Whitepaper

ContactEngine

Death of the retail bank?

Introduction

Given the many winds of change swirling around the banking industry, one wouldn't begrudge a sense of nervousness in the retail bankers around the world. Or if it doesn't already exist, maybe it should. The list of developments that could have transformative effects on the industry is long and growing, but one that should be front of mind is the exploration of a Central Bank Digital Currency, or CBDC. Depending on the policymakers in charge of its implementation, the knock-on effect of this step change could realistically cut off a retail bank's source of funds, ultimately leading to their obsolescence. Commercial banks need to identify competitive advantages with which they could continue to be relevant in the future conversation.

What is a CBDC?

In the world as it exists today, money in any country is issued by the Central Bank (the Bank of England, the Federal Reserve, the Bank of Japan etc.) in two ways. First, by issuing actual bank notes and coins to be used by the public in daily interactions. Second, in the form of reserve accounts for commercial/retail banks which are used by these institutions for large-value interbank settlements[1].

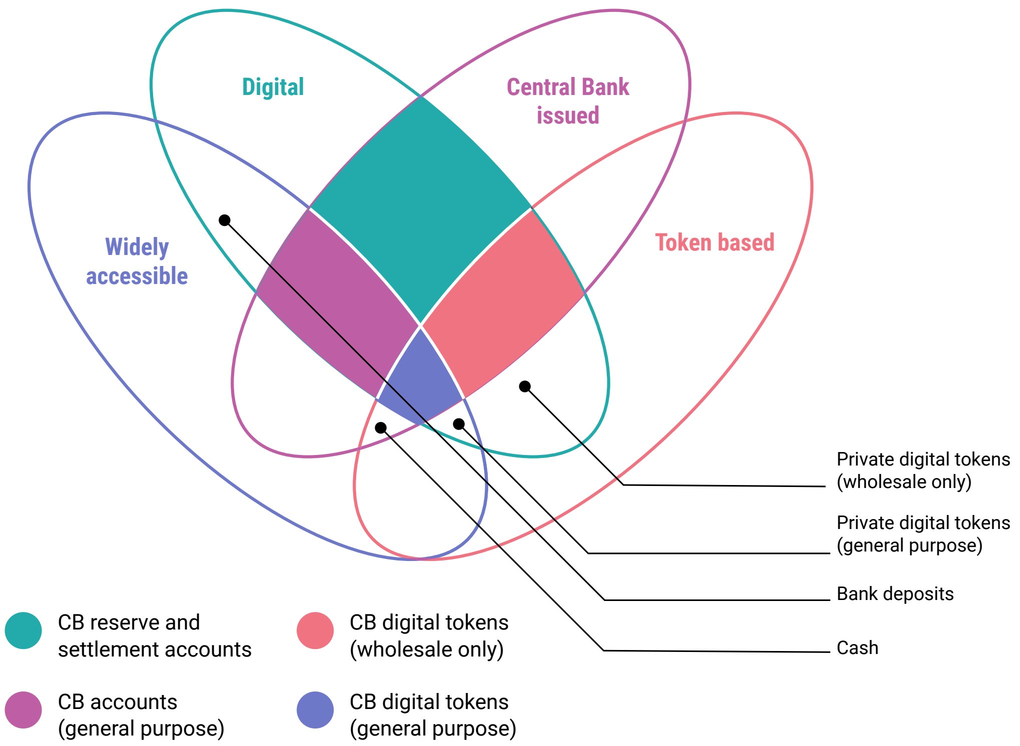
The entire purpose of commercial banks was to provide a safe and secure place to park one's money until such time as one needed to use it. In simplistic terms, banks then use these deposits to lend or invest money at higher rates than it pays to hold them, and this spread comprises the major source of funds for the institution.

As the name suggests, a CBDC is "a new form of money, issued digitally by [a country's] central bank and intended to serve as legal tender"[2]. In essence, the central banks would be providing the public with the facility of holding an account at the central bank, which is currently only available to select institutions. Thus, it is simply an extension of an existing platform as opposed to a distinct innovation. The figure below depicts how the CBDC would fit into the overall payments structure.

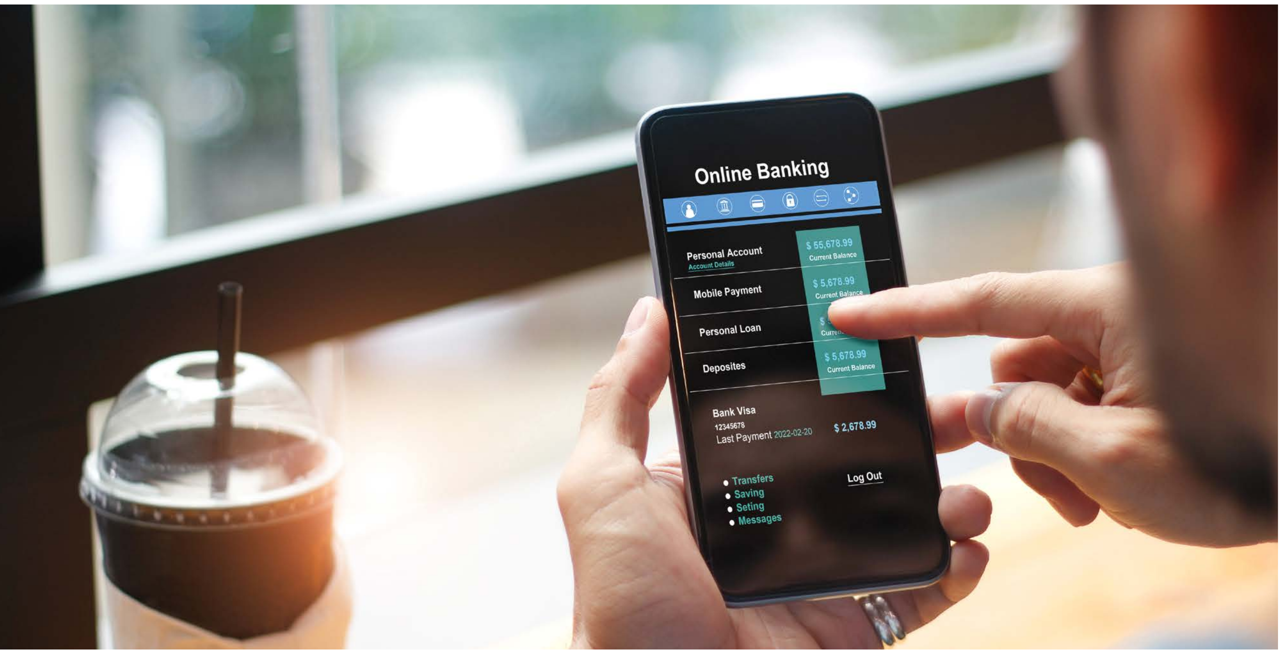
Figure 1

The Money Flower

Source: Central Bank Cryptocurrencies
BIS Quarterly Review, September 2017, pp 55-70



1. http://www.boj.or.jp/en/research/wps_rev/wps_2019/data/wp19e02.pdf
2. https://www.imf.org/~/media/Files/Publications/SDN/2018/SDN1808.ashx



There are a multitude of dimensions available to central banks relating to the design and implementation of the CBDC. For instance, the currency could be account-based or token-based. The account-based avatar would be akin to today's bank accounts held at commercial banks, except at the central bank level. Alternatively, the token-based system would have the same traits as today's cash or physical currency (in digital form). The primary differences between these two options relate to verification and anonymity, i.e. whereas accounts would provide a larger degree of veracity of who owns the currency, the token would provide the customers with a higher degree of privacy in their dealings. Striking this balance will be a judgment call, and likely differ between jurisdictions or cultures.

Furthermore, there are decisions to be made about whether to offer interest on the CBDC, and if so, at what level would that be set. And would central banks look to issue an unlimited amount of CBDC or cap it in order to avoid a "flight-to-quality", i.e. where the populace prefers its currency backed by the state as opposed to the fragility shown by the banking system in the not-so-distant past.

The customer is always right

Admittedly, the introduction of this "technology" is not imminent and depends on a number of factors. This interim period is imperative in commercial banks reimagining the priorities of their competitive advantages over their looming competitors. For instance, even though central banks can offer this new digital currency with the state's direct backing, they would be venturing into lands unknown, particularly in terms of daily interactions with large volumes of customers. Commercial banks existing experience in customer service might well be their silver bullet in the new world. These institutions have the processes and systems in place for providing effective and efficient customer service and indeed years of practice in "perfecting it".

There is undoubtedly some work to be done in this department, given that the current level of customer service at most banks isn't exactly loved by customers as evidenced by numerous surveys across multiple metrics.

According to a Global Consumer Banking survey conducted by Ernst & Young covering more than 55,000 customers, only 36% of Europeans trust their banks[3]. A Bain & Company survey reports that almost 1/3rd of customers (on a global scale) would "completely switch their primary bank if it were easy to do so[4]," suggesting that levels of customer loyalty at banks leaves something to be desired. This is vital for the bottom line when combined with the fact that banks in the US with higher loyalty scores have seen net interest income grow twice as fast as those performing lower on the loyalty front[5]. All this to say that simply having years of experience in the customer service department doesn't imply that commercial banks could hold off the challenge presented by a central bank if they were to issue a CBDC, but rather to highlight the opportunity that exists to be captured.

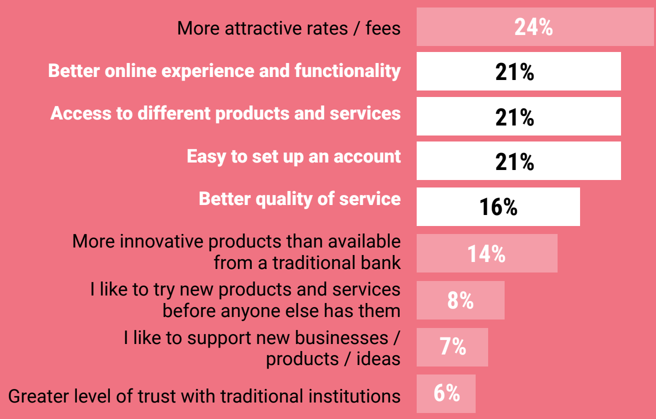
Lessons can be learned from new online or app-only "challenger banks" which are outdoing their traditional brick and mortar competitors in the customer service rankings. Monzo topped the list of UK banks based on customer satisfaction[6] followed closely by First Direct which operates on telephone and online only platforms. These institutions are banking on customer service as a USP over outdated competitors, believing that the user experience is paramount in today's environment. Taking a further step back, banks could also take a cue from technology companies like Apple and Google which garner tremendous brand affinity due to their intense focus on user experience and user design.

Experts may differ on the manner with which to best engage with customers to increase loyalty and trust, but the overarching point is to begin including customers in the conversation in the first place. For instance, a number of suggestions are centred around themes of understanding that the "customers are in control" and providing "a suite of personalized products"[7]. Boil this all down to letting the customers have a louder voice and using the existing data and relationships to serve them better.

3. https://www.ey.com/gl/en/industries/financial-services/banking---capital-markets/ey-trust-without-it-youre-just-another-bank
4. https://www.forbes.com/sites/baininsights/2016/12/15/many-banks-are-losing-customers-and-dont-even-know-it/#606adf5f2935
5. https://www.bain.com/insights/in-search-of-customers-who-love-their-bank-nps-cx-banking/
6. https://www.which.co.uk/money/banking/bank-accounts/best-and-worst-banks-a3q5d8c6dj7y
7. https://www.accenture.com/t00010101T000000Z__w__/gb-en/_acnmedia/Accenture/next-gen-3/DandM-Global-Research-Study/Accenture-Financial-Services-Global-Distribution-Marketing-Consumer-Study.pdf#zoom=50

Figure 2
Elements of the customer experience rank just behind more attractive rates/fees for customers considering a digital-only, nonbank provider (all countries).

Source: The relevance challenge: What retail banks must do to remain in the game, EY Global Consumer Banking Survey[8]



On the flipside, given this backdrop of a certain level of slack in customer service, the central banks could consider themselves in pole position with a blank canvas in reinventing the banking experience. Digital interactions involve "a variable cost of about 10 cents, a small fraction of the $4 cost of a teller or call-agent interaction[9]." As such, the legacy infrastructure of traditional brick and mortar banks could be a further impediment as they try to convince customers to continue using their services. Initial investment towards creating a more integrated platform could magnify the cost savings even further and enable central banks to be the first choice for customers.

The principal benefit of the focus on customer service would be to make the bank stick in the lives of the customers, where the experience and the ancillary services would outweigh the benefits of switching deposits to the central bank.

Survival of the fittest

The introduction of a CBDC could spur an evolution of competitive behaviour at commercial banks on further dimensions as well. In order to survive, traditional retail banks would have to pay more attention to value-add and cross-selling services. While Central Banks can offer the CBDC, it is assumed that loans and mortgages, perhaps insurance products, would still be the purview of commercial banks. And while traditional sources of funding may not be as readily available, it doesn't mean that the innovative banker could not engineer new sources of funds. If the peripheral services that are important to customers can be provided with relative ease of use to customers, it is not a stretch to believe that they would park their money (digital or otherwise) with the same institution.

As stated earlier, banks could compete on the interest rate on current and savings accounts, making it more fruitful for customers to stay on with their existing providers rather than switching to the central bank. This would involve cost benefit analyses and squeezing margins but be a tremendous boon for account holders.

8. https://www.ey.com/Publication/vwLUAssets/ey-global-consumer-banking-relevance-survey/$FILE/ey-global-consumer-banking-relevance-survey.pdf
9. https://www.bain.com/insights/customer-loyalty-in-retail-banking-2016

On a grander scale, there is also the route of banks developing their own cryptocurrencies to pre-empt the CBDCs. There are plenty of private blockchain or distributed ledger technology (DLT) based currencies having been introduced into the market, the most famous of these being Bitcoin, first introduced in 2009[10]. Now banks are getting in on the act, with JP Morgan introducing its own digital currency (titled "JPM Coin") in February 2019[11], granted that initial use cases relate only to institutional clients.

Swiss bank UBS also initiated an "effort to create a digital cash system that would allow financial markets to make payments and settle transactions quickly via blockchain technology[12]" in 2015. They have since been joined by several major banks including Barclay's, HSBC and Credit Suisse. The concept behind the 'Utility Settlement Coin' was to replicate the functionality of fiat currency in a digital form.

Whether these efforts will be ultimately impeded, aided or subsumed by the CBDC is anyone's guess but given the existing volatility around private endeavours in this arena so far, a state-backed option, relatively immune to speculation, would be a clear winner.

Conclusion

The CBDC may never come to fruition. Central banks around the world are still exploring whether it is viable, whether it's a stop gap, or whether it is mana from the heavens. There is also the more philosophical and somewhat scary question of the political impact of the CBDC. Depending on the independence with which a central bank operates, there is some danger of allowing political interests to creep into the lending process, with favoured lobbies or industries potentially getting easier access to credit. But that topic merits a discussion of its own.

Regardless, there is a clear movement towards a cash-less society, with cash reaching its lowest level of prevalence, particularly in certain geographies. In Sweden, for instance, "cash now accounts for just 13 percent of payments in stores"[13]. Similarly, in the UK, the percentage of transactions made in cash has fallen from 62% in 2006, to 40% in 2016, and is projected to drop to 21% by 2026[14].

10. https://bitcoin.org/en/faq
11. https://www.cnbc.com/2019/02/13/jp-morgan-is-rolling-out-the-first-us-bank-backed-cryptocurrency-to-transform-payments--.html
12. https://uk.reuters.com/article/us-blockchain-banks/six-big-banks-join-blockchain-digital-cash-settlement-project-idUKKCN1BB0UA
13. https://www.imf.org/external/pubs/ft/fandd/2018/06/central-banks-and-digital-currencies/point.htm
14. https://www.theguardian.com/money/2018/feb/19/peak-cash-over-uk-rise-of-debit-cards-unbanked-contactless-payments

Thus, on the spectrum of using all cash all the time to using no cash ever, the world seems to be moving towards the digital payments end. In the scenario where CBDCs are deemed infeasible and Central Banks aren't ready to take on the level of responsibility accompanied by such a move, commercial banks can carry on in their merry ways, perhaps investing in their own digital currencies, or partnering with the slew of digital wallets already available.

However, if the CBDC does gain prominence around the world, banks will be questioning their place in the grand scheme of things. If there is a "flight to quality," commercial banks will lose a large chunk of their customer base as well as their low-risk liquidity. This is not to say that they will be defunct as banks provide a number of other services in addition to acting as a placeholder for society's money. However, adapting to that changing environment, and indeed planning for its impending arrival will be crucial to long-term survival.

The so-called x-factor in the battle of the banks could come down to customer experience. There is no guarantee that the level of service at central banks will be anything to shout about. However, if it is even at par with the current levels of service provided at people's primary bank, then it is a simpler decision for the consumer to switch to a state-backed institution, as opposed to trusting an industry still recovering from the throes of the biggest financial crisis since the Great Depression. The ancillary services argument could fall flat as well given the niche online and app-only companies trying to disaggregate the bundle into individual offerings.

For example, focusing exclusively on zero international transaction fees, small business loans, student loans, etc. If, however, traditional banks want to avoid going the way of the dinosaur, they'd best start thinking in similar terms, i.e. instead of looking at customer service as a good to have, defining it broadly as a primary focus around which to build a coherent strategy.

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