Capturing Growth in U.S. Retail Banking

Building a Sustainable Right to Win
The retail banking industry faces significant growth challenges

### Trends

1. **Macroeconomic**
   - Elevated unemployment (although lower than 2010 peak)
   - Extended low-interest-rate environment (amid potential concerns of inflation)
   - Slowly stabilizing home values

2. **Consumer Behavior**
   - Reduced willingness to incur new debt
   - Higher rate of savings and investment in simple financial products
   - Deterioration in trust leading to erosion of bank loyalty

3. **Regulatory**
   - Heightened consumer protection laws focused on reducing fees and increasing transparency
   - New regulatory oversight costs, increased capital requirements, and direct fees to cover federal intervention

### Implications

- Stagnant top-line revenue growth
- Declining profitability, particularly in mass-market segment
- Low return on equity
- High nonperforming assets
- Continued consolidation (driven by bank failures and strategic acquisitions)
- Increased competition, particularly for creditworthy customers
- More stringent risk management practices

Source: Booz & Company analysis
Macroeconomic headwinds remain, fueled by lingering uncertainty about when a full recovery will take root

Trends

- **Unemployment** broadly impacts revenue streams and is not expected to return to pre-recession levels until 2012 or 2013
  - Lack of job security and financial stability will continue to limit borrowing
- **Interest rates** will inevitably rise from record lows in response to GDP growth and inflationary pressures
  - The Fed is expected to raise rates by late 2010 or early 2011 in response to inflationary concerns
  - Yield curve is expected to flatten by 2013, putting pressure on net interest margins
- **Home values** will slowly improve starting in 2011, after falling precipitously from 2006 to 2009
  - Home values have a direct impact on the mortgage industry and act as a leading indicator for other financial services

Source: Global Insight; Mortgage Bankers Association; Booz & Company analysis
Consumer and commercial clients are using fewer bank products, investing more conservatively, and exhibiting less loyalty to banks

### Trends

- **Savings** – Recent attentiveness to saving more and spending less should persist for several more years
  - Higher savings rates bode well for bank deposits and wealth management sector
  - Credit vehicles will have less appeal
- **Risk aversion** – Conservative investment strategies will dominate until real economic growth reduces market volatility in 2012
  - Lower-risk, highly transparent, and less profitable investment products make up a larger percentage of assets under management than in previous years
- **Deleveraging** – Businesses will delay capital investments, and consumers will accelerate debt reduction until 2013
  - Mortgage and credit facility revenues will continue to plummet in the short term and will grow very slowly even in the long term
- **Customer loyalty** – Existing banking relationships are being tested due to a general deterioration in trust

### Source

Federal Reserve; Booz & Company analysis
New regulations are reshaping the banking landscape, reducing operating profits by ~US$200 billion over the next five years

<table>
<thead>
<tr>
<th>Lost Revenue</th>
<th>Description</th>
<th>Impact</th>
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<tbody>
<tr>
<td>Regulation E</td>
<td>Consumers must consent to overdraft service for ATM and debit card transactions</td>
<td>Estimated loss of $7.3 billion in 2010 and $34.3 billion through 2014, about 19 percent of total nonsufficient funds/overdraft (NSF/OD) fees</td>
</tr>
<tr>
<td>CARD Act</td>
<td>Limit on credit card fees; restrictions on rate changes and marketing to under-21 segment; clearer terms and conditions</td>
<td>$5.5 billion in lost revenue in 2010 and more than $50 billion through 2015</td>
</tr>
<tr>
<td>Interchange Fee</td>
<td>Interchange rates on debit PIN and signature transactions are being cut by 25 to 75 percent</td>
<td>Revenues for banks that issue debit cards could fall by an estimated $5 billion</td>
</tr>
<tr>
<td>FDIC Prepayment</td>
<td>Early payments for 2010 through 2012 to rebuild FDIC insurance fund</td>
<td>$45 billion in prepaid insurance from the fourth quarter of 2009 to the end of 2012</td>
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<table>
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<tr>
<th>Additional Expenses</th>
<th>Description</th>
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<tr>
<td>TARP Tax</td>
<td>15-basis-point tax on liabilities, focused on wholesale funding, for banks with more than $50 billion in assets</td>
<td>Proposed fee expected to raise $90 billion over the next 10 years</td>
</tr>
<tr>
<td>Financial Reform</td>
<td>Creates consumer protection authority</td>
<td>$50 billion to $150 billion liquidity fund paid for by large banks</td>
</tr>
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Source: Press releases and news articles; annual reports; FDIC; Bretton Woods; websites of Senator Christopher Dodd and Congressman Barney Frank; Booz & Company analysis
Revenue and operating profit growth in many product segments will stagnate over the next five years

Revenue Growth (CAGR)  | Profit Growth (CAGR)
---|---
2004-2009 | 4.8% | 2004-2009 | 3.8%
2009-2014F | 1.2% | 2009-2014F | -1.1%

1) Excludes insurance (life, property and casualty, etc.) and capital markets.
2) Excludes loan loss provisions, nonrecurring gains or losses, and income taxes.
3) Excludes commercial real estate.
4) Includes home equity lines of credit, auto loans, student financing, and other consumer lending products; excludes mortgage and credit cards.
5) Includes originations, holdings, and servicing of multifamily, commercial, and farm mortgages; excludes securitization.
6) Includes originations, holdings, and servicing of 1- to 4-unit residential mortgages; excludes securitization.
7) Includes interchange fees from credit and debit card transactions, in addition to fees from cash management, online payment processing, global trade, and wire transfers.

Source: Federal Reserve; FDIC; Nilson Report; Mortgage Bankers Association; 2010 Financial Services Fact Book; analyst reports; industry newsletters; news articles; annual reports; Booz & Company analysis
Capturing available profit pools will require banks to clearly align their distinctive capabilities with market opportunity

<table>
<thead>
<tr>
<th>Traditional Approach to Growth</th>
<th>Coherent Approach</th>
</tr>
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<tr>
<td>▪ Most banks have historically used expansion to fuel growth:</td>
<td>▪ In a low-growth environment, banks will need a much more surgical approach; they cannot afford to invest across the board</td>
</tr>
<tr>
<td>– Branch expansion</td>
<td></td>
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<td>– Bank acquisitions</td>
<td></td>
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<tr>
<td>– New products (mortgage, real estate lending, etc.)</td>
<td>▪ Banks need to first understand what they excel at, channel scarce resources toward building these capabilities further to make them best in class, and then identify market opportunities that leverage those capabilities</td>
</tr>
<tr>
<td>▪ They have over-invested in these so-called adjacencies (i.e., in related businesses where they perceive they have a “right to win”); such strategies often produce short-term gain but long-term pain</td>
<td>▪ This distinctiveness will give them a right to win in a highly competitive environment</td>
</tr>
</tbody>
</table>

Source: Booz & Company analysis
Leading banks have successfully earned a right to win by asking three fundamental questions

A How are we going to face the market?
- What is our “way to play”?
- Do the executives, managers, and employees at every level understand the way the company creates value for customers?

B What capabilities do we have and what do we need?
- What do we do well that customers value and competitors can’t beat?
- How do these capabilities work together in a system?

C What are we going to sell and to whom?
- Is every product and service offering aligned with the capabilities system and the way to play?

Source: Booz & Company analysis
Banks are increasingly competing in one of four ways to play

<table>
<thead>
<tr>
<th>Way to Play</th>
<th>Competitive Characteristics</th>
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<tr>
<td>Distribution Giants</td>
<td>▪ Extensive branch network and broad channel access</td>
</tr>
<tr>
<td></td>
<td>▪ Competitive pricing and convenience</td>
</tr>
<tr>
<td></td>
<td>▪ Broadest range of products</td>
</tr>
<tr>
<td>Product Innovators</td>
<td>▪ Dense branch network coupled with reliance on other channels (e.g., online, mobile)</td>
</tr>
<tr>
<td></td>
<td>▪ Focus on product innovation, features, and packages</td>
</tr>
<tr>
<td></td>
<td>▪ Use of M&amp;A to expand footprint and product abilities</td>
</tr>
<tr>
<td>Community Banks</td>
<td>▪ Trusted brand in the community</td>
</tr>
<tr>
<td></td>
<td>▪ Deep relationships through local leadership and decision making</td>
</tr>
<tr>
<td></td>
<td>▪ Traditional product set</td>
</tr>
<tr>
<td></td>
<td>▪ Branch-centric delivery</td>
</tr>
<tr>
<td>Segment Specialists</td>
<td>▪ Targeting defined segment(s) and/or product(s)</td>
</tr>
<tr>
<td></td>
<td>▪ Deep client and industry expertise and product knowledge</td>
</tr>
<tr>
<td></td>
<td>▪ Specialized product sets and custom solutions</td>
</tr>
</tbody>
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Source: Booz & Company analysis
Winning banks have developed a distinct and coherent capabilities system that supports their way to play

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<td><strong>Examples of Winning Banks</strong></td>
<td><strong>Chase</strong></td>
<td><strong>PNC</strong></td>
<td><strong>BB&amp;T</strong></td>
<td><strong>USAA</strong></td>
</tr>
<tr>
<td><strong>Client Experience</strong></td>
<td>• Siloed measurement and response, channel-driven</td>
<td>• Institutionalized measurement and response</td>
<td>• Embedded in the value proposition with local focus</td>
<td>• Relationship- and value-based customized experience</td>
</tr>
<tr>
<td><strong>Client Insights and Analytics</strong></td>
<td>• Analytics embedded in product silos</td>
<td>• Some noninstitutionalized insights</td>
<td>• Local insights, limited institutionally</td>
<td>• Local insights on target segments</td>
</tr>
<tr>
<td><strong>Product Development and Innovation</strong></td>
<td>• Lean product manufacturing, broad product capability set</td>
<td>• Rapid product innovation driven by deep client insights</td>
<td>• Traditional product offering</td>
<td>• Custom products for targeted segments</td>
</tr>
<tr>
<td><strong>Distribution Management</strong></td>
<td>• Pervasive footprint, rapid channel innovation</td>
<td>• Strong branch density, growing other channels</td>
<td>• Largely branch-based model with local delivery</td>
<td>• Average branch density, focus on alternative channels</td>
</tr>
<tr>
<td><strong>Acquisition and Integration</strong></td>
<td>• Defined M&amp;A process for acquiring outside footprint</td>
<td>• Real-time market intelligence on innovations and technology</td>
<td>• Expertise in acquiring small banks in micropolitan areas</td>
<td>• M&amp;A discipline with focus on enhancing customer value</td>
</tr>
<tr>
<td><strong>Risk and Capital Management</strong></td>
<td>• Foundational risk management within product silos</td>
<td>• Prudent risk management, local decisions on relationships</td>
<td>• Prudent risk management, local decisions on relationships</td>
<td>• Prudent risk management, focus on diversifying earnings</td>
</tr>
<tr>
<td><strong>Human Capital</strong></td>
<td>• Centralized talent management, basic training</td>
<td>• Centralized talent management, linked metrics and behaviors</td>
<td>• Localized talent management, long-tenured employees</td>
<td>• Centralized, knowledge of industry and segments</td>
</tr>
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</table>

* Winning banks can compete with different capabilities systems. This exhibit shows, at a high level, the capabilities for select banks, not for the broader categories in which they are classified.

Source: Booz & Company analysis
Banks use their capabilities in different ways to determine the products they sell and the customers they target

Examples of Product and Service Portfolios for Select Banks

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<td><strong>USAA</strong></td>
</tr>
<tr>
<td><strong>What are we going to sell …</strong></td>
<td>• Broad array of core products and services manufactured in-house</td>
<td>• Emphasis on innovative products and features that leverage technology, customer insights, and analytics</td>
<td>• Traditional set of products (deposits, credit cards, mortgages, etc.) augmented by meaningful customer relationships</td>
<td>• Deep set of products across core categories</td>
</tr>
<tr>
<td><strong>… and to whom?</strong></td>
<td>• Focus on product bundles and cross-selling across multiple points of sale</td>
<td>• Products that generate fee income</td>
<td>• Customers who have a preference for local banking relationships</td>
<td>• Personalized and mass-customized solutions, depending on particular needs</td>
</tr>
<tr>
<td></td>
<td>• All customer segments, from mass market to ultrahigh net worth</td>
<td></td>
<td>• Small and middle-market businesses based in the community</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• All businesses and institutions</td>
<td></td>
<td>• Low-cost channels</td>
<td></td>
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* Winning banks can compete with different capabilities systems. This exhibit shows, at a high level, the capabilities for select banks, not for the broader categories in which they are classified.

Source: Booz & Company analysis
For example, Chase uses its coast-to-coast distribution network to deliver a consistent set of products to each segment.

**Chase: A Distribution Giant**

- **Way to Play**
  - Branch density in major metropolitan areas attracts customers who value the proximity of the branch.
  - Serves needs of all customers, but mostly focused on affluent segment in urban markets.
  - Uses branches to facilitate cross-selling (e.g., placing loan officers in branches).

- **Capabilities System**
  - Coast-to-coast branch network:
    - Proprietary data and analytics used to optimize existing branch network.
    - Well-defined M&A and post-merger integration process designed to identify, acquire, and absorb large retail banks outside JPMorgan Chase footprint.

- **Segment/Product Alignment**
  - Broad product set:
    - Leverages economies of scale by developing, deploying, and managing products in-house.
    - Extensive set of products distributed through coast-to-coast branch network serving the needs of most customer segments and businesses.

**Measured Progress (as of 1/2010)**

- 5,100 retail branches and 15,400 ATMs across 23 states (mostly in highly populated areas)
  - Covers 42 percent of U.S. population and 46 percent of U.S. businesses
  - Deposit share leader: first in Chicago and New York, second in Los Angeles, third in Miami and San Francisco.

Source: Company website; annual reports; investor presentations; press releases; SNL Financial; Booz & Company analysis.
PNC’s Virtual Wallet uses product innovation to target Gen Y and other Internet-savvy customers in a unique way

**PNC Financial: A Product Innovator**

- Has increased focus on product innovation to accelerate customer acquisition in select segments
- Leverages technology to develop virtual products that cater to non-branch customers
- Diversifies revenue streams through fee-based products

**Capabilities System**

Product innovations linked to targeted segments:
- Ability to leverage technology, customer insights, and client analytics to develop innovative products
- Ability to expand the use of innovations to different customer profiles (e.g., students and parents)

Nontraditional delivery channels:
- Adept use of nontraditional marketing and distribution channels (e.g., YouTube, mobile apps)

**Segment/Product Alignment**

- Innovative products servicing the needs of specific target segments (e.g., Gen Y, early adopters)
- Used as a means to increase wallet share, acquire new customers, and reduce distribution costs

**Notable Features of Virtual Wallet**

- **Calendar:** Know when you need to pay your bills and when you get paid
- **Alert:** Know when you are at risk of overdrawing your account
- **Wish List:** Monitor how much money you have set aside for wish-list items
- **Chart:** Know how much you are spending on utilities, groceries, and other items

**Measured Progress (as of 1/2010)**

- 150,000 PNC customers use Virtual Wallet, representing a 14 percent increase in the bank’s Gen Y customer base
- Investment cost about $15 million, with a two-year breakeven period (one year less than a de novo branch)

Source: Company website; annual reports; investor presentations; press releases; SNL Financial; Booz & Company analysis
BB&T’s high branch density in small communities outside major cities caters to local clientele and small businesses

**BB&T: A Community Bank**

- High branch density in homogenous markets (aims to achieve top-five position in each market)
- Caters to local clients (e.g., small businesses) that value branch convenience and hometown experience
- Core consumer products augmented by value-added, fee-based services (e.g., insurance)

**Strong presence in micropolitan areas:**
- Disciplined approach to market positioning: Focus on micropolitan areas, where few large players exist

**Local decision making:**
- Optimal balance between local and centralized decision making in order to leverage scale while remaining close to clients

- Core savings, lending, and investment products augmented by deep client relationships and a focus on local clientele

**Measured Progress (as of 1/2010)**

- Diversified product and service portfolio supports bank during trying economic times
  - Fee income is about 40 percent of total revenue
- Leading positions in key markets and businesses
  - Seventh largest insurance agency in the U.S.
  - Top-five retail bank in about 70 percent of micropolitan areas

*BB&T acquired Colonial in August 2009.
Source: Company website; annual reports; investor presentations; press releases; SNL Financial; Booz & Company analysis
USAA is a segment specialist targeting military personnel with products and services that align with their needs.

**USAA: A Segment Specialist**

- **Way to Play**
  - Focuses on serving complete financial needs of military personnel and their families
  - Uses life insurance to gain client’s trust, then cross-sells based on client analytics

- **Capabilities System**
  - High-end customer service:
    - Ability to consistently deliver a superior client experience that resonates with targeted audience

- **Segment/ Product Alignment**
  - Segment-specific products:
    - Ability to develop and market segment-specific products (e.g., youth and college banking)
  
  - Online delivery:
    - Adept at leveraging and customizing mobile technology to support needs of military personnel stationed overseas
  
  - Top-notch products and services that cater to a specific (nontraditional) customer segment (e.g., military personnel and their families)

**Awards and Accolades 2009-10**

- Ranked #1 2009 Customer Service Hall of Fame MSN Money
- Ranked #2 Customer Service Champs Business Week
- Ranked #1 USAA Brokerage Customer Satisfaction AAII Journal
- Top Financial Strength Ratings A.M. Best, Moody’s, Standard & Poor’s

**Measured Progress (as of 1/2010)**

- High level of customer satisfaction and retention
  - 98 percent member retention
  - 97 percent customer satisfaction

- Growing customer base with 6 percent customer acquisition in 2009 (420,000 new members)

- Effective cross-selling: Customers average 4.2 USAA products

*Source: Company website; annual reports; press releases; Booz & Company analysis*
Empowering a coherent strategy results in superior performance; on average, leading banks had positive growth in share price

The Coherence Premium
Average Return on Equity (ROE) and Change in Stock Price, 2004-09

Discussion

- Investing in distinctive capabilities has enabled leading banks to maintain momentum, even through the recent crisis.
- Banks with coherent strategies perform better than their peers and generate greater shareholder return:
  - Average return on equity is 3.4 percent higher than industry benchmark.
  - Significant growth in share price relative to industry (industry decline of about 45 percent).

2) The average return on equity from 2004 to 2009.
3) Does not include USAA, which is a private company.
4) The Dow Jones U.S. Financial Services Index is a proxy for the change in stock price of the average U.S. bank; return on average equity of all FDIC-insured institutions represents the industry ROE.
5) Actual ROE and stock price data from prominent U.S. banks that lack a coherent strategy.

Source: FDIC; SNL Financial; Booz & Company analysis.
Getting started: Evaluate your internal capabilities in the context of the external market to determine what gives you the right to win

### Evaluating Internal Capabilities

- How are we going to face the market?
  - Are we clear about how we choose to create value in the marketplace?

### Assessing the External Market

- What external trends impact our business? What is the outlook?
- How much regulatory exposure do we have?
- Can we draw parallels from other industries or historical market cycles?

### What capabilities do we have and what do we need?

- Can we articulate the three to six capabilities that describe what we do better than anyone else?
- Have we defined how they work together in a system?

### What are we going to sell and to whom?

- Have we specified our product and service “sweet spot”?
- Do we understand how to leverage the capabilities system in new or unexpected ways?

- What are the barriers to entry in the market?
- How has the value chain been impacted by the market?
- What strategies are competitors using? Where do they have a right to win?

- Who are our customers? How engaged are they with this category? How have their expectations changed?
- How is technology impacting our products, channels, and segments?

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Coherence can help align your M&A strategy to your capabilities system and eliminate non-core activities and expenses

Source: Booz & Company analysis
Contact Information

Atlanta
Daniel O'Keefe
Partner
+1-404-581-3489
daniel.o'keefe@booz.com

Chicago
Ashish Jain
Principal
+1-312-578-4753
ashish.jain@booz.com

New York
Paul Hyde
Partner
+1-212-551-6069
paul.hyde@booz.com

San Francisco
Tracie Redd
Partner
+1-415-281-5034
tracie.redd@booz.com
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