The Consequences of Electronic Delivery Channels on The Retail Banking Industry

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The development of communications technology today allows services to be delivered in a number of different ways. Banking services are no exception, even though the retail sector has been so far less affected by communications technology than other financial services. The reason for such a delay is the very nature of retail banking : retail banks deal with individuals or small firms, who are slower to adapt to changing technology. However, banks are thinking ahead, and a range of different Electronic Delivery Channels are being studied and tried out. Touch point terminals, smart ATM machines, interactive TV, the Internet, PC banking are among them.

But how will these affect the banking industry? What will retail banking be like in 15 years time ? Will banks operate substantially differently from today ? Today's banks offer substantially two different types of services : money handling and a category which I will call, for now, other services. Money handling comprises all those services which are currently provided through current accounts : crediting of one's salary, paying for shopping, paying bills, setting up standing orders, sending money drafts and wire transfers, cashing cheques. In brief, paying money and being paid money. 20 years ago the payment industry was, to a large extent, the crux of banking. The reason for this was mainly the physical nature of money. People put gold, and then cash, in a bank because it was (and is) not safe to simply keep it under the mattress, and because cash is bulky. It is cheaper and safer to receive one's salary in a bank account than as an envelope full of cash. It is cheaper to hand out a cheque or make a wire transfer than to ship a bag of banknotes. Why banks ? Because the handling of the money itself and of the millions of cheques and other documents is very expensive, and requires large economies of scale. However, today paper has been, to a great extent, already eliminated from the payment system.

This graph shows the major world countries and their current payment system. Horizontally, the graph measures the amount of cash, in terms of notes and coins, in circulation in the economy, as a % of GDP. Countries to the left use less cash than those to the right. On the y axis, we see the proportion of non cash transactions done through electronic means. Countries closer to the origin use mainly paper based payment instruments. Countries in the bottom right quadrant use mainly paper based instruments for their payments, such as cheques. Countries in the bottom right quadrant have a less developed, cash based payment system. Countries in the top left use mainly electronic systems, whereas countries in the top right use a combination of cash and electronic instruments. As it can be seen, only a marginal fraction of payments are done through cash, and the proportion of payments done through other paper based payment instruments, such as cheques, is dropping steadily. This means that the barriers to enter the payments industry are becoming less and less substantial. And this can be proved by witnessing the large number of organisations entering the market. Most large retailers today have their own credit cards. Economies of scale are making electronic payment systems, delivered through whatever channel, more and more preferable with respect to paper based systems. Already some banks, especially in the US, are charging customers for any paper based transaction. If we project these trends in the future, it is likely that the vast majority of transactions are going to be electronic, whether through credit and debit cards, smart cards, ecash or any other means. Obviously cash will not disappear, but it will become even more irrelevant than today. When cash will still exist, banks and other institutions will handle it through sophisticated ATMs, capable of recognising notes and recycling them. Manned tills will almost cease existing, with the exception of a few to serve those customers that don't want or like to use the machines. With time, however, they will probably disappear.

The consequences for retail banks are quite substantial. They will find themselves in a more competitive industry, and their only advantage over other non banks will be the trust and the relationship that they have built with their customers. When it is a matter of handling money, people tend to trust banks more than supermarkets. However, if banks are not ready to compete with the other market entrants, customers will soon adapt to the new context. At the same time, the competitivity of the industry will make it much harder to charge a fee for running the account. This will tend to become a free service everywhere, as it already is in some countries. Thirdly, the profits banks make because of high cash balances on accounts will tend to fall too, as it will become easier and less time consuming to move money from one's account to other interest bearing (or higher return) assets. I will avoid talking about the international implications deriving from the new electronic delivery channels. The Internet, for instance, could allow customers to choose any bank in the world and use its services as if it were around the corner. As such developments depend to a large extent on how the governments will react, it is less clear what will be the outcome.

Besides money transmission, today banks offer a number of other services. Lending is certainly one of them. The sale of interest bearing assets is another. In some countries, such interest bearing assets are the accounts themselves ; in others, assets such as savings bonds, treasury operations, etc. are offered. How will such services evolve ? It is less likely that these services will be significantly affected.

When it comes to lending money, it is more likely that customers will prefer to actually see and talk to a human being. The more the value of the loan, the more seems to be the need to talk to a person. Would you ever apply for a mortgage through a machine ? This is because the advisory service becomes more and more relevant. It is therefore more likely that, at least until videoconferencing and digital signatures will become the norm, banks will retain the advantage of having a retail branch network. Savings and investment are also services in which customers prefer to have the advice of a human being. This relationship will be the crux of the service, more than the service itself. At the same time, however, customers will have more choice and better information. It is likely that it will be possible to shop around electronically for the best assets or cheapest loans, by programming a smart agent to hunt the Internet, or whatever other interactive network, for the best prices. The more sophisticated customers will be able to buy and move money between different assets more easily, and with a better knowledge of prices. The less sophisticated, or more risk averse customers will rely on a personalised relationship with a sales person, who will sell him the service and the relationship.

Overall, how will the banks' revenue change ? Banks receive a revenue from three sources : seignorage (the possibility to use its own liablities as means of payment), commissions and fees, and float (the income deriving from the bank being able to dispose of money during the time necessary for a payment to reach destination). Electronic payment systems affect all the three of them.

Seignorage is likely to grow in importance, as cash becomes less and less important. The banking sector multiplier of money is thus likely to grow, as the use of cards, prepaid instruments and electronic cash grows in the economy.

Income from commissions is likely to become more important too, as banks will need to increase commissions and fees to compensate for the inevitable loss of income from float and intermediation. Float will drop, as electronic payments are faster than paper ones, and will eventually be regulated in real time. Intermediation margins (i.e. the spread between bid and ask rates) will also drop, pushed by competition and by the greater availability of price information.

As a conclusion, we can say that the retail banking industry will be significantly affected by the development of new electronic delivery channels. Changes will be gradual but unavoidable. Banks will manage to remain the most important financial institutions in the industry only if they will be quick to adapt to the changes, thus avoiding the migration of customers to new entrants.