Direct Banks and the Future of Consumer Banking

Direct Banks Emerge as the New Winners

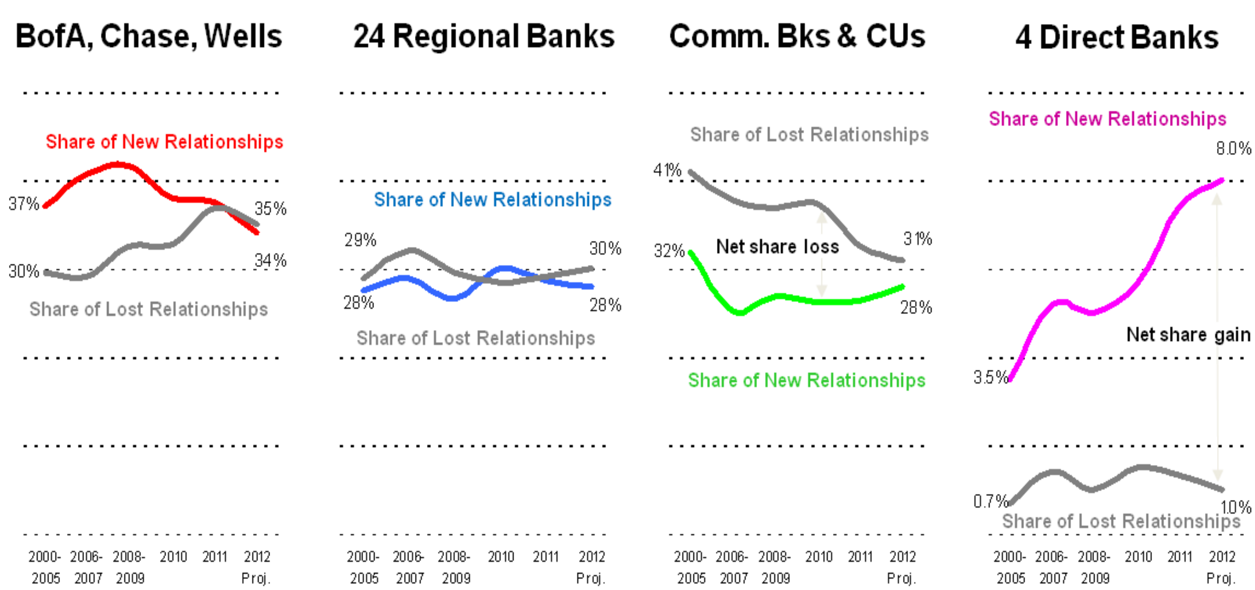
You may not be surprised that America's biggest banks are losing market share. Tarnished reputations, consumer disdain, and inferior customer satisfaction have recently ended an era of organic growth for the three largest consumer banks. This is a big change. Convenience is king in consumer banking and, with their enormous branch networks; these banks enjoyed a run of significant organic growth that lasted at least twenty years.

The largest regional banks have long struggled to maintain share in consumer banking on an organic basis. Even smaller banks and credit unions, which are perceived much more favorably but which can't compete on convenience, have been losing market share organically for years.

Of four categories of competitors, only direct banks are winning. Deposits at the four largest direct banks – Ally Bank, Discover Bank, ING Direct (now being rebranded as Capital One 360,) and USAA Federal Savings Bank – have more than doubled over the past five years, a growth rate more than three times the industry average.

Direct banks enjoy an obvious cost advantage that enables them to offer more attractive pricing than brick-and-mortar banks. There is now new evidence that direct banks are beginning to undermine traditional banks' convenience advantage. More direct bank customers describe their bank as "the most convenient bank for me to use" than do customers of traditional brick and mortar banks. These days, direct bank relationships are less likely to be confined to savings accounts and CDs. Collectively, these four direct banks will attract as many new "primary bank" relationships in 2012 as the four largest regional banks combined.

Figure 1: Share of New and Lost Primary Bank Relationships
Source: TNS Retail Banking Monitor



Making the matter worse for traditional banks, direct banks are skimming off some of the industry's most sought-after customers. Direct bank customers are younger, have higher incomes, and have more investable assets than consumers at large.

Figure 2: Demographics of Direct Bank Customers
Source: TNS Retail Banking Monitor

	All American Households	Direct Banks	Index
Age			
18 to 24	13%	8%	63
25 to 34	18%	22%	125
35 to 44	19%	23%	125
45 to 54	20%	19%	98
55 to 64	15%	13%	90
65 to 74	13%	11%	88
75+	3%	2%	72
Total	100%	100%	
Annual Household Income			
Under $30,000	22%	10%	46
$30,000 to under $50,000	21%	17%	77
$50,000 to under $75,000	20%	21%	107
$75,000 to under $100,000	13%	16%	124
$100,000 to under $150,000	14%	21%	147
$150,000 to under $200,000	6%	10%	161
$200,000 or more	3%	5%	153
Total	100%	100%	
Investable Assets			
Under $5,000	32%	18%	60
$5,000 - $9,999	8%	8%	108
$10,000 - $24,999	10%	11%	110
$25,000 - $49,999	10%	11%	120
$50,000 - $99,999	11%	13%	130
$100,000 - $199,999	11%	14%	138
$200,000 - $499,999	10%	15%	153
$500,000 - $999,999	4%	6%	151
$1 million or more	3%	4%	145
Total	100%	100%	

All signs point to continued success for the direct banks. More than three-quarters of consumers now interact with their banks online. Mobile banking is booming. Two-thirds of consumers use the online or mobile channel for monetary transactions, e.g., deposits, transfers, and bill payments. At the same time, fewer consumers are conducting these transactions at physical bank branches.

There remains, though, a substantial perceived imperfection in the direct bank model, a weakness that significantly limits their growth potential in the near term. The overwhelming majority of consumers – even many direct bank customers – want something that only traditional brick-and-mortar banks have: physical offices.

Figure 3: Selected Consumer Comments on Direct Banking
Source: TNS' Direct Banking in the U.S., Qualitative Research

"I am not yet comfortable dealing with an entity that is entirely electronic, with no people to sit down and see (and possibly go back to if something goes wrong). I assume the direct bank would have customer service reps available by phone, but that doesn't ease my unease!"

"I worry about little things. Like, if I lost my debit card or it was stolen, how soon when I get another one? This just happened to me recently, and I was able to walk into (the bank) and immediately receive a temporary card."

"With a traditional bank you would at least be able to go into a location if you felt you weren't getting the proper customer assistance or service. It's less likely someone will be rude or unkind to your face than it is over the phone."

"Sometimes nothing beats being able to talk to someone face to face and this is something that I obviously will not get at a direct bank."

To achieve broad adoption in today's market, direct banks will need to address consumer demand for in-person, face-to-face interaction with bank employees. But rather than set up and staff branch offices for accepting deposits and cashing checks, direct banks need offices for that rare and critical moment when a customer has a problem to fix or a need to fill.

It should be clear that direct banks can no longer be dismissed as merely competing on the fringe. They are quickly becoming mainstream. What is not yet clear is how direct banks will evolve and what this means for the rest of the banking industry.

Direct banks have a successful track record of introducing new technology to mitigate obstacles to growth. Recently, remote deposit capture via smart phones has largely eliminated complaints about the difficulty of depositing checks into direct bank accounts. Maybe video conferencing can fill consumer demand for interaction with live humans.

Or, perhaps direct banks will move toward a business model in which they operate a small number of branches – maybe one per city – to provide high-value sales and service. On the surface, at least, this model seems to offer promise: It addresses the largest attitudinal factor favoring traditional brick-and-mortar banks, while largely retaining the cost advantages of the direct bank model.

There is evidence that the same forces that have created direct banking are also forcing change in the rest of the industry. Companies like Bank of America, PNC, and KeyCorp have all announced plans to shutter branches to reduce expenses and respond to consumers' adoption of alternative channels. The number of branches operated in the U.S. by FDIC-Insured institutions has declined for each of the past three years. Does the rise of direct banking portend the decline of massive, densely-packed branch systems operated by traditional banks?

You may be interested in…

This whitepaper is drawn from a much larger report titled "Direct Banks in the U.S. - 2012" which summarizes qualitative and quantitative research examining the experience of America's four leading direct banks. Major areas of analysis include:

• **The Direct Bank Customer** – The report presents a demographic, behavioral, financial, and attitudinal profile of direct bank customers.

• **Competitive Momentum** – Focusing on the experience of the top 4 direct banks, the report examines the recent performance of direct banks in acquiring, retaining, and expanding customer relationships, and evaluates likely future performance.

• **The Direct Bank Experience** – The report looks at how customers interact with their direct banks, measures customer satisfaction, and assesses specific attributes of the customer experience. Emphasis is placed on understanding how the dynamics of customer loyalty differ for direct banks compared to traditional brick-and-mortar banks.

• **Direct Bank Brands** – The analysis assesses the overall strength of the leading direct bank brands vis-à-vis leading traditional bank brands, evaluates brand perceptions, and identifies the image attributes that attract – and deter – new customers.

• **The Role of Marketing** – The effectiveness of marketing by the leading direct banks is evaluated. The report also assesses the importance of advertising, word-of-mouth, and press coverage in driving consumer usage of direct banks.

• **The Direct Bank Purchase Decision** – The study explores the circumstances that lead to the consumer decision to select a direct bank, and identifies perceived benefits and drawbacks.

For additional information about Direct Banks in the U.S. – 2012, please contact Charles Schembri at 212 991-6021