NEW TECHNOLOGY AND BANKING EXCLUSION

By Paul Gosling *(The Future of Banking)*

New technology has been a major factor in the withdrawal of bank branches from low income areas, but as the townships of South Africa have proved they can also be the means by which banking facilities are extended to a previously marginalised community.

The financial services industry has gone through a commercial revolution in the last decade. Call centres and the internet have given corporations the opportunity to enter the banking market at a lower cost than existing branch-based banks. This approach has been led in the UK by Direct Line - backed by the Royal Bank of Scotland - in the insurance sector, and by First Direct - a subsidiary of the Midland Bank and part of the giant global business the Hongkong and Shanghai Banking Corporation - in banking.

Other financial services companies are also moving into new technology banking. Prudential has launched its high interest bearing Egg accounts, which will be mainly serviced through what the company hopes will quickly become Britain's largest internet banking operation.

But the biggest threat to the traditional banks comes from outside the sector. An amazing array of new competitors has entered the banking industry. These corporations are focusing on low cost operations using call centres, the internet, outsourcing and high quality computer databases built up from other activities. They hope that they can use strong non-banking brands to quickly build large customer numbers to benefit from economies of scale and low core costs, to compete by undercutting established banks.

Companies adopting this approach include Virgin Direct, the airline to music global brand, which entered financial services through insurance and savings products, and which aims to launch its own banking operation without a branch network. GE Capital is a major credit card issuer and lender, based in the UK from a call centre in Leeds, which is part of the United States' General Electric corporation. British Gas has its own credit card, built up by a strong customer database. AT&T, the largest telecoms operator in the US, is also one of the world's largest credit card issuers. Other market entrants include the Ford Motor Company.

It is the supermarkets that are causing the most damage to the banks, apart from the Prudential. (The Egg account has captured £3bn of savings - half of the total gained by the new banks at the expense of the traditional ones.) Tesco and Sainsbury have launched attractive new bank accounts, combined with other financial products, wrapped into their loyalty cards which offer discounts and bonuses to valued customers.

These supermarket banks are an extension to the established principle of own-branded products. The difference is that instead of own-brand baked beans, production of which is outsourced, this time it is a banking service. The product again is outsourced. Responsibility for the mechanics of the accounts lies with smaller banks trying to improve their own economies of scale - the Royal Bank of Scotland and the Bank of Scotland.

In the longer term, these supermarket banks are likely to present an even greater threat to the traditional banks. Loyalty cards may become general purpose 'smart cards', containing computer chips making them effectively miniature computers but in the size and style of a credit card. These smart loyalty cards will be capable of storing reward points, personal bank account details and be a credit and debit card. They could hold several currencies for frequent travellers. But they could also be electronic purses.

Electronic purses cause bankers to lose sleep. They store a monetary value on a multi-purpose smart card, which can be topped-up from a cash machine; money can be down-loaded electronically on a personal computer with a smart card reader (these will soon be standard); or even over a mobile phone (mobiles containing smart card readers are already in low volume production). Not just the branch network, but the cash machine network could soon be made redundant.

Once smart cards become generally adopted, the governments will be fully involved. The British Government is in discussion with the banks about incorporating public access codes onto the smart cards that they issue. Functions are likely to include passports, driving licences, public

transport concessions, public building access and even library membership. However, it could be the supermarkets rather than the banks that cream off the largest share of this potentially lucrative market using the strength of their existing loyalty cards.

Lower cost base

The driving factor behind these strong new competitors to the banks is their lower cost base. It is the expensive branch networks that particularly penalise the old banks. Figures quoted by the Department of Trade and Industry (part of the UK Government) show that a financial transaction conducted through a bank branch typically costs $1.07; over a telephone call centre the cost is 52 cents; using a cash machine it falls to 27 cents; but over the internet it is just one cent.*1

It is easy to see, then, that First Direct which has no bank branches but a strong call centre base is able to very strongly cost-cut compared with a bank like NatWest's which has a massive network of 1,730 branches despite having already closed 220. However, this is as nothing compared with the advantage that Prudential's Egg will have once it is firmly established as an internet bank. Not only is Egg able to avoid the investment in fixed assets and staffing associated with branches, it is also using a method by which customers are directly 'self-servicing' - they are inputting their own details and issuing their own instructions to the computers directly.

While branch networks have largely survived (although badly damaged, to the detriment of poorer communities) many of the remaining branches are barely viable. Even a small loss of customers will make many more branches redundant. The emphasis now is on branches turning 'tellers into sellers', as the expression goes, to make branches more like non-banking retail outlets, staffed by experts in pensions, insurance policies and savings products. This requires a heavy investment by the banks in re-training and recruitment. It also explains why our high streets are being transformed as old, large branches are being converted into cafes and bars, while new branches appear between shoe shops and pharmacies.

Many fewer tellers are needed now, with the reliance on cheques reduced, and the introduction of automatic cheque reading facilities. These 'back office' functions are now fulfilled, typically, on industrial estates in low wages regions. Call centres are usually located in similar environments. The loss of traditional branch banking is not only damaging to low income customers, but also helps to drive down skills and wages within much of the banking industry.

There is a further factor assisted by new technology which is to the detriment of poorer customers. Direct Line's shockwaves through the insurance industry were created by its significant reduction in premiums compared with its established competitors. This was only partly reflecting its lower operating costs. It also was the result of a radical difference in pricing policy.

Insurance has traditionally been about pooling risk. Direct Line was much more pro-active in correctly assessing risk. Potential high risk customers were not sought or encouraged. Instead, lower risk customers were given extremely attractive premium quotes. Insurance became less about sharing risk across a large group of people, and more about allocating it to those people most likely to crash their cars or be a victim of crime.

An equivalent process is more slowly happening in the banking industry. Even those banks which persist with large branch networks are keen to charge those customers who use branch banking, compared with those who use the internet, call centres or cash machines. Established banks will be better situated to compete with new entrants to the market if they can offer their lowest charges to their most lucrative customers. An example of this new approach has been adopted by Germany's BHW Bank, which offers a 50% discount on bank charges to customers moving to phone or PC banking. Some US banks have even offered $50 to each customer who signed up for internet banking. Citigroup in the US, which claims to have invented home banking, found that PC banking only took off when it was made free of bank charges.

These approaches, when they become more common, will mark the most significant push yet away from branch banking towards home banking, especially for the more lucrative customer with access to a home PC. After all, banks are just as interested in how much profit a customer can earn them as they are in how much it costs the bank to service them. So customers who take out other financial products - such as insurance or pensions - through their bank, or who persistently have high levels of deposits in their accounts, will find their bank charges fall. (This directly mirrors the approach taken to grocery shopping by the major supermarket chains.) Conversely, poorer

customers can expect to gradually pay more for their banking. Asking all customers to accept a pooling of costs is being phased out in banking, in the same way that the pooling of risks is disappearing in insurance.

In both cases, the power of computer databases to analyse the value and cost of customers is the key factor in enabling financial services providers to assess whether customers earn them profits or losses. In the past banks analysed products sold, but knew little about profiles of individual customers. A bank typically would have no idea about whether a particular person was a customer for just one product, or for a whole of products. Consequently, it had little idea how loyal a customer was, or how much they generated in profits.

All that is changing. Banks have had to invest massively in new computer systems, which are helping to further revolutionise the banking industry. A typical financial services call centre today will have a fully integrated customer database as well as caller line identification. When a call is received, the phone number called from will be displayed on a screen. This number will be compared with the database, and the customer calling can normally be identified. Instantly, the customer's details will be displayed on screen, showing which products they have bought, the balance in all accounts, and details of any recent complaints or disputes.

It will be much easier to make detailed customer profiles, illustrating the level of profit a customer generates, or, alternatively, that the customer actually loses the bank money. This type of sophisticated analysis has already been conducted by one computer company, which is now retailing products from a competitor especially to sell to troublesome customers to reduce the workload on its call centres.

Not all the banks have yet converted their computer systems to operate at this level. When they do, poorer customers can expect to notice their bank charges rise further.

Internet service providers

It is unlikely that we have yet seen the extent to which new technology will damage the traditional banking industry. It may not simply be internet banking that drives a new wave of cost cutting and therefore branch closures by the banks, it could also be the developing role to be played by internet service providers (ISPs).

ISPs are controlling the virtual retail environment of the internet, and helping to re-define the role of banks for the 21st Century. Banks, after all, are essentially facilitators for commerce. If much of the commerce in the future is to be conducted over the internet, it is the corporations that control the contact between business and consumer - or between business buyer and business seller - which can become the banks of the future.

Major corporations are now recognising the potentially enormous significance of becoming ISPs - those benefits can include commissions on sales of advertised products, advertising revenue, promotion of own brand products and of the corporate brand. Media companies ranging from News Corporation to Disney, IT corporations like Microsoft and supermarkets including Tesco have all moved into this market.

Banks, too, recognise these opportunities. The Prudential, Barclays and the giant Citigroup of the United States have all become free membership ISPs. Their services will not only be aimed at customers who use home or work PCs to do their banking. They will be equally important as more people use mobile phones as integrated electronic communication devices. In South Africa, the Nedcar bank even gives its more wealthy customers a free mobile phone, enabling them to build up stronger customer profiles.

Clearly, the growing significance of the internet and the mobile phone will be further damaging to poorer customers without access to either. It is another aspect of the growing trend towards valuing wealthy clients, devaluing others.

Does it have to be like this?

Clearly not. When the African National Congress replaced South Africa's Nationalist Party in government, its commitment to opening up society to blacks was at the heart of its policy objectives. Businesses were told in no uncertain terms, if they wanted to be successful in modern South Africa they had to ensure that they were working with blacks - promoting black staff, recruiting more blacks, and servicing more blacks as their customers. The businesses took notice.

Banks, in effect, had to sign up more black customers. But if they took on more customers by opening more branches they would lose money. They decided to find cheaper ways to service the extra customers. At the same time, the ANC government was looking for partnerships with

banks to pay welfare payments to pensioners and the unemployed.

Cash machines have been installed by the Absa bank in the middle of the bush, where even phones are a rarity, using satellite communication systems. These automated telling machines (ATMs) not only dispense cash, they also take deposits and sell cinema tickets. South African banks are keen to extend their functions to provide a wider range of products. Similar machines in Japan, placed in workplaces, are used to order groceries for home deliveries.

Another major South African bank, First National, has created a network of advanced cash machines in Kwazulu Natal to make welfare payments to pensioners. Half a million pensioners are paid using this system, with payments authorised by smart cards and biometric testing to authenticate the card holder as the rightful beneficiary.

Creating networks of advanced cash machines installed in poorer areas may not be regarded by many as an adequate substitute for closed bank branches. However, the experience of South Africa does illustrate that banks can at low cost create an infrastructure which does service lower income customers (including benefit claimants) and reduce their economic marginalisation.

*1 'The Knowledge Driven Economy' white paper, published by the Department of Trade and Industry, 1999.