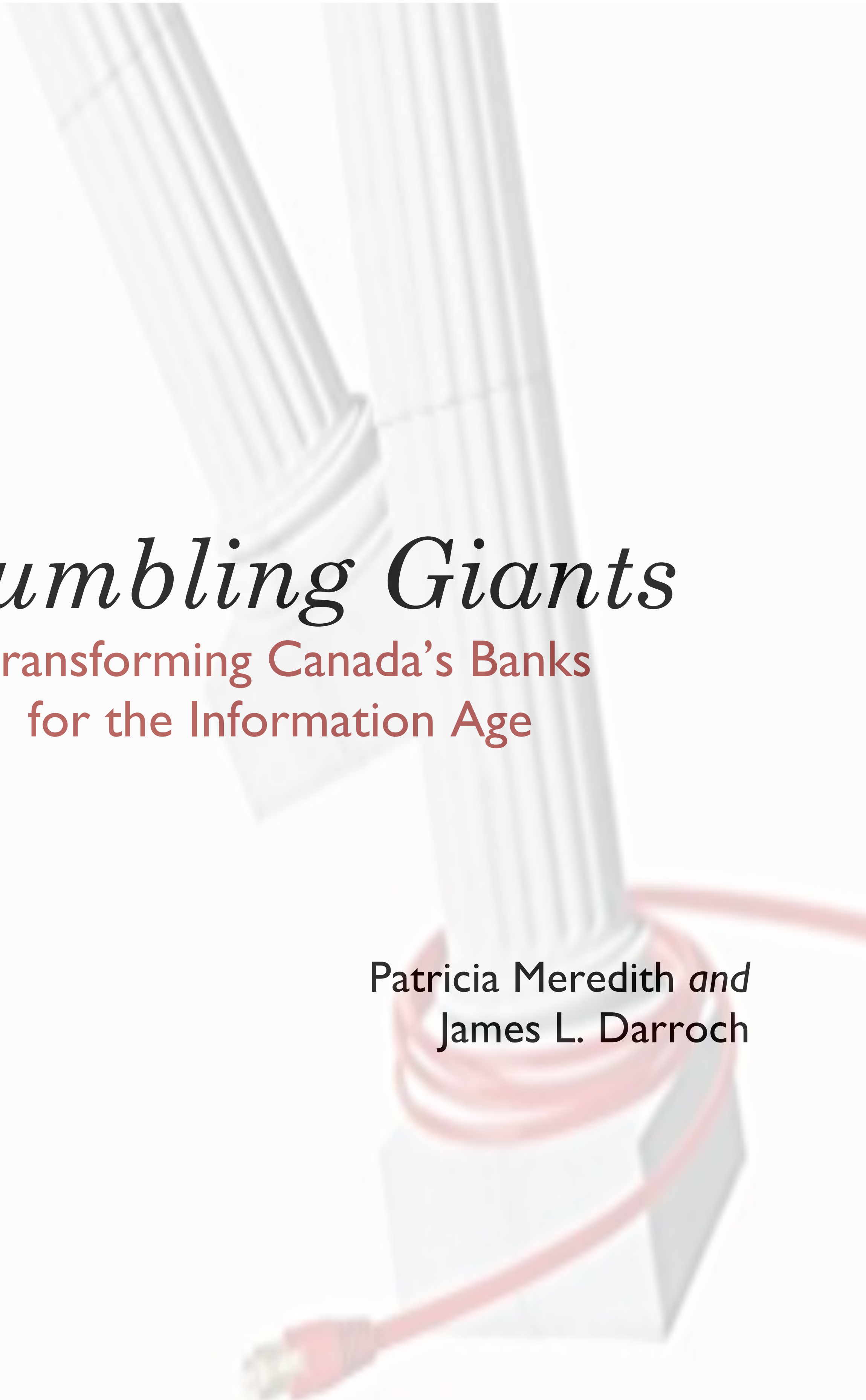

Stumbling Giants

Transforming Canada's Banks for the Information Age

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Canada's big six banks weathered the 2008 financial crisis very well. Their adherence to tried and tested twentieth-century products and services made them a safe harbour in the financial storm. However, as the modern global information economy continues to develop, the banks must confront their innovation crisis, or they will fail.

STUMBLING GIANTS: TRANSFORMING CANADA'S BANKS FOR THE INFORMATION AGE

WHY WE WROTE THIS BOOK

In November 2010, Mike Kitchen, a senior executive at Bank of Montreal, presented the *Tech-tonic Shift* scenario to the Payments Roundtable, a group convened by the Payments Task Force, which I (Patricia Meredith) was chairing at the time. Mike painted a bleak picture of the future of banks and other traditional financial institutions. With the rapid adoption of mobile technology, banks were in danger of losing their competitive edge. Profits from transactions would drop, most of their lucrative small payments business would be lost, and, worst of all, their unflinching attachment to outdated systems would prevent them from keeping pace with the new herd of nimble financial technology companies. As Mike described it, this scenario might spell trouble for the banks, but it did not signal their demise; after all, they still had plenty of pro table niche businesses to focus on.

As things turned out, it didn't take long for Mike's story line to start coming true. Within a few years, Apple had launched the Apple Pay smartphone app in Canada in partnership with American Express. Apple Pay has created a tsunami in the financial services industry, and for banks in particular. Now, customers can register their payment cards in Apple's mobile wallet to make payments and receive receipts. Google has gone one step further, adding loyalty cards to its mobile wallet, Android Pay. Instead of being the linchpins of financial transactions, the banks are on their way to becoming bit players. They are even paying companies like Apple and Google to give them a role. By mid-2016, the Canadian banks had caved in to Apple's demands for a share of their payment fees and had agreed to make their services available to the 40 per cent of Canadians with iPhones who are Apple Pay's potential users. As Mike Kitchen and his team had predicted, the end of banking as we know it was in sight. Armed with services such as Apple, Android, Samsung Pay, PayPal, and other offerings by a swarm of innovative financial technology companies, Canadians are no longer hostages to the big banks.

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Mike's presentation was music to my ears. It drove home a message that I had been trying to get across since the mid-1990s, namely, that Internet technology, agile new players, and changing customer attitudes were about to turn the banks' business upside down. For fifteen years, they had ignored my entreaties that they shift their attention to the future. They were confident that the music would not stop on their watch and that someone else would deal with the problem in the far distant future.

The working title of this book started out as *The End of Banks: How Canada's Banks Missed the Future and Cost Canadians Dearly*. It reflected my pessimism about the future of Canada's big banks and my frustration with their focus on short-term profits at tremendous cost to consumers, employees, long-term investors, and the Canadian economy. But I struggled to write a succinct conclusion.

Then my co-author, James Darroch, reminded me of the huge role that public policy and regulation have played in shaping this country's financial services industry.

> **We recognized that Canada's unique circumstances demanded a made-in-Canada solution, and that we could hope for such an outcome only if we challenged all those involved in the banking industry, including policy makers, regulators, customers, suppliers, investors, and bankers, to work together to design a financial system for the twenty-first century.**

The result is *Stumbling Giants: Transforming Canada's Banks for the Information Age.* We constantly encounter enthusiastic young bankers who realize that their industry must change if it is to regain its reputation as a vibrant enabler of economic growth. We wrote this book for them in the hope that it will catalyze the industry to transform itself before it is too late. But the dreams of these men and women will not be realized unless a broad cross-section of Canadians – policy makers and regulators, customers, suppliers, investors, and, not least, the bankers themselves – work together to create a banking system better suited to the twenty-first century.

DIGITAL DISRUPTION AND OTHER HEADWINDS

If payments go away, what does this mean for the future of banking? *Stumbling Giants: Transforming Canada's Banks for the Information Age* tries to answer this question. We begin by looking at the most successful bank in North America – United Services Automobile Association. USAA provides banking, insurance and investment products and services to more than 10 million members of the armed forces and their families. In 2016, USAA had a net promoter score of 75. In other words, its customers are very likely to strongly recommend USAA's products and services to friends and colleagues. USAA also had the highest customer satisfaction score in wealth management (both full service and discount), even though they had not been in this business a long time. But the average for the large U.S. national banks was close to zero.

In Canada, only one bank boasted a score of 50 or higher in 2016. That distinction went to Tangerine (formerly ING Direct), which overtook President's Choice, a joint venture between Loblaw's supermarket chain and CIBC. The Canadian banks net promoter scores were 50 points lower, averaging around 20, hardly a vote of confidence.

While Canadian banks may trumpet their commitment to superior and customer service they have clearly failed to deliver. Small and mid-sized businesses tend to have an even lower opinion of the banks than individual customers. Surveys by the Canadian Federation of Independent Business over the past decade consistently show that of its members give the banks a score of five or less out of 10. Such poor ratings translate into negative net promoter scores; in other words, all these small business owners are, in effect, telling others to steer clear of the banks.

Not only are USAA and ING Direct delighting their customers, but they are doing it at a much lower cost. A milestone in USAA's history was the introduction of toll-free phone service to replace snail mail or telegraph. That forced it to re-engineer its systems and processes to serve customers when they called, rather than when it suited the bank to respond to them. Because they have no branches, they decided to deliver services immediately in response to customers 1-800 call, e-mail or app. This direct approach meant dramatically lower costs, and higher customer satisfaction.

A speech by Brian Porter (CEO of Scotiabank) to a group of Western University business students a year ago, sheds some light on the magnitude of difference in cost savings and customer service. In 2016, Tangerine, formerly ING Direct, served 2 million customers with 1,000 staff while the rest of Scotiabank served 21 million customers with 90,000 staff.

To match USAA and ING Direct's customer satisfaction scores and cost ratios, the banks will have to replace their core transaction system and convert millions of customers over to the new platform. In other words, they will have to transform themselves into direct banks.

But even that will not be enough, because all the banks traditional businesses are facing headwinds. Consumer loan growth, which has fueled bank profits for the past two and a half decades has resulted in record high consumer debt levels, leaving little room for them to borrow more. Wealth management customers are beginning to wake up to the outrageous fees they are paying to manage their money. As a recent Questrade ad asked: "whose retirement are you funding, yours or your bankers? Are mutual funds fees costing you more than 30% of your retirement?" And after years of neglect by their bankers, small businesses are looking elsewhere for loans and other services. Finally, a multitude of new fintech companies are finding profitable niches in all parts of the banking value chain to start new businesses.

With return on equity of about 40% in domestic retail banking, it is not surprising that the Canadian banks are a prime target for new entrants, especially when banks in the rest of the world struggle to earn a double-digit return. As consumers, Canadians are paying top dollar for yesterday's products and services, an unsustainable value proposition. While we may not be able to pinpoint the exact threat, clearly change is coming.

THE BANKS DOUBLED-DOWN ON THE PAST, LOSING THEIR WAY

The Canadian banks high returns have given them plenty of money to invest in new technology for the future. Yet, until recently, they gave priority to adding more branches and ATMs, both inside and outside of Canada, even though such bricks-and-mortar facilities are heading the way of the dinosaur. But the socio-technological revolution is now starting to overwhelm them. Customers expect immediate delivery of financial services, at any place and any time. Direct banks, those without a physical presence and with very little human intervention, can provide these services, and more, at much lower cost. Unlike the banks, they are harnessing such twenty-first-century technologies as the mobile Internet, Cloud computing, artificial intelligence, and social media. On another front, a new generation of nimble financial technology companies, known as fintechs, are offering innovative lending, wealth management, and payments products.

The 2008 financial crisis was a turning point for banks around the world. But Canada escaped the brunt of the storm. The Canadian banks' good fortune has its roots in the British North America Act, which created Canada in 1867. Under that law, banks are federally regulated, but capital markets are overseen by the provinces. This arrangement has kept the banks strong and capital markets less developed. Furthermore, because our banks have been so critical in financing the growth of this nation over the past century and a half, public policy has protected them, putting the emphasis on stability and profitability. Banks have only been allowed to expand into new businesses, including mortgage-backed securities, after they proved they could manage the risks.

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These priorities may have served Canada well in the past, but they now cast a shadow over the future. Rather than helping to propel our economy forward, the focus on stability and the aversion to risk are now holding us back. Without significant market-based funding and more access to bank loans, the small businesses that play such a vital role in shaping a competitive economy are increasingly forced to look south of the border for the funds they need to grow. Worse, their founders are tempted to move to Silicon Valley, and their companies will be gobbled up by deep-pocketed rivals from the United States and beyond. Without a super-fast, information-rich payments system, Canada's productivity will sag under the burden of inefficient, paper-based invoices and payments. Companies will be unable to access the data essential for innovative online services. In short, Canada will find itself fenced off from large chunks of the digital world, cut off from some of the most rewarding areas of economic growth.

A BANKING SYSTEM FOR THE TWENTY-FIRST CENTURY

Canadians still need banks, at a minimum to protect their savings, provide home mortgages, fund loans to small and mid-sized businesses, and support the capital markets for investors and large corporate and government issuers. The banks will always play a key role in helping the Bank of Canada execute its monetary policies. Nonetheless, this book's central theme is that change is long overdue for the banks and the rules that govern them. Boards of directors and long-term investors must force banks to invest in innovation. Government policy needs to find a better balance between stability and innovation. Market-based lending and bank financing for businesses must be encouraged, perhaps with government inducements. The burgeoning array of fintechs, large and small, must have easier access to a modern payments system to spur competition and innovation. Tighter regulation in other areas, such as fuller disclosure of investment management fees, an expanded Canada Pension Plan, and a much stronger Financial Consumer Agency of Canada, will help Canadian consumers take advantage of cheaper alternatives to grow their retirement savings and manage their transactions.

> **Finding the common ground necessary to ensure that Canadians continue to benefit from a safe and secure banking system is good for us all.**

Catalytic Governance, a tested alternative model for productive change in the information change, offers a way forward. Through this model, the industry could engage a diverse group of stakeholders, with different backgrounds, mindsets and interests, in a dialogue to build a community that works together to realize a preferred future they have determined together. It is clear that the world is changing rapidly, threatening the Canadian banking system as we know it. We would all be much better off if this important industry took the lead in transforming itself, before the massive forces of this socio-technological revolution overtake them.

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