Chapter 14

CHANNEL STRATEGY EVOLUTION IN RETAIL BANKING

Reynold E. Byers\textsuperscript{a} and Phillip J. Lederer\textsuperscript{b}

\textsuperscript{a}Graduate School of Management, University of California, Irvine, CA 92697; \textsuperscript{b}William E. Simon Graduate School of Business Administration, University of Rochester, Rochester, NY 14627

Abstract

Information and banking technology have combined to throw the retail banking business model into disarray. Many predicted that lower cost online-oriented services such as Citibank’s Citi f/i venture would dominate the retail banking market and drive out high cost old technologies. The subsequent failure of Citi f/i and other virtual banks raises questions about how technology choice affects retail banking competition: Under what conditions would an online-only banking strategy be successful? When can a bank deploy both old and new technologies and still be competitive? Can an ATM network substitute for a branch network? Do customers’ attitudes about technology affect banking strategy? We use an economic model of a competitive retail banking market to address those and other questions. Our model allows banks to choose their technology, including establishing separate branch and ATM networks or relying on third party ATM networks. We also include customers that have differing attitudes toward technology. Our analysis suggests that customer preferences, rather than technology cost structure, drive the evolution of banks’ strategic technology choices. Also, banks in our model tend to deploy ATMs in the same numbers as branches, despite ATM’s cost advantages. Finally we show that virtual banks will remain unprofitable until a much larger proportion of the population is comfortable with online bank transaction technology. These results suggest that banks should carefully study their customers’ preferences to align major strategy shifts with customer attitudes.

1. INTRODUCTION

The rise of the information economy with its associated technological developments radically altered the retail banking distribution model. New distribution technologies including PC banking, Electronic Bill Payment and Presentment, and remote wireless access have all contributed to changing the way
that customers and banks interact with one another. Banks love the fact that new distribution technologies have drastically lower cost structures than old technologies. Further, the growth and development of information systems technology makes each distribution channel potentially more powerful. However, the banking industry has reacted to that growing power and technological sophistication with uncertainty and high profile failures. Even the largest banks that are considered savvy users of technology, such as Citibank, have made serious missteps resulting to millions of wasted dollars and alienated customers. Uncertainty and failure have led to many unanswered questions in the industry: Can a “virtual bank,” originally predicted to dominate, even survive? Are branches really dead? Can ATMs serve as a primary point of physical customer contact? We seek to address these issues with an economic model of a competitive banking market. First we will discuss Citibank’s experience to illustrate the problems the industry faces.

Citibank has long been among the largest five banks in the U.S. and among the most technologically advanced, but even they have had problems adjusting to the use of new technologies. While Citi was not the first to deploy a PC banking system, they were among the earliest, allowing customers to connect via modem using Citi’s “Direct Access” banking product. Direct Access was considered one of the best PC banking products and as Internet technology came to the fore it morphed and grew to become a full-featured transactional website that was, again, considered one of the best in the business. Citibank was also the first major bank to eliminate all fees for its online banking channels. This move was seen as a major attempt to be highly customer-oriented, to drive transaction traffic to the cheaper online channels, and to set the bar for the entire industry. Despite these early successes, Citibank’s desire to further leverage electronic channels led them into a major failed initiative called Citi f/i. The vision driving Citi f/i was to cater to technologically aware customers and minimize transaction costs by relying only on ATMs and the online banking channel. In fact, Citi f/i customers would not be allowed to use branches. Keeping transactions out of teller-staffed branches would mean very low costs. The hope was that customers that were comfortable with ATMs and the Internet would prefer the convenience, speed and self-service nature of electronic channels. Citi f/i was quietly launched in August of 1999 and less than a year later Citibank announced that Citi f/i would be discontinued and replaced with a “new service.” It was clearly stated that the new service likely would not include a “ban on branch transactions” as Citi f/i had. While there were many questions about the viability of Internet-only banking strategies, Citi f/i had planned to overcome those doubts by using ATMs to serve as a physical presence. That physical presence, however, was not enough to sustain Citi f/i. Further, Citibank was not alone, as other banks made the same error and closed