THE BANK OF THE FUTURE:
innovative solutions to meet the challenges of the new environment

Syndicate 1 team members:

<table>
<thead>
<tr>
<th>Name</th>
<th>Telephone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jerome Bagley</td>
<td>0829017524</td>
<td><a href="mailto:jeromeb@nedbank.co.za">jeromeb@nedbank.co.za</a></td>
</tr>
<tr>
<td>Michele Bovet</td>
<td>0836552395</td>
<td><a href="mailto:micheleb@sahomeloans.com">micheleb@sahomeloans.com</a></td>
</tr>
<tr>
<td>Kabelo Mothlala</td>
<td>0798767059</td>
<td><a href="mailto:kmothlala@fnb.co.za">kmothlala@fnb.co.za</a></td>
</tr>
<tr>
<td>Sifiso Musundwa</td>
<td>0760517514</td>
<td><a href="mailto:sifiso.musundwa@absa.co.za">sifiso.musundwa@absa.co.za</a></td>
</tr>
<tr>
<td>Nolwazi Nzama</td>
<td>0713517702</td>
<td><a href="mailto:nolwazi.nzama@standardbank.co.za">nolwazi.nzama@standardbank.co.za</a></td>
</tr>
<tr>
<td>Kumaran Pather</td>
<td>0833910101</td>
<td><a href="mailto:kumix20@gmail.com">kumix20@gmail.com</a></td>
</tr>
<tr>
<td>Aneesa Razack</td>
<td>0823992568</td>
<td><a href="mailto:arazack@fnb.co.za">arazack@fnb.co.za</a></td>
</tr>
</tbody>
</table>

Project Coach:

<table>
<thead>
<tr>
<th>Name</th>
<th>Telephone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>David Makovah</td>
<td>0836763987</td>
<td><a href="mailto:davidm@advantica.co.za">davidm@advantica.co.za</a></td>
</tr>
</tbody>
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Executive Summary
The banking industry is faced with a rapidly changing competitive landscape that is putting pressure on the relevance and future profitability of the traditional retail banks. The past five years has seen an increase in the entry of non-traditional banking players; rapid technological advancement in the devices that are used by clients; and changes in consumer needs and behaviour with regard to the delivery of bank services in key segments and their expectations of their financial services provider. Faced with this new environment, it is imperative that innovative solutions are found that will ensure that the bank of the future remains relevant, profitable and sustainable.

We researched international trends with regard to client expectations, branch networks, digital usage and technological developments – drawing information from research and consultative papers done on the financial sector in developed economies such as UK, Europe, USA as well as emerging economies and research done by local banks.

We then consulted widely with industry experts throughout the banking sector in South Africa, probing how they saw the future of banking in SA and collating this with the insights we gained in our trips to Uganda, Dubai and UK.

Our initial research pointed towards the move of banking to digital channels as a logical outcome of the exponential development of technology, digital penetration and associated client behaviour. But as our research continued, it revealed a common view of the continued need for a branch network as an integral part of the distribution channel. However, the future of banking requires a branch model that is very different to the one we see today. We propose in this project a new branch network model that optimises the various channels to ensure sustained profitability and relevance. This model incorporates a customer centric approach that focuses customer usage and needs, migrating clients to appropriate channels for their transactions or interactions, while maximising the value for the banks through flexibility and local market tailoring. This will create long term value for the banks which boosts revenue potential over the long term.
Chapter 1: PROJECT SCOPE

1.1 Purpose
The purpose of this study is to understand the new banking environment with a specific focus on determining the threats and opportunities that this provides for traditional retail banks. Our aim is to use the insights gained from international and local research as well as trends in banking and consumer behaviour to assess which challenges, if addressed, will assist in ensuring the future financial profitability and sustainability of the traditional banking sector. We will seek to provide practical, implementable, and cost-effective recommendations that can be implemented within a 10 year time-frame.

1.2 Problem Statement
The problems that this project will attempt to address are:

- How the banks can better understand their clients’ changing needs and behaviours and then segment this market to effectively deliver services that meet their expectations.
- How the banks can respond to the rapid technological advancements that are threatening the relevance of the traditional banking delivery channels.
- How the entry of new and existing non-traditional banking providers is challenging the traditional banks, and how the banks can respond to this challenge to defend their share of wallet and profitability.
- What the implications are of the changing environment from a revenue, cost, product offering, and market distribution point of view.

1.3 Focus and limitations
We will look at this topic with regard to RETAIL banking only. Our focus will be the following:

- To define the new environment – clarifying the characteristics of the new environment by comparing key drivers of the old and new environment.
- To provide an analysis of the status quo of the traditional banking providers To provide an analysis of existing non-traditional banking providers and new competitors who are about to enter the market, comparing their strengths, weaknesses, opportunities and threats with those of the traditional banks.
• To identify areas of strength and opportunity where the traditional banks can focus and innovate.
• To assess the changes in client needs, behaviour and expectations with respect to banking services (client centric perspective)
• To provide a suggestion of how banks could better segment their target market going forward (from a client centric perspective)
• To analyse, propose and test the customer value proposition
• To provide proposals for an approach by traditional banks that better meets client expectations and competes more effectively with non-traditional banking providers.

We acknowledge the high impact of the regulatory changes, specifically Basel 3, on the new environment, and the suggestions proposed for the “Bank of the Future” will of necessity fall within the framework of these regulations. However we will not complete an in-depth analysis of these regulations.
Chapter 2: RESEARCH ANALYSIS

2.1 Desktop Research

2.1.1 The new environment

2.1.1.1 Definitions
This study will use the term “traditional banks” to refer to the retail banks which have been the major financial institutions in South Africa for many years: ABSA, First National Bank, Nedbank and Standard Bank. There are other smaller niche banks with targeted offerings – Capitec, Investec, African Bank, U Bank and The Land Bank – which have been able to come in with different value propositions that are challenging the traditional banks, which are compelled to be everything to everyone.

“Non-traditional” players are deemed to be other non-bank competitors within the financial sector who offer alternative retail financial products including unsecured loans, mortgages, money transfer, credit cards, and savings products. Examples of these non-traditional financial players would include players such as Woolworths Financial Services, Discovery and Virgin Money, amongst others. There are numerous retail partnerships with the banks offering personal loans and credit facilities in the retail sector – such as Ellerines and Edgars - that could also be regarded as non-traditional options. Furthermore there are currently applications for banking licenses from new entrants that include the telecommunications companies and Pep stores, which will also form part of the non-traditional grouping.

2.1.1.2 Traditional SA Banking Environment

Political

Due to the apartheid history of this country, South Africa had been subject to extensive sanctions which left it isolated from the rest of the global community and the developments that were occurring both socially and technologically. As a result, after 1994, changes in the banking system, expectations of customers accelerated by the inclusion of previously excluded parts of the population and advancement in technology were all catalysts for change.
Legislation

The South African banking sector has undergone significant changes in the past 22 years, since the promulgation and enactment of the Banks Act of 1990 ("Bank’s Act"), with the early 1990s being characterised by a process of consolidation resulting from mergers of a number of banks and renewed interest by foreign banks to enter the South African market. This also created opportunities for a number of new entries into the market, some of which are now noteworthy players despite their smaller size.

Currently, South Africa has a well developed and highly regulated banking system which easily compares and even surpasses the developed countries’ banking systems. As the sector has become increasingly regulated, there have been significant increases in the compliance costs incurred by traditional banks arising from money laundering legislation (commonly known as "FICA") and also increasing consumer welfare legislation (FAIS, the National Credit Act and the recently enacted Consumer Protection Act). The bombardment of this sector with regulation and legislation has had a significant impact on the competitive dynamics and has impacted the established banks far more than the “non-bank” and “non-traditional banks” that are entering or currently trading in the market. The regulatory burden has been further exacerbated by the implementation of Basel I, 2 and now recently 3 which is directly impacting the traditional banks’ ability to lend, the cost of lending and ultimately the pricing of banking products and services in the market.

Competition

Traditional banks have also been facing competition from non-traditional and non-bank financial providers. The fact that some of the activities of the non-banks and non-traditional banks are not being regulated - or are regulated to a far lesser extent - means that the regulatory burden and associated costs are substantially higher for the traditional banks. This has resulted in differing cost bases, as well as different strategic objectives, which has had a significant impact on the competitive conduct of the various players.

In the current business environment, the traditional “Big Four” South African banks are being forced to improve and expand their current business operations to ensure profitability and maintain customer relationships. Smaller banks such as Capitec and African Bank have forced the traditional banks to reassess some of their customer value propositions.
Economic

Even though the South African economy has been slowing down in recent years with the impact of the financial crisis, competition for a share of limited customer's wallets has been intensifying at rapid rate. South Africa has a large population, however high unemployment rates continue to reduce the customer base for which the banks are competing. As a response to the competition, retail banking is witnessing a dramatic change in the patterns of product creation and consumption. Growing consumerism has resulted in increased demand for products such as credit cards, loans, customized products and services.

2.1.1.3 Industry analysis - SWOT

Strengths
The traditional banking sector has significant strengths which have contributed to them being dominant and unassailable to date. One of the key strengths is their deposit base, which forms a cheap source of funding which the non-bank players, who cannot take deposits, simply cannot match. With the new regulations increasing liquidity requirements, this cheap source of funding is a significant competitive advantage and provides a barrier to entry for non-bank entrants. This may also provide an opportunity for the banks for consolidation or acquisition of some of the smaller banks, who may struggle to meet the liquidity requirements of new banking regulations.

The bigger banks have well developed and sophisticated technology systems which would be costly for competitors to match. Their extensive customer base provides a ready market to which to cross sell products, as well as a large fee base which provides significant operational economies of scale. This extensive client base also provides a huge source of valuable data, with client transaction behaviour readily available to build client insight and projection models for new products. Given the implications of this in providing sophisticated and comprehensive customer analytics, this data is a significant competitive advantage which smaller or new players simply do not yet have, and an opportunity which the banks must exploit in the move to a more customer-centric focus.

The variety of products available through the banks ensures that there is cross-subsidisation, with profitable products being able to compensate for less profitable products which are required in order to meet the full range of client needs. The significance of this is
clear when considering the high losses incurred in the home loans divisions following the financial crisis in 2008, which would have closed the doors of smaller lenders who did not have the profit of other products to carry these losses.

The banks in South Africa still have a very strong brand positioning, with a high degree of trust and brand awareness, and a reputation of providing security for their clients’ finances. This perception is enhanced by the extensive branch structures, since many customers equate bricks and mortar with stability, credibility and permanence – all important factors when considering where to place ones hard earned money. The high visibility and accessibility afforded by branches makes this a significant advantage over smaller players.

**Weaknesses**

The banks have considerable weaknesses which impact on their ability to adapt to the challenges of the new environment.

The nature of the business means there is significant dependence on IT systems, with compliance and core processing being the biggest priority, making innovation difficult and time consuming (*KMPG, 2007*). This is a key weakness compared to some of the new non-bank retail entrants as well as niche banks such as Capitec, who do not have these legacy systems slowing them down, and they are more easily able to innovate and develop different offerings that do not have to fit into cumbersome existing structures.

The size of the traditional “Big Four” banks also makes them relatively inflexible and slow, with bureaucratic structures inhibiting decision-making and speed to market. This is further exacerbated by the pervasiveness of multiple product silos within the banks, which can make strategy implementation difficult with policy decisions moving slowly from the top down. Extensive bank branch structures are a high-cost operation and good cost efficiencies are hard to achieve.

The bigger banks also labour under a poor client service reputation – banks are not known for their customer focus, and are seen to have a rather dismissive “one size fits all” approach where client needs are disregarded. Clients often feel like just a number, with the lack of personalised service being a significant frustration to clients who feel they have no control or real choice (*SA Home Loans customer research, 2010*). This poor perception is exacerbated by increased resistance to high bank fees, which are comparatively higher
than most developed countries, and this is providing a key advantage to competitors such as Capitec who have seized on this as a key differentiator in their brand positioning.

Another key weakness of the traditional banks is that they are all focused on the same market - the middle to upper income bracket - and this market is saturated. There is already over 90% banking penetration amongst those earning over R2000 per month. Banking is largely being supported by only 10.5% of SA population (4.97m people in 2006) who earn over R4058 per month (Lafaria & Moore, 2011). The effort by banks to target the lower income levels - the “unbanked” - have not yet been successful on a large scale, however this remains a key opportunity and political imperative for the future.

**Threats**

The threats to banks in the new environment are significant. With the higher liquidity requirements of Basel 3, margins are being squeezed and the cost of doing business is increasing. This provides opportunities for non-bank competitors – who do not have to comply with the same banking regulations – to offer competitively priced products which the banks may not be able to match.

New entrants, such as large retail and telecommunications groups who already have well developed customer relationship management systems but without the cumbersome legacy systems, have a clear opportunity to come in with innovative, disruptive products and distribution channels. The more customer-centric approach of retailers and telecoms companies, in addition to their extensive databases for customer analytics, gives them the opportunity to better meet customer needs and provide a significantly superior customer experience. With customers becoming increasingly fickle due to the commoditisation of banking products and a general scepticism of marketing claims, they are more willing to switch or try new lending products.

**2.1.2 Implications of the new environment**

**2.1.2.1 Comparing the challenges faced by developed and developing economies**

One of the key catalysts of the challenges facing banking today is undoubtedly the financial crisis of 2008/9, and the continued impact of this in the Eurozone debt crisis. While the
entire banking system is facing some of the same challenges, the impact of the financial crisis has been different in developed and developing countries.

Most developing economies escaped the immediate fallout of the crisis which saw the bailout of US and UK banks, with significant loss of investor and client wealth. Regulations in South Africa prevented exposure to some of the key areas which led to the crisis. However, although South African banks came out comparatively unscathed, the impact of investor confidence on world markets was nevertheless high, with stock markets reflecting the global shock waves, and emerging markets were the first to suffer. This continues to impact on South Africa and other African countries, whose biggest export markets are the European Union countries and with the deepening debt crisis resulting in widespread austerity measures, the reduced demand for South African and African products is impacting hard on local industries.

A crisis of confidence in the banking system by customers was a key issue in developed economies (specifically USA and UK) following the financial meltdown, and this breakdown of trust and confidence continues to have an impact on customers' perceptions of, and loyalty to, banks in general. There is a high degree of scepticism and criticism, expressed in highly-publicised consumer movements such as Occupy Wall Street, which spread across USA. The recent Libor rigging scandal in UK has exacerbated this mistrust, casting questions over the integrity and culture of the financial sector, which is impacting on market confidence. While the banks in developing economies have escaped such bad PR, the litany of reports about exorbitant bank executive bonuses and underhand dealings have certainly made consumers everywhere more aware of the need - and vocal in their demand - for transparent and ethical corporate governance.

2.1.2.2 Regulatory implications of Basel 3 for SA Banks
The global banking crisis of 2008/9 resulted in a liquidity crisis which led to banks refusing to lend to each other. The crisis resulted in billions of dollars being wiped out of peoples investments; this was extremely severe for Europe and the USA. South Africa was fortunate, however, in that the South African banks were well capitalised, had healthy
liquidity positions and the financial regulation in place at the time shielded the banks from getting involved in the complex derivatives that culminated in the financial crises.

The crisis in 2008 resulted in the introduction of Basel 3 in 2010/11, which is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the Basel committee on Banking Supervision.

The new regulations were introduced to ensure that the banking system is more resilient to shocks in the market. Basel 3 introduces the following:

- New stricter definition of capital, which is designed to increase quality, consistency and transparency of the capital base.
- Global liquidity standards, defined by two new liquidity ratios:
  - The short-term Liquidity Coverage Ratio (LCR) and
  - The longer-term Net Stable Funding Ratio (NSFR)

This relates mainly to the need for banks to increase their high-quality liquid assets and obtain more stable sources of funding, while required to adhere to sound principles of liquidity risk management.

The net resultant impact is negative for banks for the following reasons:

The introduction of LCR and NSFR will force South African banking industry to rethink their liquidity positions. The NSFR is likely to create problems for the South African banks, as historically the South African banks do not have access to a large local base of long term funding. South African banks in general run a funding shortfall which is funded via the wholesale market. What the NSFR will do is force banks to increase their long-term funding which has always been more expensive, this will likely result in long-term products such as mortgages to be more expensive and could result a negative impact on the property market.

The new regulation will additionally force banks to increase their information technology (IT) spend in order to meet the new regulatory changes, and staff costs will also increase as suitably qualified individuals are sought to meet compliance. It is estimated that, for a full Basel 3 implementation, this would result in an increase of approximately 20% to 40% in funding costs.
Thus the costs of banking for banks are set to increase as Basel 3 is implemented. The squeeze this will place on profit margins will be exacerbated by poor cost efficiencies experienced by an increasingly expensive branch infrastructure; resistance to any increase in fees by clients who already see fees as too high relative to international standards; and increased costs of funding on the international markets by way of securitisation or investment, with banks competing internationally for the funding required to meet the regulatory requirements.

2.1.3 International trends
Internationally, banking customers are increasingly expecting more convenience, accessibility, personalisation and reliability across the distribution channel network. Banks need to deliver these features by leveraging innovative technologies and solutions for a seamless and personalised experience. There is a clear demand for banks to invest in their channel networks to make them more customer-centric and user friendly, while in the process improving the channel efficiencies for better return on investment and increased profitability.

These changes have led to the emergence of five key international trends across retail banking channels:

a) Increased online market presence using advanced technology platforms such as Web 2.0 and social networks.

The online banking channel has evolved into an essential part of the banking channel mix. Banks are now focusing on achieving the optimal balance between channels with self-service capabilities (such as online and mobile) for day-to-day financial transactions, and advisory-based channels (such as the branches) for more complex client needs. Easy availability and affordability of high speed internet, personal computers, and improved online security are also contributing towards the increase in Web 2.0 adoption.

US retail banks have been the most active in adopting Web 2.0 technologies for marketing and communications, with European and Asian counterparts not far behind. While the online channel is becoming important for banks globally, differences exist across mature and emerging markets. In mature markets, the key focus area for banks is to upgrade their existing online platform by supplementing them with advanced
functionalities and features. In emerging markets, the focus is on investing in online banking technologies to meet customer demand.

Banks have been relatively slow compared to industries that have already embraced Web 2.0 and social networks.

The ultimate goal is to attract new customers and generate increased loyalty across existing customer segments, which will help banks increase their revenues and profitability.

b) Investment in enterprise mobile financial service solutions to drive innovation and reduce costs.

Even though mobile banking has been around for over a decade, its penetration and popularity have grown over the last few years. Customer attitudes towards mobile banking have become positive due to the emergence of advanced mobile and smartphone technology, advancements in functionalities and security features, and an overall increase in the use of smartphones by the banking public.

The drive towards technological adoption is just one factor changing the nature of the traditional retail bank’s relationship with its customers. Today it is not just a plethora of technological tools and channels that is driving transactions out of branches; there is also an increasing range of new organisations lining up to take a share of traditional retail banking business.

As the Ernst & Young “Global Banking” report points out: “Banks are facing new competitors, including institutions in emerging markets and nonbank companies such as utilities, retailers, and mobile services providers.” (Ernst & Young, 2012, Chp. 2 p. 1)

As a new avenue for faster and more efficient money transactions, mobile money, also referred to as mobile banking services, is now seen throughout the developing countries of the world. Knowing that a significant section of the population in the developing world have mobile phones but no bank accounts, the advantages of cashless transactions through mobile money is indeed a great alternative. The simplicity of this system makes it ideal, especially to those who don’t have the access to banks or those who are far from ATMs and money transfer networks. Uganda is an example of how this is
impacting banking in developing economies. As we discovered during discussions with Ugandan banking experts during our tour in Kampala, in 2011 Ugandan banks focused increasingly on the development of electronic banking products as a move towards cheaper alternatives to branches for service provision. These services allow customers to use their computers and cell phones to carry out limited transactions outside the confines of a normal bank branch. There were also increased partnerships between banks and mobile network operators for the provision of mobile money transfer services.

As the demand for mobile banking services grew, Ugandan banks implemented solutions that would allow their customers to perform basic financial transactions on their mobile devices. It appears that banks in developed countries are following this trend and are no longer looking at the mobile banking channel in isolation and are focusing now on a multi-channel approach to deliver a seamless customer experience.

c) Increased push towards web-based activities to put the online channel on an equal footing with branch networks.

While the growth of online banking is important for banks as they seek to reduce their cost-to-serve, there is also a trend towards consumers being more likely to use the online channel for buying less complex financial products and services in the future. Though banking customers continue to rely on branches for complex transactions, the web has emerged as the key banking channel for doing simple transactions, gathering information, and checking account status. The online channel has emerged as a high-investment priority for global banks due to its low cost-to-serve, higher profitability, and client adoption rate.

A Novantas customer survey in the US also showed that customer preferences, attitudes and behaviours continue to shift away from traditional branch banking to remote channels. According to this survey, this shift is visible for nearly all categories of activity (Novantas, 2012, p.3). The trend has given rise to a substantial, valuable, and growing segment of customers who see online, call centres and the mobile phone as their primary channels today, with the branch as the alternative channel for limited, high-value interactions with the bank. These individuals still use traditional branches in some capacity, but sparingly (less than once every four months) (Novantas, 2012, p.7). They want to shop, buy, and service their banking relationships through remote channels,
using the branch less for routine transactions and more for important situations such as getting financial advice, purchasing complex products (e.g. mortgages), and resolving major problems.

More customers are adopting these technologies and are becoming increasingly self-service oriented. The percentage of customers who prefer self-service channels for the majority of their service transactions has grown to 53% from 49% over the year since the last survey. This trend is even more pronounced in the younger age groups. *(Novantas, 2012, p.4)*

d) More emphasis on seamless multi-channel integration to better serve clients and gain competitive edge.

The key challenges banks face today in achieving a true seamless integration are existing legacy applications and systems, bank processes operating in silos, and the lack of staff training to be able to function in a multichannel environment. For retail banks today, channel management is moving from being an operational function to being a tactical tool as part of their larger business strategy.

There are three main dimensions that banks are focusing on to achieve a true multichannel management which is integrated with a successful overall business strategy:

- Review the channel strategy before making a channel investment.
- Move the right customer to the right channel to optimize satisfaction and profits.
- Design the channel experience with a customer-centric approach.

Today’s multi-product, multi-channel environment presents significant challenges for retail banks. The key challenge is the ad-hoc approach followed by banks in delivering products and services to their customers. Due to this, banks can easily fall into the “3E trap” by trying to sell everything to everyone, everywhere. To address these challenges, banks will have to develop distribution strategies that take into account customer segmentation and profiling for directing the right product to the right customer through the right channel. Though banks have made some progress in achieving multi-channel
integration, banking customers globally are demanding the ability to fluidly switch back and forth across different channels for the same sales or service event.

Research by Nedbank in 2012 showed that both ABM Amro, as well as BBVA, has embarked on the process of creating branches that offer clients a range of channels they can use to do their banking. ABN has split its branches into full function and sales and service only outlets. In BBVA they also created Kids zones that allow clients to do their banking while their kids are safely entertained. A combination of workstations, called cocoons, for sales and service advice is set in one area and in the other there are Self Service kiosks and iPad stations supported by signage around client education on mobile banking. We saw similar layouts in Barclays and HBSC while in London, with branches featuring a number of self-service machines within the branch and consultants available for one-on-one consultations if clients required more personalised service.

For advocates of traditional branch banking, a March 2012 report by BT and Avaya provided similar reassurance. The study found that, despite the growing use of telephone, mobile and internet banking 73% of customers in the UK see their local branch as the most vital link with their bank in the future – second only to cash machines. After the ATM, the branch is the second most widely used channel sample of online consumers. Going forward, the branch retains its popularity, with 64% choosing it as their channel of choice for the future (BT and Avaya, 2012).

e) Increased spending on customer analytics tools to improve customer relationships.

In retail banking, the customer should be at the core of operations. Developing a long term relationship with existing and potential customers is important to gain and retain market share. Due to growth in product complexity and customer touch-points, banks’ relationships with their customers have become more complex over time. To better understand customer demands across a more global and heterogeneous client base, it is important for banks to effectively leverage analytical tools and technologies to enhance customer value and increase market share.
They require a robust analytical solution to better understand drivers for customer retention and attrition. Banks therefore need to increase their adoption of financial
analytics, customer intelligence, and performance management, and look beyond the transactional nature of their existing systems. Trends show that banks are segmenting customers on the basis of their age, gender, and net-worth to ensure better service to their customer segments (Capgemini, 2012). This also ensures that relationship managers have a greater opportunity to cross-sell depending on the nature of different customer segments.

Embracing analytics is helping banks understand the real power of combining customer data with business intelligence and predictive analytics. Predictive analytics helps increase customer value by offering management insights to devise pricing strategies based on predictions of customer risk and value over time. There are multiple benefits that banks can achieve by adopting a robust analytical solution, including reduction in customer attrition, increased profitability, increase in cross-sell opportunities, and enhanced customer value.

2.1.4 Local trends
South Africa has seen remarkable growth in consumer access to technology with penetration levels exceeding most predictions, and this is driving and shaping significant changes in consumer behaviour and expectations.

Internet penetration in South Africa reached 17% of the total population by the end of 2011 (Goldstuck, 2012). This represents 8.5-million internet users, and this grew by 25% versus 2010. World Wide Worx research shows that growth is being driven by exponential growth of smartphones in the South African market, but blames the low penetration on price – broadband services in South Africa being more costly than in other African countries such as Nigeria, Kenya, Egypt and Morocco where internet penetration is significantly higher.

Cellular penetration is, however, much higher. With 63-million SIM cards in use, this would equate to 126% penetration, but allowing for dual SIM card usage and other commercial applications, Goldstuck estimates that the true figure is closer to 80% penetration.

While not all cellphone users are using the internet, it is estimated that by 2013, smartphone sales will overtake those of ordinary handsets. The implications of this are significant. Goldstuck postulates that social media and gaming are the entry point to the internet for many, including those living in rural areas. The use of games on phones is
higher amongst rural than urban users. This indicates that users are exploring their phone capabilities – and predicts that gaming will be followed by social networking, followed eventually by browsing and internet usage.

Goldstuck has developed what he calls a “Digital Participation Curve” which is based on the premise that the average internet user needs to have access to online technology for 5 years or more before actively engaging with high-level applications such as retail transactions. This evolves with a combination of experience, comfort with using the medium, as well as confidence and trust. This 5 year “lag” would explain the failure if such digital initiatives as 20Twenty in 2001, which Goldstuck believes was ahead of its time, as in 2001 digital participation in SA was still very low, even though internet penetration had started to grow. The graph below illustrates this digital participation curve (in blue) which lags behind digital penetration (in red).

![Digital Participation Curve](image)

It can thus be realistically expected that South African consumers will follow the international trends described in 2.2 above, with a lag of between 5 – 10 years. The implications for banking, and specifically for the branch systems, are evident: in developed economies such as UK and USA, as well as in the higher income sectors of SA banking, customers are readily using the internet and their phones for banking. According to a survey reported in The Economist, the widespread adoption of smartphones is resulting in fewer visits to bank branches.
Earlier innovations like ATMs and telephone banking did not reduce the frequency of branch visits but did increase the number of transactions. *(The Economist, 2012)*. By contrast, smartphones and tablets appear to be radically changing bank customers' behaviour, with significantly fewer visits as well as increased numbers of transactions. Banking applications for smartphones with touch-screens is driving even higher engagement. The convenience afforded by mobile devices allows online access at any time, from almost any location.

This represents a huge opportunity for the banks. According to a report by PwC “The New Digital Tipping Point”, which surveyed 3000 banking customers across 9 different developed and emerging markets (China, India, Mexico, UAE, UK, Canada, France, Australia and Poland), banks are missing a vital source of revenue growth arising from digital adoption. They discovered that customers are willing to pay a premium for innovative digital banking services that offer convenience and value, such as social media notifications, electronic wallets and financial tools. *(PwC, 2012)*.

This report indicates four reasons for changed customer behaviour:

a) The traditional role of banks as financial experts has been replaced by the rapid emergence of social media, with customers turning to peers for information and advice rather than the banks.

b) Customers are better informed due to greater access to information, data and research.

c) Customers are able to compare and purchase competitive financial products online, which has opened up a range of non-traditional options, including peer-to-peer lending.

d) The rise of social media has amplified consumer voices, giving them significantly more influence and increasing the risk of reputational damage from perceived poor experiences by bank customers.

The survey also found that most respondents still trust their bank over other providers, but that new entrants are acting as catalysts for change – suggesting that banks should be looking to partner with or acquire these new entrants in order to deliver on the digital platforms customers expect.
The PwC report recommends that this new behaviour necessitates a new, more customer-centric business model by banks, suggesting that digital banking is key to achieving this. Digital banking is not only a lower cost channel than the branches, but also a key lever to improving the customer experience. “The banks that offer a differentiated digital experience with advice and relationship elements tailored to the individual customer, will secure deeper engagement and more profitable relationships with their customers.” (PwC, 2012, p. 40)

2.2 Insights from Qualitative Research
We interviewed selected executives and strategists within the financial sector to identify the key challenges and to find out what they believed the future of banking looked like. Respondents included non-banks (Woolworths Financial Services, Transactional Capital, World Wide Worx) as well as the traditional banks (Nedbank, SBSA, U Bank, Capitec, African Bank). There was agreement amongst all respondents on key issues, and these are highlighted below.

Customer Centricity
One overarching theme that was repeated by non-traditional banks like Capitec and African Bank, as well as the non-bank respondents was that banks need to change the way they think about their customers. Banks are strongly perceived to be product-focused rather than customer-focused, hampered by legacy systems which make them inflexible and cumbersome.

Moving to a client-centric approach is a fundamental shift that needs to take place in order for banks to surmount the challenges they face and to ensure banks remain relevant to clients, because as Carl Fischer of Capitec said: “People need banking, not banks.” Banks need to speak to their clients to understand and listen to their needs – and then to address those needs – and to do this authentically and not just pay lip-service to this.
Simplicity and Cost Effectiveness

A strong customer focus needs to translate into simpler, more easily understandable product offerings – solutions that are simple, convenient and cost-effective. Carl Fischer suggested banks need to take the lead from fast food retailers such as McDonalds who package the various offerings into menu selections, making it easy for customers to choose what they want. When combined with a transparent and affordable pricing strategy, this would allow banks to create differentiation and value-add to banking products that are increasingly seen to be commodities. Because banking products are easily replicated and banks are seen to be offering very similar options, banks need to look at supplementary services and activities that create value for their clients.

Transformation in Branch Design

The implications of this shift to a greater client focus will also transform branch designs. Capitec has positioned itself to be seen as more approachable and welcoming, and a key part of their strategy has been changing the branch designs to remove closed offices and create an open-plan layout, reflective of their transparency and more approachable stance in contrast to the traditional banks.

This move to open-plan layouts is a noticeable trend in the UK as well, where traditional banks such as Barclays and new entrants like Metro have created branch layouts with no offices and unrestricted counters with no glass barriers, creating easy access of clients to the ATM’s situated in the branches with consultants walking the floor to assist people as they come in. The overall impression is one of being welcoming, transparent and accessible – and distinctly less intimidating to those who have never banked before.

Customer Analytics

Another theme that was repeated amongst the non-traditional sector respondents is that banks need to think like retailers. This will prevent the progressive disintermediation by non-bank players who are presenting a threat to the traditional banks, perceived to be stuck with cumbersome legacy systems and a silo-mentality. Retailers such as Apple, Amazon,
Tesco and Woolworths were mentioned by Anton de Wet at Nedbank as businesses that will mould the future for their focus on the customer experience as well as their use of customer analytics to predict purchasing patterns of their clients. With the wealth of transactional behaviour information available to the banks, this is a “no-brainer” for future innovation – banks have a gold-mine of information on their clients that can be converted into intelligent personalised communication with smart sales suggestions based on their current needs. Customer data can be used to anticipate client needs proactively and to communicate to clients as their needs change.

**Branches are key for personalisation**

Unsurprisingly, all respondents emphasised the role that technology will play in changing customer behaviour, with bank service offerings in the future moving from “bricks to clicks” (*Anton de Wet, Nedbank*). Customer sophistication and access to information means that clients will define their needs and products should adapt to meet those needs. Banking will be more self-driven and flexible. However, it was also expressed that, while the remote channels are increasingly important and will continue to grow in usage, there will always be a need for branches which provide personal contact and advice on more complex and customised services and products. There was general agreement among the bank experts that branches will need to change from their current format in which all banking products and services are offered at all outlets, to specialised branch outlets that offer specific services, segmented according to client requirements in each area.

Retaining physical branch structures is also important to provide clients with an impression of security – “bricks & mortar” visibility is still a fundamental part of what gives banks their perception of permanence, security and credibility. This is especially important in a market where the bulk of the market is not extensively banked, is less technologically sophisticated and has limited online transactional experience.

**Outcome of insights**

The themes and ideas expressed during our interviews and highlighted in our research were remarkably similar, and our business case for the “bank of the future” took shape: clients will utilise multiple access channels, increasingly moving towards remote channels
for basic transactional banking and only utilising the branch channels for specialised services.

With this basic proposition drafted, we commenced our tour of London, and at every opportunity we tested this proposition against what we saw and heard amongst UK banking experts. Interestingly, Barclays shared their channel usage statistics with us, and these served to support our business case – see below. While Barclays did not define “branch usage” specifically, the high 95% branch channel usage indicates that this probably includes ATM usage as well, as these are generally situated within the branches in UK banks. However the real issue in the chart below is how much multi-channel usage there is, with 19% of clients using all 3 channels – highlighting the continued importance of branch in the channel mix.

![Barclays Channel Usage Chart](source-url)
Chapter 3: BUSINESS CASE

3.1 Recommendations

Industry experts including ourselves at the outset of this project were of the opinion that challenging branch economics and changing customer channel preferences are creating unquestionable ambiguity over the future role of the branch. Our research however, has shown that both industry experts and executives continue to identify the branch as an integral component of the distribution channel. The branch continues to provide the bank with competitiveness and flexibility and hence is potentially one of the largest contributors to future growth.

Current distribution strategies are largely based on historical notions of the value that customers place on the branches rather than current customer usage patterns. This disregards the customer needs and behavioural patterns which are fuelled by alternate channel usage and migration as well as the entrance of non-traditional players into the market.

Non-traditional players and newentrant banks have geared for simplicity and having a single view of the customer. Traditional banks however have built complex systems over time and treat customer needs in a more reactive as opposed to a proactive way.

With the emergence of alternate channels, the long-term decline in low-value, routine branch transaction volume is unavoidable and irreversible. Developing integrated, multi channel distribution strategies which enable the branch to deliver superior experiences on fewer high-value interactions will create economically and experientially optimal benefits for both customers and banks.

According to research done by the Peppers and Rodgers group, in today’s competitive environment, customers are in full control of their relationship with their financial service providers. “Always on” access to information through the branch, call center, Web and mobile channels create commodities of financial products. To compete, financial institutions must now realize that channel management is much more than a simple organizational enabler. Companies that create a robust strategy, migration plan, and integrated
multichannel processes with a customer-focused approach can turn their channel management efforts into a key differentiator. (Peppers & Rodgers, 2009)

This migration to alternate channels also presents an opportunity to recover the branch channel economically and present alternate and superior customer experience. The branch channel poses three largely untapped opportunities - Local Market Tailoring; Personal Contact and Flexibility.

**Local Market Tailoring:** Whereas the branch has typically been regarded as the most generic channel in the distribution arsenal, changes in technology, physical layout, and staffing enable it to provide a highly differentiated customer experience. In contrast to the call centre, mobile and Internet which best serve broad markets. The branch is the focal point for complex and exceptional transactions that create unique customer experiences.

Using research on their customers and market demographics, branches need to identify high-growth markets and high-opportunity customer groups as well as highlight the future opportunity value of each segment within specific geographies. The combination of client analytics and regional tiering of market potential will enable banks to activate strategies specifically to maximize local market opportunities, determine the appropriate mix of sales and service staff as well as design the most appropriate physical layout.

Individual branches can continually assess and adapt staffing, set measurement goals, and evaluate management structures to match evolving sales and service requirements. Banks will need to staff its branches according to market potential rather than historical volumes. By routinely adapting its staffing to market potential and target demographics, the bank is better able to serve specific, profitable customer segments, even as the customer mix and opportunities change over time.

**Personal Contact:** While there are questions regarding the relevance of the future role of the physical branch, research indicates that there is still a need for personal contact. Within the South African environment specifically we acknowledge that, with the diverse customer base banks have, the need for and type of personal contact may differ for various customer groups or locations.
The fact that customers can walk into a branch and talk to a person, makes branches ideally suited for customer-specific interactions that can only be resolved face-to-face. Rather than focusing on driving routine sales and service volume into branches, banks need to adapt a new model based on fulfilling exceptions-oriented sales and service transactions in the branch. This will increase customer satisfaction and loyalty as interactions become more personalized and needs orientated over time.

**Flexibility:** Whereas the branch is commonly viewed as a rigid asset, paradoxically, it can become a flexible channel. In viewing the branch as a fixed cost asset, institutions have constrained their ability to manage the natural life cycle of the branch. Banks have invested sizable resources in the branch channel and in order to maximize their return on investment, banks need to leverage branch flexibility to continually adapt to individual customer needs as well as local market preferences.

In order to enhance its multichannel customer experience, banks needs to analyse customer preferences for conducting simple and complex transactions in different channels to drive greater service consistency across channels and develop effective channel migration strategies. This coordination will enable banks to proactively migrate customers to alternate bank channels and lose less revenue than if they had migrated to channels outside the bank.

**3.2 Rationale**

- By creating a scalable branch format that both adapts to local market conditions and maintains bank wide brand integrity, banks can maximize local opportunities and proactively deploy targeted activation strategies. This will result in needs based sales campaigns with greater revenue boosting potential.

- The entire existing branch network can be analysed based on their respective location and market potential. This will result in staffing and a design that is suitable to the location within which it operates.
- Through analysis of their customer channel preferences, banks can activate targeted channel migration strategies and reduce the level at which customers use costly channels for their respective needs. Banks can thereby achieve the optimal balance between channels with self-service capabilities for day-to-day financial transactions, and advisory-based channels for more complex client needs.

- A robust customer analytical solution will ensure the banks better understand drivers for customer retention and attrition. This will help banks unleash the real power of combining customer data with business intelligence and predictive analytics. This will result in reduced customer attrition, increased profitability, increase in cross-sell opportunities and enhanced customer value.

- Creating flexibility in the branch network will enable branches to adapt to the geographical location within which they operate. Branches will be able to alter the ratio of sales to service personnel in branches over their life cycles or staff according to projected growth. This will enhance the customer experience through the provision of solutions in terms of specific, individual needs that cannot be easily fulfilled through other channels. Customer satisfaction can be expected to be enhanced as a result and long term value created which boosts revenue potential over the long term.

- A customer-centric model through personalisation is likely to attract new customers and generate increased loyalty across existing customer segments, which will in turn increase revenue and profitability.
3.3 Branch network model
Networks composed solely of full-service branches with duplicate services and skills are no longer sustainable. The branch network model must be designed with careful consideration to differentiated formats and integrated in a multichannel view that is able to maintain territorial coverage, react to local customer needs and optimize skills and capabilities.

This extends beyond full-service branches and hubs to include light branches (with an average of 4-5 employees), kiosks and cash-less branches. By migrating low value activities to digital channels and retail-based formats, banks can satisfy new customer segments and further overall branch network transformation.

An efficient “hub and spoke” branch model can help enable a bank to decrease the branches in its overall network by 15-20 percent and reduce average branch staff by 25 percent with the proper mix of flagship, full-service, light and kiosk branches. Furthermore, by specializing in specific services or activities, each branch format is able to deliver a more tailored customer experience and, ultimately, help increase customer satisfaction and loyalty.

The operational capabilities of these branches will further be enhanced by classifying the critical transactional types in terms of probability of occurrence. The most common is cash deposit, cash withdrawal, card replacement and statement enquiry. The banks have already started to develop basic mobile banking capabilities to provide services that take full advantage of the “on the go, anywhere, anytime” nature of mobile devices that addresses migration.

The chart below gives a definition of the four envisaged branch formats and a description of how they will meet the needs of the future.
<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Key features</th>
<th>Rollout strategy:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cashless or Digital Kiosks - maintain for service</td>
<td>100% transactions</td>
<td>Advanced ATM</td>
<td>We are mindful of the unconventional nature of our recommendation and the fact that most of the four big traditional banks have incurred losses related to branch investment so, as result, we feel it is prudent to pilot our recommendation with a single optimally-situated branch which would become a Flagship Store when this has proved to be successful.</td>
</tr>
<tr>
<td>Light Branches – maintain for sales</td>
<td>Open every day with 1 – 2 staff</td>
<td>Opening hours differentiated per local needs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reciprocity income</td>
<td>Self service desk</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Minimal staffing levels (people from retailing sector)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fully automated</td>
<td>Advanced ATM</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belonging to full service/light branches</td>
<td>Mobile sales force</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tailored merchandising generating branch traffic</td>
<td>Digital queue management system</td>
<td></td>
</tr>
<tr>
<td>Full Service Hubs – maintain for advanced banking</td>
<td>50% transactions and 50% sales</td>
<td>Simple product mix</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tailored hours</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales lead generation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Regular staffing: meter and greeter, cashier and junior RMs</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Able to accept and manage anything</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belonging to full-service branches</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Standard merchandising</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Highly skilled staffing: business cashiers and seasoned RMs</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Highly specialized Advisory services</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Supports light branches for complex service/sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Full merchandising</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flagship Stores - innovate, attract</td>
<td>40% transactions and 60% sales</td>
<td>Mobile sales force</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Extended hours</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sales lead generation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Centre of sales and service excellence</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Specific staffing (depending on area/segment served): dedicated business cashiers and permanent regional managers</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Location of experts</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Supports all other types for complex sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tailored merchandising, focus on innovation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Coverage. 50%</th>
<th>Coverage. 30%</th>
<th>Coverage. 15%</th>
<th>Coverage. 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>100% transactions</td>
<td>50% transactions and 50% sales</td>
<td>40% transactions and 60% sales</td>
<td>30% transactions and 70% sales</td>
</tr>
<tr>
<td></td>
<td>Open every day with 1 – 2 staff</td>
<td>Tailored hours</td>
<td>Extended hours</td>
<td>Extended hours</td>
</tr>
<tr>
<td></td>
<td>Reciprocity income</td>
<td>Sales lead generation</td>
<td>Sales lead generation</td>
<td>Centre of sales and service excellence</td>
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<tr>
<td></td>
<td>Minimal staffing levels (people from retailing sector)</td>
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<td>Fully automated</td>
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</tr>
<tr>
<td></td>
<td>Belonging to full service/light branches</td>
<td>Belonging to full-service branches</td>
<td>Supports light branches for complex service/sales</td>
<td>Supports all other types for complex sales</td>
</tr>
<tr>
<td></td>
<td>Tailored merchandising generating branch traffic</td>
<td>Standard merchandising</td>
<td>Full merchandising</td>
<td>Tailored merchandising, focus on innovation</td>
</tr>
</tbody>
</table>

| Rollout strategy: | |
|-------------------|---|---|---|
| We are mindful of the unconventional nature of our recommendation and the fact that most of the four big traditional banks have incurred losses related to branch investment so, as result, we feel it is prudent to pilot our recommendation with a single optimally-situated branch which would become a Flagship Store when this has proved to be successful. |
### 3.4 Financial Projection

Three year financial projection:

<table>
<thead>
<tr>
<th></th>
<th>Cashless</th>
<th>Light Branches</th>
<th>Full Service</th>
<th>Flagship</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non Interest Revenue</strong></td>
<td>R 7,737,655.00</td>
<td>R 14,328,990.00</td>
<td>R 15,761,889.00</td>
<td>R 17,194,788.00</td>
</tr>
<tr>
<td><strong>Interest Revenue</strong></td>
<td>R 8,597,394.00</td>
<td>R 9,457,133.00</td>
<td>R 10,316,873.00</td>
<td></td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>R 0.00</td>
<td>R 22,926,384.00</td>
<td>R 25,219,022.00</td>
<td>R 27,511,661.00</td>
</tr>
<tr>
<td><strong>Direct Costs</strong></td>
<td>R 7,190,124.00</td>
<td>R 11,463,192.00</td>
<td>R 16,609,511.20</td>
<td>R 19,755,830.40</td>
</tr>
<tr>
<td><strong>Margin</strong></td>
<td>R 547,531.00</td>
<td>R 11,463,192.00</td>
<td>R 8,609,510.80</td>
<td>R 7,755,830.60</td>
</tr>
<tr>
<td><strong>Margin %</strong></td>
<td>7%</td>
<td>50%</td>
<td>34%</td>
<td>28%</td>
</tr>
<tr>
<td><strong>Overheads</strong></td>
<td>R 54,753.10</td>
<td>R 1,146,319.20</td>
<td>R 860,951.08</td>
<td>R 775,583.06</td>
</tr>
<tr>
<td><strong>Marketing</strong></td>
<td>R 5,475.31</td>
<td>R 137,558.30</td>
<td>R 103,314.13</td>
<td>R 116,337.46</td>
</tr>
<tr>
<td><strong>Net Profit/Loss</strong></td>
<td>R 487,302.59</td>
<td>R 10,179,314.50</td>
<td>R 7,645,245.59</td>
<td>R 6,863,910.08</td>
</tr>
<tr>
<td><strong>Development and Capex Cost</strong></td>
<td>R 100,000.00</td>
<td>R 800,000.00</td>
<td>R 2,000,000.00</td>
<td>R 4,000,000.00</td>
</tr>
<tr>
<td><strong>Break even month</strong></td>
<td>9</td>
<td>12</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td><strong>Pay period</strong></td>
<td>12</td>
<td>12</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td><strong>IRR %</strong></td>
<td>20%</td>
<td>27%</td>
<td>32%</td>
<td>25%</td>
</tr>
<tr>
<td><strong>NPV %</strong></td>
<td>5%</td>
<td>15%</td>
<td>17%</td>
<td>14%</td>
</tr>
</tbody>
</table>

### Key Assumptions

Revenue:
- To grow account base by 10,000 from Flagship on a sliding scale
- To grow account base by CPIX (5.7%) plus GDP (2.7%) and 3% organic growth.
- Target a cross-selling ratio of 5 products per customer
- Target a market share of 25% and 2% of compound increase.
- Kiosk to be used for migration purposes.

Costs:
- 50% of the cost base will comprise salary base made of base plus commission
- Processes to be automated to make it paperless and reduce storage costs
- Advanced ATM will reduce security costs of holding cash.

Key Benefits
- Increased active base
  - Increased customer touch point
- Increased Vertical Sales Index (VSI)
  - Single view of the customer platform
- Increased operational efficiency.
  - Improved business unit processes that price customers according to preferences.
  - Effective branch interface
  - Increase move to electronic channels
Chapter 4: RESEARCH METHODOLOGY

Our research followed the steps below:

1. Desktop research – the team did extensive desktop research of papers, presentations and research reports by local and international academics and consultancy groups. We also referenced research and presentations done by our own organisations.

2. Interviews with industry experts – once we had developed a context for our project and identified the key challenges and trends taking place internationally and locally, we identified key industry experts in both the bank and non-bank sector. This included selected senior executives from the following organisations:
   - Nedbank
   - Standard Chartered
   - Standard Bank
   - U Bank
   - African Bank
   - Capitec
   - Woolworths Financial Services
   - Transactional Capital
   - World Wide Worx

3. Field research – our visits to Kampala, Dubai and London provided us with the opportunity to engage with banking experts in each country, to assess the banking models used and to probe how they thought the future of banking would look. The field research in London was particularly useful to our topic given that the UK is a trend-leader in world banking, with SA banking being modelled closely on UK banking despite differences in the actual client market. Thus trends seen in UK are likely to follow in SA within 5 – 10 years, allowing for innovation and adjustment to meet the local market needs.

4. Development of the business case – once the opportunities had been researched and identified, we developed a business case which aims to provide an economically viable, implementable and sustainable customer value proposition.
Chapter 5: REFERENCES

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15. SA Home Loans consumer research surveys (2007 and 2010)


