Navigating the brave new world of banking

Knowing your customer is at the heart of any successful business. It is especially important for banks right now as they strive to cut costs by reducing the number of branches and coaxing clients to make more use of digital services. A country like Spain that still has a bloated banking network can make use of the tools of behavioural economics to smooth this transition while minimising the threat of losing valued customers.

Banks caught between the anvil and the hammer

European banks are in the midst of a profound transformation. With record low interest rates squeezing their revenues, banks are eager to cut costs and closing branches is one way to achieve this. They are also responding to a growing preference on the part of customers to bank online as the speed and quality of internet and mobile broadband services improve.

But while the switch from an intensive bricks-and-mortar branch model might seem natural, it is not without its potential perils. Spain, where the twin phenomena of branch closures and digitisation have been particularly pronounced, encapsulates these risks.

Between 2007 and 2018, the number of bank branches in Spain fell by 44%. The drop was not quite as steep as in Greece, where the total halved, but it was much higher than in Italy (24%), Portugal (31%) or Germany (32%). True, Spanish branches typically have fewer employees, but the country remains overbanked. As of last year, there were almost 60 branches per 100,000 people, compared with 40 in the likes of Italy, Germany and Portugal and just 12 in the UK and 7.6 in Estonia, the EU member state with the lowest ratio.

Spain's banking merger mania

The driving force behind the branch closures in Spain was a wave of bank mergers. There were two main motives for the mergers: banks would be able to write off expected loan losses against their capital, thereby reducing the need for provisions in the P&L account, and they could generate synergies that would boost ROE and bolster future capital.

The synergies, in turn, were to be achieved by consolidating central services such as IT and compliance and, importantly, by eliminating branch overlaps. Sure enough, in the period 2007-2014 the number of branches fell by 5.8% a year, slowing to 4.9% from 2015 to 2018. In 2013, when the merger wave crested, fully 13% of all branches were closed.

How did managers decide which branches to shutter? Quite simply, by looking at the numbers. If a merged entity had two outlets of similar size located close to each other, typically the financially weaker one would be earmarked for closure. Clients could be migrated to the surviving branch with a minimum of fuss.

Though talk is swirling of fresh amalgamations, banking mergers in Spain have stopped for now. But branch closures have not. With the European Central Bank driving its short-term policy rate ever deeper into negative territory, the pressure on lenders to keep cutting costs is relentless. Fortunately for them, the demand for counter services continues to fall, helping to justify further streamlining of the branch network.

Tellingly, over the period 2014-2018 there was a positive correlation between the pace of branch closures and the adoption of online banking: the lenders that were most aggressive in shutting branches were the ones that racked up more digital customers.

Closing a branch? Put the customer first

Although the rationale for closing branches remains the same, the risks for banks have changed now that they have eliminated the blatant overlaps in their networks. Few account holders would object to walking down the street to a different branch. But migrating more and more of them to cheaper, more efficient digital channels is a different matter. Get it wrong, and you will lose the customer. Their perspective cannot and must not be forgotten.

That being the case, it is no longer appropriate to judge the relative merits of two branches on their financial performance. The supposedly weaker one may have a greater proportion of clients who risk taking their business elsewhere if they feel forced to shift to banking online. Understanding the customer base in order to avoid unpleasant confrontations becomes critical in these circumstances. Banks cannot penalise clients who are not comfortable using the internet; positive ways must be found to nudge them to use digital channels, for instance by demonstrating that online banking is quicker and more efficient.

Pass the behavioural tools, please

At Frontier, we have helped lenders to encourage customers to opt for cheaper ways of doing their banking, with a particular view to reducing transactions at the branch counter. We believe that the most effective way to test the impact of any proposition is through randomised controlled live trials (RCTs) and that behavioural economics is a valuable toolkit for this type of initiative.

Alternative approaches to testing have clear shortcomings. Banks cannot learn what clients want or need simply by asking them, because surveys can be misleading; people tend to rationalise their choices after the event. Focus groups can be tricky, while a particular course of action should not be adopted just because “the boss said so”.

Instead, banks can gain an understanding of how clients behave by looking at what they are doing, not what they are saying. RCTs can then be held to explore the best solutions to help people change these behaviours.

After all, banks already know which types of transactions are most costly and which are most common, and it is usually possible to map them to different customer segments. Note that these are based on behaviour, not determined by wealth or income. In our experience, the more we can identify such specific forms of behaviour, and attribute value to changing them, the easier it is to find cost-effective ways of influencing people’s habits.

A laser-like focus on the client is typically a bank’s declared main objective. This should especially be the case when rethinking and restructuring the branch network. By applying the lessons of behavioural economics, banks can tailor their branches to the needs and characteristics of their clientele. In doing so they reduce the risk of unintended consequences from the transformation of their business model and increase the level of customer satisfaction. With the sector under fierce pressure, both elements are crucial.

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