RESHAPING BANKING FOR CHANGING TIMES

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Modern Banking - the current scenario

Banking has never been commoditized to the extent we see it today in the 21st century. The expectations of clients from the banking system have varied from custodian to borrowings to financial advisory all under one roof. It is correct to say Modern Banking today is a reinvention of old banking in a new form of delivery. Traditional deposits and lending of deposits hold a lot of sway in Asian markets as it did prior to the financial crisis. The success of the recipe has led to experimenting with the old model which is a far cry from the old banking. Borrower requirements are essentially short term even for long term projects. The financial crisis showed what is important is capital and capital is a function of profits and profits are a function of risk taking. Therefore modern banking has in effect every intention of making the customer a slave of the banking system. "A customer forever and a day".

The service element compares readily with the FMCG industry while the good that is consumed is money which is the bane of the controllers within and outside the banking institutions. How much of service is good for clients? How much of service could be offered without sacrificing the sanctity of banking, the principles of risk and reward which are the bedrock on which a bank's business strategy would be formed.Banks would seek to protect and reinforce their core businesses. A clear difference to traditional banking is the fierce competition that banks face from within and outside the industry which has made banks look at the cost structures with utmost care. They need to trim the fat without cutting the muscle. Banks have huge advertising spend, IT spend and entertainment spend. Over the years the budgets have ballooned for these items with the return on investment lagging behind expected targets. Advertising could be a situation of tiger by the tail rather than increased market share while entertainment beyond a limit would breed ever high expectations in the customer's mind without the bank's ability to generate revenue commensurate with such expenditure. IT expenditure has not kept pace with IT infrastructure utilization for decision making which would enable the realization of economies of scale and management information for business initiatives.

The service element which was exemplified in Relationship Banking has had its backlash in recent times during the financial crisis where confidence levels in the banking sector staff plummeted. However customer expectations are too high to exit from this model to automated banking or impersonal banking which is not a viable proposition for banks. A lot is expected from banks coupled with the age old trust which is the tight rope walk bankers need to walk in catering to high expectations. The regulator has caused natural attrition of expectations in this environment which in a manner of speaking has contributed to the bank's sustainability although causing obstacles to innovation, growth and talent retention within the industry.

The Business Model

The model is based strictly upon the strategy which in turn is based on whom a bank wishes to serve, which financial needs of the target groups it wishes to cater to, which mode/ modes of delivery the bank wishes to use and the bank's ability to train and retain a motivated well performing staff over a long period of time. Accordingly models could be based on delivery systems, relationship banking, innovation or a niche player.

The current climate in the industry promotes consolidation which has indicated to banks in Sri Lanka that size matters and whilst too big to fail was the norm during the financial crisis it is followed by too small to succeed. The early nineties of the 20th century saw a number of new entrants to the industry one or two of which were unsuccessful. Subsequent developments saw a few additional players who entered the industry and struggle for survival in the face of changing economic and social climates.

The future business models will be based on the agility of banks to read macroeconomic shifts, understanding customer needs and complying with regulations.

Future Trends in Banking in Sri Lanka

Low spreads

The spreads have been narrowing continuously as benchmark rates have lost their relevance and context in which they are set. The deposit rate and the prime lending rate have been more or less equal for many weeks now. Low spreads would be a permanent feature in our markets necessitating the diversification of assets in the industry.

Asset growth headwinds

The requirement for capital has increased for the sector by as much as 300 per cent over the last decade. The banks which were well managed, profitable have been able to maintain their capital levels without too much of an effort while the others who grew faster than their capital levels permitted had to return to the shareholders and issue subordinated debt to boost their capital levels. Both types have discovered that in a low spread environment it is growth that would lead to survival rather than a high margin low volume business. In this regard the next in the sequence would be asset quality which would deteriorate with ambitious growth which require impairment charges and affect profits for which a higher capital level would be required. Therefore the trend is that growth for Sri Lankan banks would be costly and growth would require infrastructure changes.

Rise of Retail Banking

This would be a direct result of the rise in living standards in the country. The Generation Y or the Millenials banking requirements call for products which were not offered by banks before. This is where partnerships with IT service and solution providers, distributors and networks and offering platform and trust becomes crucial for banks. A new generation of customers do not want to come to the bank and wish the bank to come to them at their time. Margins in the retail sector are notably higher and requires comparatively less evaluation than a corporate credit transaction which enables the commoditization of the products offered.

Ageing population with demand for accumulation products such as pensions and drawdown products such as annuities is also increasing. The interest rates will stabilize over a period at a corrected level which will bring forth a host of such products again offered by the trusted agency, viz banks. The tie ups here are different. However some of the same needs of the Millenials could be witnessed in this group as they too may not be able to come to the bank physically. However this group may not be very technology savvy which means delivery channels have to be thought through in an innovative manner.

Advertising

Social Media as a mode of advertising will soon overtake the traditional print, voice and electronic media.

CSR

Customers, specially in Asia are anticipating reputed banks to engage in CSR even in tough economic times. Therefore banks would need to spend more time and funds on CSR which may need the forming of specialised CSR staff.

Engagement Banking

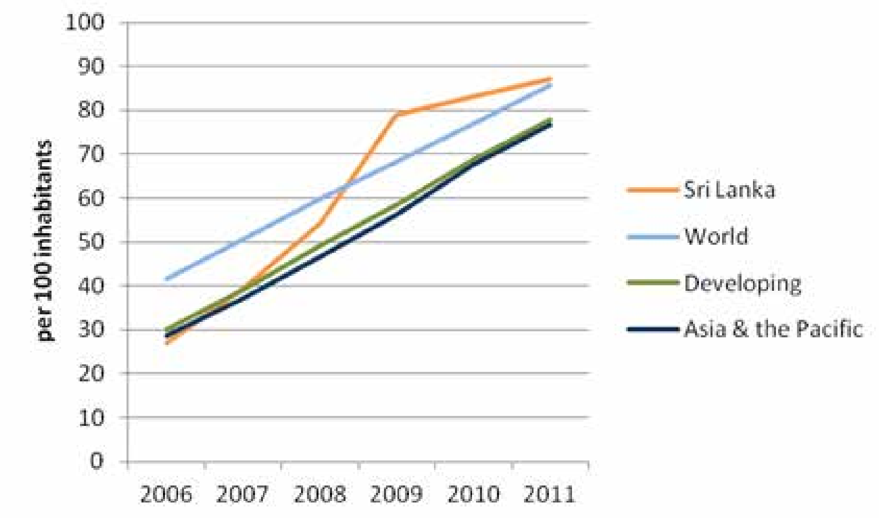
The customer of the future requires the bank to be contextual in their life. The designing of all advertising and document material is crucial to engage the customer. The reams of information required from the customer requires to be simplified still keeping the regulator satisfied. The experience with a bank for a first time customer is a lifetime opportunity which should be harnessed to the fullest as customers always remember their first experience.

Networks and Virtual Banking

Real estate costs money and in more developed cities in Asia the prices of real estate have been climbing rapidly. Every square meter requires staff, rent and rates which are avoidable costs to the bank. Virtual banking is the answer. In Sri Lanka internet penetration is increasing. There are nearly two million internet users in Sri Lanka, representing 14 percent of the population. Of this, 1.2 million users access the internet weekly or more often with the majority being in the 15 to 25 years age group where internet usage is as high as 26 percent. (Source Nielsen Sri Lanka; March 2011). This percentage has seen a tremendous increase in its rate of growth over the past five years. Banks can no longer evade the digital media revolution citing that internet penetration is insignificant. That would be a myopic view. Therefore it is crucial to understand how the population accesses internet.

The graph below indicates that Sri Lanka's mobile phone usage is higher than the regional average.

Graph 1- Mobile Cellular Penetration in Sri Lanka 2006-2011



Source: International Telecommunication Union(ITU) Statistical Market Overview-Sri Lanka

Natural disasters have struck many Asian countries such as Sri Lanka, Japan and South Korea. Hence the danger to physical property is ever present which is another compulsion for virtual banking.

High cost of regulation

Regulation is here to stay and based on the developments in the developed world Asia still has some leeway in terms of regulation. The flip side of the coin is that as a developing country the cost of regulation itself is a deterrent to financial inclusion and the ability to offer retail banking products without passing the cost to the customer.

The Business Model would be based on the following goals of a bank:

1. Balance sheet size

The regulator in their current policy framework (Financial Consolidation of Sri Lanka presented by the honourable Governor CBSL, 17th January 2014) encourages big banks with three types of banks. These will be the mega, specialized. There will be one large Development Bank and smaller banks. The mega banks would have assets exceeding 1 Rs trillion and have a regional presence while the smaller banks would have assets exceeding 100 Rs billion. Each bank would select their slot based on their consolidation plans.

2. Digital strategy-reach and channels

Identity management and trust would keep banks in business which are key ingredients in online banking. The challenge is to surf the data without drowning in data.The whole purpose is data is for it to be processed into useful information to deepen customer relationships and increase intimacy.Partnering providers of innovative services will ensure safer faster consistent distribution using bank platforms.

There are four types of service centres/strategies which appear to be taking shape in the modern banking era of the new millennium second decade in Asia and Sri Lanka.

a) Smaller branches with effective segmentation

The branch strategy today appears to be that more is better. However some branches have an idle squarefoot space where footfall is less. In these situations it is best to effectively segment based on market demographics and realign branches.

b) Wealth management centres

In Asia the high networth individual is treasured and closely held by banks to ensure loyalty. These centres are still required and would have a role to play even in the era of virtual banking. The challenge here is to retain a trained, financially literate staff who could provide financial advisory services.

c) Reduced virtual banking fees

The savings from not paying for brick and mortar may mean that virtual banking customers can enjoy lower servicing and investment management fees. There are also cost savings from a cash management standpoint, in terms of reduced expenses for tellers, transport, insurance and storage, and the opportunity to segment customers into more clearly differentiated consumer groups.

On the other hand, if there are enough useful online banking services, consumers might even agree to higher virtual banking surcharges in exchange for greater convenience. In fact this is an opportunity for banks to increase fee income in a world of diminishing and disappearing interest margins.

d) Online security services

Higher security and more functionality will be required before banks can serve their virtual banking customers through computers or mobile platforms such as their smart phones and tablets. With more virtual banking will come the demand for more secure online banking solutions. This could involve anything from signature recognition programs or fingerprint scans or even voice recognition. Once banks can securely verify the virtual identity of their customers, they will be able to conduct virtual face-to-face services more cost-efficiently through video conferencing and screen-sharing functions. It would also be more convenient for customers to discuss their financial situations with someone that they can put a face to, and save time from not having to visit a branch. In a Sri Lankan context based on the size of the Island the need for total virtual banking would not be that acute as in countries like Malaysia and Indonesia where the customers have to commute vast distances. However as opposed to this fact the burgeoning internet and mobile penetration make it imperative that at least semi-virtual banking would be required due to tech savvyness and time consideration.

The final decision for a virtual banking strategy would depend on cost and regulatory considerations.

3. Organic /inorganic growth

In terms of the Sri Lankan banking landscape, inorganic growth appears to be the most obvious strategy. Inorganic growth is usually considered when there are synergies to be exploited. The usual synergies are products, systems, marketshare and human and physical resources.

4. Using social media as a marketing tool

Social media is one of the cheapest marketing tools. Banks have generally lagged behind other corporates in using this as a media. Even international banks mostly use their Twitter accounts to make corporate announcements. Some banks in the west have gone ahead with a social media strategy where there is a separate page for the bank and customers are encouraged to share ideas and discuss just like any other facebook page. Whilst this may encourage all types of comments some which the bank may find damaging to their reputation the thinking that has been employed is that it is better to have criticism out in the open so that the bank could deal with it quickly and effectively.

It may be sometime before a Sri Lankan bank would be able to implement the same strategy but we are not very far away from doing it. The early adopters would reap the benefits and suffer the guinea pig syndrome as well. Social media is the cheapest possible way to do crowdsourcing,viz information of customers and what they think of you which is wonderful for strategy formulation and implementation. Indeed it is a great promotional tool as well as forum for conducting polls. In the west after the financial crisis social media has been used by banks to ensure transparency and build trust.

In Asia this is not a priority and due to the cultural setting it would be counterproductive. It is crucial to ensure that all divisions of the bank are geared to deal with the issues and challenges brought forth by using social media actively. Since the institution is in the public eye as never before the corporate communications, call centres, operations and publicity staff have to be of very high quality and with a focused training to handle customer complaints.

In Malaysia CIMB has developed an application which is available on mobile devices so that any news flashes on product releases etc could be immediately downloaded through social media while the customer is on the move. Social media should be highly acceptable to Asians who are collectivistic and community minded by nature. It is a good opportunity for the banks to group product information at targeted group who could discuss openly which is not possible through any other media on an online real time basis.Social and digital media can allow banks to communicate with niche segments and targeted audiences.

Social media users share their interests on social sites, directly and indirectly, and that allows you to target and attract audiences based on their interests. Knowing their interests allows you to create messaging that ties into topics that are important to them and may indirectly lead them to the bank. It's important to use social media to develop long term relationships through educational and lifestyle content, so when the users do have a banking need your bank is top of mind.Social media pages that have been opened by Sri Lankan corporates are performing excellently while the banks appear to have used the tool sparingly if not at all. The banks are not in the top 25 list of most visited facebook pages in the country as tracked by Viber Lanka.

Another key aspect to social media usage is the checklist for compliance for which software companies are producing applications so that both marketing and compliance could coordinate the content which is published.

5. Target market segment

While each bank will decide on the target market it wishes toserve, it is imperative that the bank has critical mass in whatever they offer to the targeted segment. The foregoing paragraphs articulated the demographic changes and habits of the Sri Lankan population which would be the starting point to select the segment. The future banking would endeavour to cater to more segments than the current banking. The rationale is that target markets habits are changing and hence building infrastructure and training staff to cater to a niche market would be a key strategy that would formulate all marketing decisions from the beginning. The future banking could encompass many segments due to the delivery, ability to be agile and the digi era.

6. Product portfolio and retail banking

Retail products would dominate the future banking product spectrum. The retail banking product suite would include both liability and asset products with scalability and granularity in a full package. The products should span the ages and the needs. In an era of convenience and time saving being multi-banked could be a headache to the customer who wishes to have a transparent fair banking solution. Commoditisation of banking clearly linked to retail banking as this is where the customer would consider the bank counters as a shopfront to obtain all his financial and banking requirements. If the customer has to go to a different bank for one of his requirements the bank's product suite has failed the customer. The following simple diagram illustrates the reachout to and from a customer with the bank.

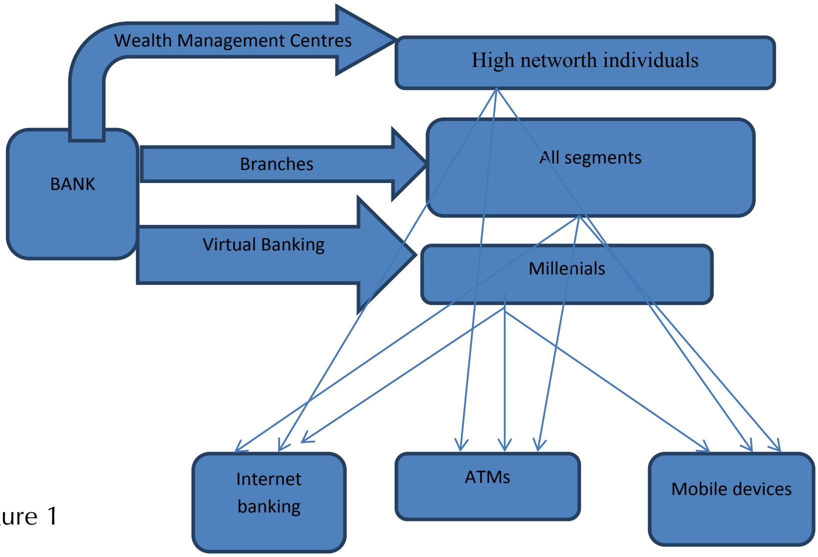


Figure 1

7. External focus

The stakeholders of a bank are many ranging from employees, owners/shareholders and bond holders, customers, regulators, rating agencies and the media. The bank's positioning will determine its external focus. For example in future a bank would decide which parameters are important to the organization in forming the external focus such as, credit rating, profitability, image, ethical and other compliance, corporate social responsibility etc. In all of these the bank would prioritise after meeting with minimum or comfortable tolerance levels for compliance and regulatory requirements.A bank with a AAA rating may or may not be the most profitable under stringent capital and risk management criteria. However a bank may well attain all financial goals with quite an acceptable rating of AA. These are intelligent choices that a bank would need to make in determining their business model.

8. People

In this highly people driven business future banks would invest much more in human capital than they did before. Technology, disaster planning and business process reengineering all initiatives would require investments in people. It is predicted that there will be further specialization in banking rather than generalists to cater to very specialized requirements of IT systems, regulators and of course the customers. At least 20% to 30% of bank staff would need to have specilised IT skills and training to manage all planned IT implementations and another 20% in training in risk and security management of the systems implemented. Hence the sector would employ more manpower in different skill categories.

People from non-financial organisations would require to be attracted to the banking sector with different pay and career structures to career generalist bankers.

9. Security

Security is all about cementing the weak link. The links would be many in future banking with virtual banking and IT driven applications delivering banking solutions in the coming years. Need for physical security will remain but need for data security will increase by manifold. Authentication and accountability for e banking transactions, physical security measures such as graded access control, iris and x-ray scanners, CCTV and detection systems, hotline and wireless links, fingerprint readers, various sensors and concealed cameras would be required in plenty.

10. Regulatory Stance

Future banking of Sri Lanka would depend greatly on the regulator being able to provide a climate which is conducive for free innovation in technology and related product development. Human resources training in the IT field by the regulator too would be mandatory.

Conclusion

Sri Lanka would be easily able to deliver and march into future banking with its leterate workforce, IT savvyness of its people, developed payment systems and the excellent telecommunication structure.