

MBA 503 Economics Component Case 2

Due: Monday 10/29/01

RATIONALE FOR ONLINE BANKING STARTS TO SHIFT

No longer considered a cost saver, the Internet becomes the channel that helps retain the most valuable customers

American Banker, 03/12/2001, Vol. 166 Issue 48, p6A, 1p, 1c

When most brick-and-mortar banks started offering online banking services about three years ago, they had specific goals: Reduce expenditures, and open a revenue stream.

They expected to cut costs by moving millions of transactions from branches into the cheaper electronic channel and to charge customers a monthly fee for access to 24-hour banking from home.

"We said, 'This is a great opportunity,' " said Thomas J. O'Hara, a senior vice president at Huntington Bankshares in Columbus, Ohio, and the head of its Huntington.com unit. "If we can get 20, 30, or 50% of our customers, we'll cut all these transaction costs and look like heroes."

But that great opportunity for traditional banks looks markedly different today.

Neither the projected savings nor the revenue gains have materialized, bank executives and industry analysts say. But what has materialized, they say, is an important mechanism for bolstering customer relationships that has been well worth the capital investment.

"It is not a cost saver," said Douglas Andrews, director of Internet and direct retailing for Michigan National Bank in Farmington Hills. "And we can't anticipate that the more customers we get on there, the less physical channel use they're going to have. But we do find that it's a wonderful retention tool."

It appears that Internet banking - when operated as a delivery channel along with branches, ATMs, and telephones - helps Michigan National hold on to its most valuable customers, Mr. Andrews said.

Some traditional banks watched the developments in the dot-com world -including the launching of Web-only banks like Security First Network Bank and CompuBank - and thought they could build a new business model based on low operating costs to serve people who forsook traditional distribution channels entirely.

Citigroup Inc. and Bank One Corp. set up Citi f/i and WingspanBank.com, respectively, to solicit customers who wanted to bank only over the Internet. Citi f/i, however, has since closed, and Wingspan is struggling.

For nearly everyone else, the early rationale for building Internet banking was partly the hope that people would be drawn by the convenience. Bankers predicted that customers would pay fewer visits to branch offices and even cut down on their use of ATMs and automated telephone service. This would reduce operating expenses, they figured, because the cost of an online transaction would be much less than that of one done in a branch and somewhat less than at an ATM or over the phone.

But just as with the ATM and automated phone systems of a generation earlier, Internet banking didn't cause a mass migration of transactions from high- to low-cost channels. Instead, bankers say, it has spurred more transactions than ever.

On the revenue side, Greg McBride, a financial analyst at Bankrate.com, said that many banks introduced online offerings with a monthly fee, typically \$4 to \$8, that has been increasingly difficult to maintain under competitive pressure.

In fact, though nearly two-thirds of all banks offering Internet banking charged a monthly access fee in March 1999, only about one-third charged such fees a year later, Mr. McBride said.

Pam Archer, vice president for strategy and market development at Huntington, said the company is moving away from charging for basic access as it introduces packages of consumer accounts.

The benefit of offering Internet banking would probably be easier to quantify if the branches had emptied out and accounts were generating monthly fees for each customer. But bankers say there is good reason to continue developing and marketing online services, even if it's tough to calculate the return on investment.

Mr. Andrews said Internet banking has become a tool for some Michigan National customers to manage their accounts more aggressively and generate less interest and fee income, at least within individual accounts. At the same time, these customers become more profitable because they concentrate a larger share of their business in the bank and then are much less likely to move, he said.

Wendy Grover, a spokeswoman for Wells Fargo & Co.'s Internet services group, said the San Francisco banking company has seen the same benefits that Mr. Andrews described and more. The company is no longer worrying about the kind of benefits it initially expected from online banking, she said, and instead enjoys customer retention, cross-selling, and balance growth rewards.

Online customers were 50% less likely to leave the bank, and those who pay bills electronically are even less likely to leave, Ms. Grover said. Moreover, the biggest boost in retention was among checking-only and check-and-savings-only customers, who can be the toughest to retain, she said.

As the principal rationale behind Internet banking shifts from cost cutting and fee income to retention and improving customer relations, many banks are changing the way they handle online efforts.

For example, the notion that Internet banking should be a line of business, with its own profit-and-loss reporting, is giving way to the idea that the Web is a delivery channel for supporting established lines of business, like retail, mortgage, small-business, and corporate banking.

"We had set up the group as a profit center, but now distribute income to our banking network," said Paal Kaperdal, senior vice president for e-business at BB&T Corp.

The Winston-Salem, N.C., company decided early last year to attribute revenue associated with its Internet services to branches where customers have their primary accounts, Mr. Kaperdal said. Besides dropping the designation of Internet banking as a product and embracing the idea that it is a channel, BB&T has stopped charging for basic access to accounts through the Internet.

But perhaps even more important, BB&T and other banks are concentrating on different online projects than they would have otherwise, reflecting an even stronger rejection of the stand-alone business model that CompuBank and WingspanBank exemplify.

"We're focusing on integration and will be trying to create opportunities to sell to clients in multiple channels" rather than single-channel applications, Mr. Kaperdal said.

It would be relatively easy to build a system that accepts online mortgage applications if it were not necessary to give branch and call center employees all the same information about a pending application in real time, Mr. Kaperdal said. But customers want to jump from channel to channel, especially during something as complicated as a mortgage application, and BB&T wants to accommodate them, even if it takes longer to build, he said.

"We want to do something that is multichannel," Mr. Kaperdal said. "That requires more integration and is more difficult to implement."

This is the thinking that will drive most developments of Internet banking, many industry observers say.

"The focus is going to be on making sure they're enhancing the relationship, making sure they're improving the satisfaction of customers and that they're providing the right range of choices for their most valuable customers," said Chuck Hieronymi, managing director for financial services at Dove Consulting in Boston.

However, not everyone thinks that it's enough to treat the Internet as just another delivery channel, even if it boosts customer retention.

"I think that's a reactionary view that has a lot of current uptake," said Richard Bell, an analyst at TowerGroup in Needham, Mass. "I don't think it will last."

Though the early-round efforts to charge fees for Internet banking have given way in the face of competitive pressures, additional revenue opportunities will arise, Mr. Bell predicted.

"Internet banking is interesting not for the things you already did, but for the things you never did or couldn't do as easily and at as low a cost," he said.

Just as banks charge for services such as electronic bill payment, they will be able to impose fees on other services designed to take advantage of Internet strengths, Mr. Bell said. For example, they might develop online financial planning tools, notification services, and bill categorization services, he said.

And even Mr. Hieronymi - who argued that retaining good customers will be seen as the main benefit of Internet banking - said that when it comes to charging customers for banking over the Internet, the pendulum could swing back again.

"There may be some experiments in trying to charge again, now that a certain segment of the population is hooked," he said.

Assignment

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1. Comparing the use of bank tellers, ATMs, telephones and the internet, which transactions will have relatively higher fixed costs and which will have higher variable costs? Explain the rationale for your answer.
2. Based on what you know about long-run costs, would you expect smaller banks to have higher or lower costs per internet transaction than larger banks? Explain.
3. The article describes what banks expected to happen to costs by using more online banking and what actually happened to costs. Use cost theory to explain what banks expected to happen, and supply and demand theory to explain why those expectations did not materialize.
4. Given that shifting to online banking did not lower costs, why do banks continue to offer these services?
5. Other than costs and supply/demand, find and explain/discuss another economic concept (that we have discussed up to this point) in this article.