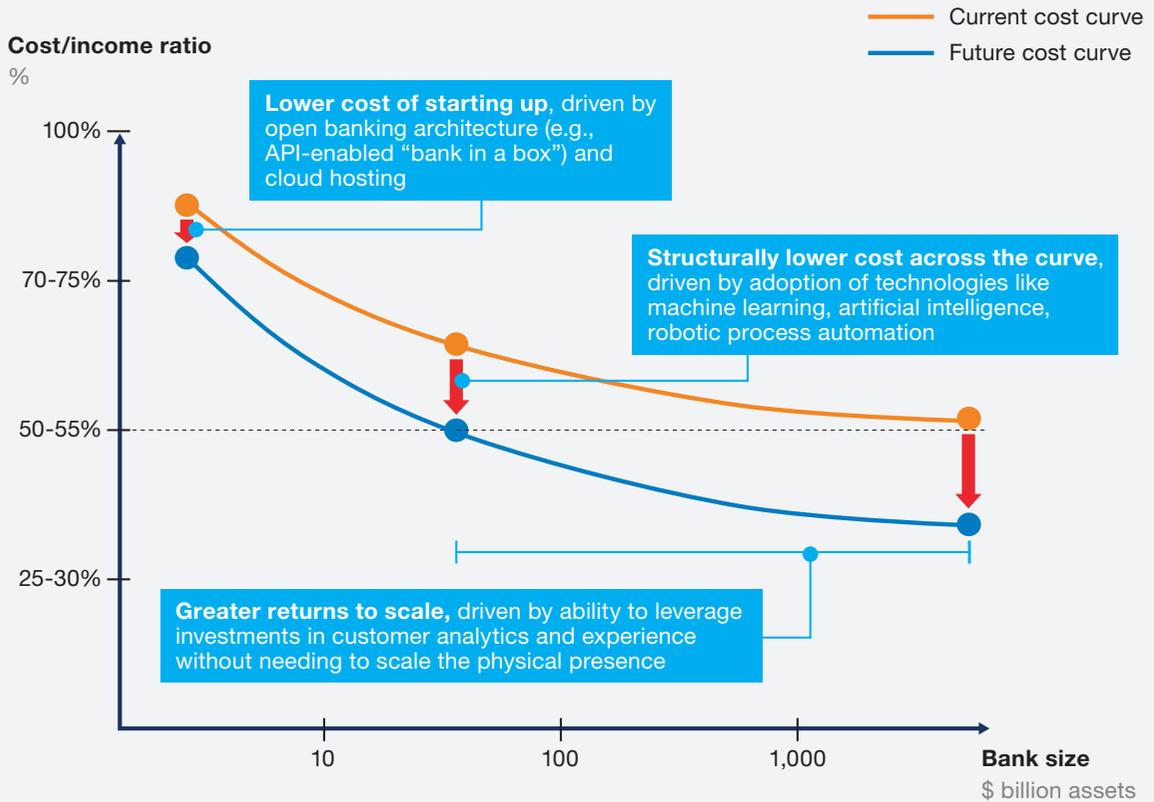
The second factor leading to a wave of productivity improvement in retail banking is the shift from physical to digital channels for

customer acquisition. Banks with scale—and skills in leveraging that advantage—will achieve customer acquisition costs of up to two to three times lower than their smaller peers. Their outsized volumes of customer data will lead to better targeting and funnel conversion. As investments are shifted toward digital channels, the productivity gap between large and small banks will widen (Exhibit 9).

This dynamic has played out in more digitally mature industries, with firms like Amazon and

Exhibit 9

Over the next 5 years, we expect the industry cost curve to shift fundamentally downward, with greater returns to scale for larger institutions.



Source: SNL; S&P Market Intelligence; McKinsey analysis

Priceline acquiring customers at a significantly lower cost than competitors. As in these industries, eventually a limited number of dominant banks will emerge, squeezing out undifferentiated mid-sized and smaller banks. There are early signs of this trend: undifferentiated smaller community banks in the US have lost a significant share of deposits over the last two to three years, while the three largest banks have gained share. Of course, scale is not everything. Banks that succeed in this new wave of productivity will also have taken the following actions:

- *Use cutting-edge technology to automate:* Over the next few years, banks will increase their use of technologies such as natural language processing and artificial intelligence to automate customer-facing interactions and complex internal tasks. Already, legal and compliance departments are automating the extraction of data from documents and using algorithms to triage suspicious patterns for manual review. One leading global institution recently revamped its customer-care process with a raft of new technologies to identify potential FTE reductions

of more than 30 percent, and a North American bank used automation technologies to identify efficiency improvements of 20 percent in its finance function.

- *Build and reinforce the brand:* With rising digital sales consumers have more choice than ever in selecting a financial services provider. However, our research shows that across most categories consumers actively consider only two to three products before deciding on a purchase. So it remains as important as ever for a bank to be part of the initial consideration set. Brands with superior awareness and recognition are not only more likely to be part of the initial consideration set but also achieve higher conversion rates than lesser-known brands when they are considered. A leading credit card provider in a major European market that invested heavily in brand awareness is now twice as likely to be actively considered—by 17 percent of consumers versus 7 to 10 percent for other brands—and experiences 50 percent higher conversion when considered compared to lesser-known brands.² The returns enjoyed by banks with superior recognition—in the form of lower acquisition costs—reinforce the benefits of scale and will be an advantage over time for larger institutions that can invest heavily in building and reinforcing their brand.

4. The unbundling and “rebundling” of retail banking

The tight one-on-one retail banking relationships of old are unbundling. Forty percent of US households today hold a deposit account with more than one institution. It is common to have a mortgage with one bank, an unsecured loan with

a different lender, and separate deposit and investment accounts. The banking relationship is fragmenting even faster in countries with higher digital adoption, such as the Netherlands and the UK, where the percentage of customers that use more than two providers has increased by 20 percent over the past five years.

This decline of customer loyalty provides a perfect context for firms seeking to enter banking in a selective way—focusing on the most profitable segments. Some attackers have demonstrated that despite incumbent banks’ access to much more customer data, they can compete effectively on customer experience coupled with aggressive pricing to gain share. New entrants in financial services typically begin by focusing on a niche—making either a product or segment-focused play. For example, Wealthfront and Personal Capital in the US began with a sharp focus on mass affluent customers—providing robo advice aligned with financial goals at far less cost than traditional financial advisors. SoFi focused first on recent graduates from elite colleges, using student loan refi as a hook product. Their ambition, however, is to own the full banking relationship of this segment over time—providing cards, mortgage products, and broader banking services—although it remains to be seen how feasible this will prove in practice.

The Open Banking movement, heralded by Europe’s second Payments Service Directive and the UK’s Open Banking Standards, has the potential to accelerate the unbundling of banking in the regions where it applies, leading to increasingly intense competition over the next few years.³ The requirement for banks to share data and provide access to consumer and small

² January 2018 McKinsey research on 8,000 UK credit card applicants.

³ Alessio Botta, Nunzio Digiaco, Reinhard Höll, and Liz Oakes, “PSD2: Taking advantage of open-banking disruption,”

business accounts through a common framework of APIs is likely to fuel a wave of innovation and level the playing field for fintechs and technology providers seeking entry through payments or consumer financing. Recent McKinsey research shows that consumers are most interested in marketplace concepts that simplify comparisons and make it easier to switch between providers based on their needs and preferences.

The trend toward unbundling in financial services is well under way, but where it will lead is still an open question. In industries such as music, television, ecommerce, and transportation, digital distribution led to unbundling that destroyed value for incumbents in the short term; over time, consumers tend to converge on a single provider—often an attacker. In this context, firms that effectively orchestrate platform or ecosystem environments tend to eventually emerge as winners.

The history of the music industry over the last 20 years provides a possible model for how things will go in banking (Exhibit 10). Until the 1990s, music distribution was dominated by stores selling tracks that record companies “bundled” onto albums. In the early 2000s, digital distribution, especially via iTunes, radically reduced distribution costs. Consumers could now “unbundle” albums by purchasing individual tracks online; not surprisingly, many record stores went out of business. Over the past few years, however, we have seen a “rebundling” in the form of the streaming playlist. Streaming services are now the dominant distribution channel, with a few large players such as Spotify and Apple emerging as winners. The success of these platforms is based on their ability to create highly personalized bundles based on consumer needs and preferences, and a superior interface without the friction of purchasing tracks individually. Leaders have created significant value for consumers by using customer data and insights

to deliver a superior experience, rather than by manufacturing the underlying product.

If we apply this scenario to banking, winning firms will be those that leverage superior access to customer data to provide truly differentiated and cutting-edge experiences—potentially extending beyond financial products and services. To do this effectively, banks will need to retain privileged access to information about consumers’ sources and use of funds, especially through payments and transaction activity. Banks that rebundle effectively will use this data to deliver compelling and integrated experiences that provide seamless funding, investment, payments, and money movement capabilities. The bottom line is that in order to reverse the unbundling of financial services, banks need to make it worthwhile for consumers to have a relationship with one institution; they need to deliver not only simplicity and convenience, but also superior value. Only a few banks in each market are likely to be able to succeed with this strategy.

Already, large technology firms such as Amazon are extending into parts of the financial services value chain, starting with areas where they have a data advantage such as payments, short-term financing for purchases, and working capital loans for merchants on their platform. To counter the unbundling of their most profitable products, banks need to develop capabilities that few currently possess, and follow the lead of successful technology platforms:

- *Retain superior access to data on transactions and financial behavior:* As vast amounts of data are captured by tech firms on consumers’ behavior and preferences, one of the last bastions of valuable information is data on transactions and financial behavior. To retain unparalleled access to this data, banks will need to continue to own the transaction

able to leverage insights to create unique offerings—for example, cash in a checking account could automatically be optimized for return based on financial behaviors and spend patterns without needing to ring-fence and transfer it to a separate high-yield deposit or brokerage account. Or, when a customer takes a short-term unsecured loan the rate might be optimized based on the steadiness of their income stream and savings accumulated each month, and they could collateralize against balances in other accounts with the bank.

- *Extend beyond purely financial services and products over time:* There are a couple of clear benefits that financial institutions are likely to have relative to ecosystems being created by large tech firms. Superior access to financial information enables them to create faster and more precise offers for big-ticket products that have financing needs associated with them (e.g., homes or cars). For these types of products, banks could be well-positioned to own the full customer journey,

including the browsing experience and the transaction. One Northern European bank has developed a mobile app that integrates house searches, booking viewings, budgeting, transactions, and help with setting up a new home (e.g., utilities, appliances, and renovation).⁴ In the US, Capital One's Auto Navigator facilitates a seamless search experience for car buyers and can provide instant approval for financing before they visit a dealership.

⁴ Miklós Dietz, Reka Hamvai, Paul Jenkins, Miklos Radnai, and Michael Yee, "Deep insights, broad solutions: How banks can win in the vast housing ecosystem," McKinsey.com, June 2018.

The path forward

In the near term, competition in retail banking is likely to intensify, with only a few banks emerging as winners. These banks will take bold steps now to establish a formidable position that fends off new entrants and smaller attackers. Retail banking leaders should consider and debate the following questions as they face the challenges of the coming years:

1. What is our strategy to increase customer growth over the next three to five years, not just protect existing share of wallet?
2. How bold can we be with our distribution plan, and will it be effective two to three years from now?
3. Are we on track to deliver a superior customer experience in the next 12 months? What capabilities will differentiate us from the competition?
4. How can we deploy new technologies to reduce our cost structure? Are we building the

infrastructure to capture and harness data so we can benefit from scale?

5. Do we need to reposition or reinforce our brand, or develop new attacker brands, to tap into new customer segments?
6. Are we prepared for the impact of Open Banking and similar rules that pave the way for attackers and fintechs? What offensive and defensive moves do we need to make?
7. How do we position ourselves to rebundle products and services around customer needs? How should we design our platform and what partnerships should we pursue?

Our view is that retail banking is at an inflection point, and that the pace of change will accelerate significantly over the next three to five years. Success will require clarity in direction, and speed and agility in execution. Retail banks that capitalize on current shifts in the market will emerge with a winning position in their core markets and begin to compete across borders.

Vaibhav Gujral is a partner and **Nick Malik** is a senior partner, both in McKinsey's New York office. **Zubin Taraporevala** is a senior partner in the London office.

The authors would like to thank Ashwin Adarkar, Jacob Dahl, Filippo Delzi, Miklos Dietz, Dave Elzinga, Darius Imregun, Somesh Khanna, Marc Levesque, Alejandro Martinez, and Robert Schiff for their contributions to this article.

