**Retail banks**

In vogue

**Despite low interest rates and dismal returns, there is hot competition for customer deposits**

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WITH REGULATORS TURNING off the tap that used to allow investment banks to draw easy profits, the industry is looking to retail banking for new sources of earnings. This is a huge business. In America retail and commercial banking generate revenues of some $750 billion a year, or just over 20% of total global banking revenue, according to Novantas, a consulting firm. And in Europe, where capital markets are still less developed than in America, the fortunes of most big banking groups will depend on how their retail banks are doing over the next few years.

An equally pressing reason for the sudden revival of big banks’ interest in the tedious business of taking deposits and processing payments is that they can no longer rely on wholesale money markets for most of their funding because that would leave them vulnerable to sudden freezes. Those that depend on short-term wholesale funding are required to pay higher interest rates, have lower credit ratings and are subject to closer scrutiny from regulators. Basel 3, along with raising the amount of capital that banks have to hold, will also encourage them to get more of their funding from sources that are less fickle than the money markets. Among the best of these are deposits from retail customers. Regulators love these because they are “sticky”: ordinary savers tend not to move their funds around. So banks that wish to survive, never mind prosper, will have to compete a lot harder than they used to for the deposits and cheque accounts of millions of retail and small business customers. They would do well to look at emerging markets, which have seen some of the most exciting developments in retail banking in recent years. Banks there are leapfrogging their rich-world rivals in efficiency, technology and innovation.

“This is the branch,” says Om Prakash Bhatt, the recently retired chairman of State Bank of India (SBI), pulling his mobile phone out of his pocket. It seems an outlandish thing to say for a man who until April ran a seemingly hidebound state-owned institution so vast that if it were transplanted to America it would account for about one-sixth of all bank branches there. A decade ago SBI might have confirmed many prejudices about big state banks in poor countries. Despite a mission to serve the poor, its clients were mainly urban bureaucrats. At a time when banks elsewhere were installing huge mainframe computers, SBI balanced its books by hand. Customer payments took almost a month to process and were sent on bits of paper, couriered from one branch to another.

Now SBI and some of its emerging-market peers are teaching the world how to use technology to lower the cost of retail banking, using mobile phones, portable ATMs and the internet. “The really outstanding innovation is coming from emerging markets,” says Noel Gordon of Accenture, a consulting firm. “They are using the unbanked as a big laboratory to pilot new ways of banking.”

Banks in emerging markets have benefited from investing in technology late in the day. Most of them missed out on the mainframe era, which has left many rich-world banks saddled with ageing and inflexible computer systems. Instead they started spending money at a time when computing power was getting cheaper and becoming integrated with communications systems such as the internet and mobile phones. Whatever market you are in, being able to use zippy new computers is “an unbelievable advantage”, says Vernon Hill, who founded America’s Commerce Bancorp in 1973 and saw it grow from a single branch to 435 before its sale to Canada’s TD Bank in 2008. He recently opened Metro Bank, Britain’s newest retail bank.

Innovation in emerging markets was also prompted by the need to supply a huge market that is hungry for banking. In rural India seasonal farm labourers have work for only about five months of the year, so they need some way of saving. In the past they would buy kitchen utensils and keep them unused, then sell them back to the merchant for a 10% discount when they needed money for food, says Janmejaya Sinha of the Boston Consulting Group in Mumbai. Now technology is supplanting kitchen utensils.

To reach remote villages, SBI is appointing agents equipped with mobile phones attached to card readers. Customers swipe their savings card on the phone and hand their deposit to the agent who pockets the money. When they wish to make a withdrawal, he reaches into his pocket for the cash. The phone really is the branch, extraordinary though it may seem, and it is taking SBI into 100,000 villages that have no other banks. ICICI, India’s second-biggest bank, has a similar system of reaching out that is changing the economics of banking. “Transaction values and revenues in the Indian context are much lower, maybe one-tenth of Western banks,” says Chanda Kochhar, ICICI’s chief executive. “So we have no option but to adapt our technology strategy to this.”

In Kenya phone companies have surged ahead of the banks. About 60% of adults there use M-PESA, a system that allows them to transfer money from one mobile phone to another. Yet under a quarter of Kenyans have bank accounts.

Developing countries are also thinking about branch-based banking in new ways. One of Malaysia’s fastest-growing banks is RHB’s Easy, which is open seven days a week and has no forms for customers to fill in. “It is like a McDonald’s,” says Mr Sinha. “It only has about five things on the menu but then everything happens in less than ten minutes.”

This explosion of creativity is producing rich rewards. Banks in many emerging markets are growing at 20-25% a year, sometimes more. Many banks are reporting returns on equity of 20-25%, so they should be able to generate enough capital from their own profits to keep up as Basel 3 raises the bar.

Might these banks try to apply the lessons from their home markets to expand in America or Europe? Not for the moment, mainly because they are running as fast as they can to keep up with growth at home. “Why would I go there when I am growing at 35% a year here?” asks HDFC’s Mr Puri.

Even so, the new ways of banking that they have invented are starting to make their way into developed countries. None is more ripe for this change than America, the world’s richest banking market. The plethora of new laws and regulations that American politicians and regulators have introduced to make banking safer includes several concerning retail banking that seem designed to do the opposite. Some of the new restrictions may fundamentally change the way in which retail banks do business and their customers use banking services.

The first challenge to American retail banks will come from two pieces of legislation intended to force big banks to cut the fees they can charge for overdrafts and debit-card transactions. Both laws are meant to protect consumers by ending the cross-subsidies used by banks to make cheque accounts appear free to their holders. Consumers are not charged when they use a debit card in a store or online, but retailers pay a small transaction fee each time the card is swiped. These fees add up to rather large sums. If retail banking fees are cut by 70% or so, as has been proposed, American banks may lose around $33 billion a year, or about a third of their profits from this part of their business last year, says Sherief Meleis of Novantas, the consultancy.

Prudent but poor households will be the first to suffer. They have free bank accounts that are currently subsidised by richer customers with big savings balances and the financially disorganised who pay penalties for unauthorised overdrafts. Estimates vary, but the new rules may well make about one bank customer in ten unprofitable. Banks may also be tempted to close about one in 20 branches.

Several big banks have already responded by charging customers monthly account fees or asking for minimum balances to be maintained on their accounts. Some customers may not be able to comply and may be forced into using less formal and more costly intermediaries such as cheque-cashing services.

Next to feel the heat will be small regional and community banks, many of which will have to merge with bigger rivals. America still has one of the world’s most diverse banking markets, with more than 8,000 banks and nearly 100,000 branches, thanks partly to Depression-era laws in most states which imposed strict limits on how big banks could become. It is ironic, therefore, that the new regulations will probably cut the number of banks in America by about a third over the next few years, increasing the size and systemic threat posed by the country’s biggest ones.

But there is one reason to be optimistic: America’s market remains open enough to allow for new entrants. Since 1990 regulators have licensed an average of more than 120 banks each year. America’s retail market has also opened up to foreign competition. In 2003 only three of America’s 20 biggest banks were foreign-owned, with a paltry 2.2% share of deposits. Now the top 20 include six foreign-owned banks, among them TD Bank, HSBC, Santander and BNP Paribas. Their share of the market has doubled. Mr Meleis recalls that when he asked the chief executive of a big American bank a few years ago if he was considering an international expansion, the retort was: “Do you mean like the East Coast?” Now, he says, American bankers have bosses in Toronto, Madrid and London.

New blood and fresh ideas are already invigorating the American market. Santander’s model of using small, thinly staffed branches is helping it expand cheaply. Retail firms such as Walmart are picking up customers who might otherwise remain unbanked by offering them prepaid cards. Commerce Bank, which is now owned by Canada’s TD Financial, shook up the market with innovations such as staying open late so customers could come in after work. New technology and new ways of using it, such as social networks, will probably also create new banks and models of banking, says Stephen Cheetham, a fund manager at AllianceBernstein. Some are already inserting themselves between incumbent banks and their customers, in effect hijacking the relationship and reducing the value of the banks’ consumer franchises. One is Mint, a free internet-based financial planner that lets users put information from several sources onto a single screen and then recommends suitable products.

The vibrancy of America’s retail banking market owes something to its fragmentation. Most big retail banks, however, are not particularly spread out. In Britain and much of Europe and Asia many of the biggest retail banks are focused on their home markets. This weakens the case against breaking them up into several smaller ones with the same correlated risks.

A further question is whether there are economies of scale in retail banking that would benefit consumers, providing an argument against breaking banks up. Yet it seems that there are few real cost synergies once banks reach a certain relatively modest size. Researchers continue to argue about exactly where that threshold lies, not least because retail banking is such a local business. Banks that have many branches in a particular city tend to gain an outsized share of local deposits. Bank branches that have above-average deposits also tend to make above-average profits, and they can often get away with offering less attractive interest rates on deposits and loans without losing market share, according to Novantas. The reason is more psychological than rational. It is that a bank with branches on every corner seems safer than one with only a few, even if the deposits of both are guaranteed by the government.

But in most countries retail banks do not stand alone. In recent years the trend has been towards some form of universal banking, with the same bank providing both retail and investment services. And that has heightened the biggest concern of all: that banks are so systemically important that they cannot be allowed to go under.