The Evolution of Online Banking

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ABSTRACT

The purpose of this paper is to explore the success of U.S. banks in utilizing online banking as a distribution channel for their products and services. The emergence of the Internet as a distribution medium of revolutionary potential in the mid-1990s was greeted by the majority of banks with reservation and caution. At the beginning of this era banks were found to have difficulty integrating an effective Internet strategy into their overall business plan as a result of a striking difference between the culture of the banking community and Internet users. This resulted in a wide array of strategic responses ranging from a passive brochure strategy to a highly proactive personalization strategy.
By 1999 the distribution of effective bank strategies was distinctly bi-modal with the large majority of banking web sites being little more than unattractive informational brochures, while a much smaller number of banks struggled to offer their customers a site which created value by personalizing financial products and services. Since that point, bank strategies have generally evolved away from a passive approach to a more active approach in utilizing this distribution channel. By 2005 most online banking sites adopted a supermarket strategy (offering a broad array of attractively packaged products and services) at their Internet sites with a significant number of banks having moved toward becoming financial portals to add value for their current customers and to attract new customers. Such portal sites are technically sophisticated, attractive, convenient, and allow an individual to access numerous customized financial services and products. The banking community is seen as continuing to move towards more active Internet strategies in response to competitive pressures from non-banking financial service companies and as Internet technology continues to advance.

Introduction

The fact is that the Internet does hold revolutionary potential for the delivery of banking products and services. The Internet not only has an absolute cost advantage in providing financial products and services, it has the potential for enhancing the value of these products and services by making them more convenient for consumers to acquire, empowering consumers to make better choices, and personalizing those products and services to their individual needs. If the promise of this revolution has been thwarted by
poor implementation, the forces driving the use of Internet banking have proved inexorable. The evolution of Internet banking strategy will continue. To the extent that retail banks resist this process, they will lose market share to others at an accelerating rate. Despite the legacy of failures and mistakes, those banks that correctly utilize the Internet will be rewarded with greater profitability and growth than is currently thought possible.

The web is a tool that may be used to create competitive advantage and differentiate a bank from its competitors. In the current competitive and turbulent environment, most retail banks have already made significant efforts to increase the value and desirability of their products and services to their customers through a variety of policies and activities (e.g., extending banking hours, developing an automated telephone response system, providing complimentary products and services such as mutual funds and insurance, and "friendly" personalized customer representatives). Such approaches to creating a sustainable competitive disadvantage have had only mixed success because they are expensive and easily duplicated by competitors. The web has a special role to play for retail bankers because it represents a potentially quantum leap in the ability of the bank to interact with its customers. The leap is quantum because the web provides the capability for an extraordinarily comprehensive exchange of information on an exceptionally cost-effective basis. A successful bank web site will foster the creation of communities of interest that can serve to truly differentiate a bank from its competitors.

Successful web sites create value for present and potential customers. Saving these customers time and money can create value. Making life more convenient and pleasant can create value. Respecting and honoring the integrity of the individual can
create value. Value can be created be through empowerment, giving individuals control over their choices, lives and destiny. Value can be created through community service. Using the web as a fully integrated part of their business strategy, retail bankers have the ability to increase the attractiveness of their products and services as a way to offset the increasing commoditization of financial products and services. Indeed, the web has sufficient potential to allow retail banks to become even more profitable in an increasingly hostile and competitive environment.

Being on the web is meaningful only if this is an extension of the bank's business strategy. Numerous potentially successful business strategies are available to retail banks. An effective business strategy requires a plan targeting specific market segments with specific goals in mind. Just "doing what you have always done" is not a business strategy. Nor is "doing what others seem to be doing." It may be that such "drifting" approaches to doing business were sufficient in the past. Present trends suggest this will not be so in the future. A retail bank will be categorically unable to remain successful and independent in the coming competitive environment without a well thought-out business strategy and the web will be an integral component of this strategy.

Successfully implementing the use of the web as a component of the bank's business strategy is not a matter of all or nothing. Effective organizations generally should not make radical changes. Changes within the organization should strike a balance between preserving what the organization does well and the need to adapt to new realities in the competitive environment. The integration of the web into the bank's business will have a profound impact on the culture of the bank, its relationship with its consumers and the products and services it offers. To be effective, such change should
be gradual, impacting operations on the margin and more directed towards improving existing products and services that in creating new products and services. Properly implemented, a bank web site is a tool for doing things better, not necessarily for doing things differently.

Literature Review

Wells Fargo was the first U.S. bank to add account services to its web site in 1995. As the use of the Internet exploded in the late 1990s, the advantages of using this channel of distribution for banking and other financial services became obvious. In the United States this occurred in the context of a dynamic environment that included the blurring of traditional market boundaries between different types of financial service providers, deregulation, technological change, and a wave of consolidation and mergers. In the context of that time, Internet Banking was seen as more than just another distribution channel (Birch and Young, 1977), it was seen as a revolutionary approach to banking with 96 million potential customers that “will” be profitable (Online Banking Report, June/July, 1997, p.1, p.33). The banking industry at that time was having trouble maintaining its traditional profit margins and Internet Banking was seen as an approach to banking that would both lower costs and increase revenues by expanding market share in its traditional product areas as well as allowing banks to sell higher margin non-traditional products (e.g., insurance, brokerage services, etc.) For similar reasons, the Internet was expected to revolutionize retailing in general (Jarvenpaa and Todd, 1997).

By the end of 1999, less than .4% of households in the U.S. were using Internet Banking and the honeymoon was clearly over (Online Banking Report,
While a number of non-bank financial institutions has extraordinary success, Internet banking failed to penetrate the mass market. Innovative behaviors occurred among a few banks and the small market of techies and visionaries (Moore, 1999), but could not breach the mass market which would not buy into the new market on faith (Singer, et al 2001). “... with no historical numbers to plug into your spreadsheet, it takes a leap of faith to buy off on the speculative cash flows” (Online Banking Report, 1977). Innovative behavior in actually using the Internet for shopping, as opposed to gathering information (Gupta and Chatterjee, 1977), appears to require “nurturing” (Hui and Wan, 2004). Both banks and potential consumers proved reluctant to innovate. It was a “chicken and egg” problem. Sivanand et al (2004) has shown that Internet banking customers' value ease of access and value added services (pp.9-10). Banks were reluctant to provide such services until they could see them as profitable activities. Well publicized failures such as Wingspan Bank and Compubank didn’t encourage innovative behavior in that conservative industry.

Despite the failure of the Internet to bring about a revolutionary change in retail banking, Internet Banking has shown strong growth in the U. S. over the past nine years. This indeed is testimony to the Internet’s underlying cost effectiveness as a banking services delivery system and its power as a marketing mechanism (Bradley and Stewart, 2003). For example, it has been demonstrated that the cost of the average live service inquiry is $7.50, compared to a cost of $2.50 when the inquiry is handled by email and $.65 when the inquiry is handled through a web based self-service interface and, most importantly, the quality of the service is better from the consumer’s perspective in the web interface (Online Banking Report, April, 2004, pp. 4-6).
and in spite of the many success stories in the industry, most banks today still do not
maintain a successful web presence. This is changing. At the beginning of 2004 some 33
million U.S. households (31% of the market) were using one form or another of online
banking (Online Banking Report, January, 2004) and this market penetration has
increased the pressure on the remaining banks that have yet to develop a successful web
presence.

**The Objective**

This study seeks to identify the exact strategies banks have adopted in creating
Internet Web Sites. The strategic response of the banking community to the emergence
of the web and the opportunities it presents has varied considerably. Most small bankers
have largely ignored these developments. An action supported by their generally
conservative approach to technological change and a well-justified fear that being on the
"cutting edge" also means being on the "bloody edge". Nevertheless some banks have
been very aggressive in this area, correctly feeling that web technology heralds a new era
in banking.

This range of strategic responses response to web technology is presented below.

Figure 1

Bank Internet Strategies
Many banks have reacted to this opportunity as if it were a threat and simply avoid thinking about this technology. More than half of all banks have no Internet presence at all. The rationalizations for such behavior include: “the Internet is a fad”, “our customers aren’t on the Internet”, “security can’t be guaranteed”, “too much uncertainty”, “too expensive”, “we are a bank, not an entertainment company”, “we don’t have the expertise”, and “we’ll do it tomorrow, when the issues become more settled”.

Unless such institutions have built and fortified a sustainable competitive advantage by some other means, they will eventually be forced out of the business of offering commoditized financial services and products by larger and more efficient financial institutions. If they wait too long to develop an Internet presence, they run the danger that their customers have already given their allegiance to other organizations that were in the right place at the right time. Wooing such customers away from competitors where those customers are already getting value-added services and products will be challenging.
The brochure was the most common early approach to utilizing the Internet. This passive strategy uses the Internet as a brochure to advertise and promote its products and services. This approach requires no change in bank culture, infrastructure, product mix, or business strategy. The Internet is thought of as an alternative advertising media. Such sites are devoid of opportunities for interaction with the customer. These sites commonly feature pictures of the bank’s officers, vault doors, or bank buildings and provide customers with a history of the organization, maps of branches and ATM locations, phone numbers to call for further information, and a simple listing of products and services. This strategic response to the Internet does not constitute a suitable vehicle to develop customer relationships or create customer value.

Supermarket Strategies

Supermarket strategies are functionally oriented to provide the customer with the opportunity to serve themselves by picking and choosing among the bank’s products and services. These products and services are often attractively presented with an emphasis on their benefits to the customer (e.g., a retired couple enjoying their sailboat as a result of the IRA they created with the bank.) Limited opportunities for interaction are available. Customers can check account balances, transfer funds, apply for a variety of loans. Customers like the power and convenience of this approach and feels it enhances the value of such services and products. Bankers like the low transactions cost. This is currently the modal strategy of U.S. banks with a web presence.

Conceptually, supermarket strategies may be seen as alternative distribution channels, complimenting the bank’s existing products and services. Small changes are
required of bank culture and infrastructure, but these are marginal in nature leaving the business strategy of the bank largely unchanged.

Personal Bank Strategies

Personal bank strategies are organized around creating customer value by directly harnessing the power of the Internet. Virtual banks reorganize their business strategy, business processes, and operations around their Internet interface with the customer in an effort to enhance a distinct strategic competency and create customer value. The Internet is no longer an alternate distribution channel for an existing set of products and services, but becomes a mechanism to transform those services and products in new ways uniquely made possible by the Internet. Instead of Internet banking supporting the “bricks and mortar” banking business, the physical structure is seen as having its role in supporting the virtual bank.

The current *de facto* strategy in most banks is to have distinct product or service categories function as profit centers, each managed to maximize its operational efficiency. The bank is presented to the customer as seamless, but the set of products and services is not integrated in such a way as to focus on the customer or maximize customer value. This equation tends to turn around in a personal bank.

With a personalization strategy, the Internet becomes the delivery vehicle for a virtual bank personalized to meet each customer’s individual needs and preferences. Facilitated by the mining of a fully integrated database, the bank will know what each
customer wants, when they want it, and will deliver it to them. This personalized approach will create exceptional customer value and constitute a distinct competitive advantage, in and of itself. Within a decade, such personalization will be common on the web. From a banker’s perspective, the only question is “Will we get there before the individual’s personalized needs are recognized and satisfied by some other organization?”

Banks have both advantages and disadvantages in implementing a personalization strategy. Banks are trusted and they already have substantial knowledge of their customers, so customers may be willing to provide sufficient information to create a virtual personalized bank for themselves. This strategy tends to empower the consumer and cedes a lot of control the bank has traditionally had to the customer. Banks are often reluctant to give up this control, preferring to exploit the information asymmetries that existed prior to the creation of the Internet.

Portal Bank Strategies

Portal bank strategies are at the heart of creating differentiated products through adding value. The object of portal bank strategies is to become the means by which a bank’s customers or potential customers enter the Internet. This is accomplished by creating an interface that is so entertaining, so attractive, so useful, and so convenient that an individual chooses to consistently enters the Internet (or the financial products and services potions thereof) through this site. If this site is not their home page (and that is the most desirable type of portal), at least it is bench marked and is the first place the consumer goes to anytime they want to do anything with money or their finances.
Competition for consumers and financial services is likely to become so intense at some point in the future that having portal status with your customer will be the single most important factor in retaining that customer and in generating larger wallet share. Further, getting individuals who are not now customers to use a bank’s portal will be the critical first step in acquiring them as customers. The competitive pressure in the industry is likely to be so great that having a customer who uses another organization's financial portal will mean the eventual loss of that customer.

Individuals will want a portal because of its convenience and because of the value it adds to the experience for them. It will be far preferable than searching all over the web for whatever they are interested in each time they want to learn, act, communicate, etc. over the web. From the perspective of the organization that creates this portal, it has created a very valuable piece of electronic real estate. From this vantage point, the portal organization gets to build a relationship with the individual (through their frequent interaction), can generate trust and good will, can learn about the individual's needs and preferences, and is enabled to guide, direct, and advise the individual in making their financial decisions.

**Assessing Banks Strategic Response**

**Methodology**

Two surveys of bank web sites were conducted in 1999 and 2004 by the authors. Each web site was evaluated (Singer et al, pp. 75-89) on the basis of four factors:

- Attractiveness (images and text, color, texture, action, functionality)
- Customer Empowerment (tone, choice, interactivity)
• Community Service (identification, support, service)
• Entertainment (items of interest, humor, games, contests)

These factors were equally weighted and an overall score was created for each bank web site that was benchmarked to the various strategies as follows:

- 60 – Brochure Strategy.
- 70 – Supermarket Strategy.
- 80 – Personal Strategy
- 90 – Portal Strategy

Bank Internet Strategies in 1999

As can be seen below from Table 1 and Chart 1, the bulk of the banking community in 1999 was stuck in the brochure stage of their Internet strategy. It is interesting to note that even at this early stage in the evolution of Internet banking, a significant number of banks have moved through the supermarket stage to the personal bank strategy. Such bank strategies were exceptions at this point in time.
Table 1

Bank Strategic Profile Rankings
1999

<table>
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<td>60-64</td>
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Based on a survey of 1,753 bank Internet Sites (Singer, et al, pp. 91-146)

Chart 1

1999 Bank Internet Strategic Profile

Bank Strategies in 2004

Bank Internet strategies can be seen from Table 2 and Chart 2 to have clearly evolved from the brochure stage to the supermarket stage. The percentage of banks pursuing a personal bank strategy appears to have declined (from 26% to 20%). This
may reflect the fact that some banks have found the supermarket strategy to be more cost effective than the personal strategy. It is worth noting that a number of banks formerly pursuing a personal Internet strategy have pushed forward to a portal strategy.

Table 2
Online Bank Strategic Profile
2004

<table>
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<td>65-69</td>
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<td>70-74</td>
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<td>90-94</td>
<td>3%</td>
</tr>
<tr>
<td>95+</td>
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</tbody>
</table>

Based on a survey of 153 bank Internet sites listed at www.investorguide.com

Chart 2
The evolution toward increasingly diverse and personalized financial services may be expected to continue at double-digit rates for the rest of this decade. The current thrust of online banking web sites is to penetrate the huge online bill paying market. In 2004, 27% of online households (9% of total households) paid their bills through their bank web site—a total of 1.4 billion transactions (Online Banking Report, March, 2004.) Although the processing market is currently dominated by a non-bank (Checkfree), bank branded pay anyone mechanisms constitute the fastest growing segment of the market. This trend will be strengthened by technological innovation that will make the process increasingly seamless, transparent, and convenient (e.g., ..www.billeo.com "Your personal banking assistant.")

The past year has also seen an attack on the integrity of bank web sites, both through "phishing" stratagems and direct attempts at hacking into bank web sites. These attacks strike at the foundation of successful bank Internet strategies which involve the public's trust in using bank web sites. Banks have responded with an increase emphasis on customer privacy, safety and security. This effort has taken place both by upgrading the technology and an intensive marketing campaign. Many bank web sites today prominently feature an explicit warning about "phishing." There is little doubt that this will be a continuing source of concern in the future.

Conclusion

An Internet site offers a bank a powerful mechanism for distinguishing its products and services from that of its competitors and creating a distinct competency that translates into a value added proposition for its customers. Banks are seen as having been
initially reluctant to aggressively pursue this strategy as a result of their lack of familiarity with the technology, the uncertainty of the expense of this strategy, and a desire to control their customers. This resulted in the widespread adoption of the timid brochure strategy for Internet banking.

This approach proved not to be suited to the desires of Internet users. Internet users like to be empowered. Information (and competitors) is just a click away. As a result, the initial foray of banks onto the Internet was not particularly successful. However, there is nothing like competitive pressure to stimulate innovation. As banks began to experience the ability of a supermarket or personalized Internet strategy to differentiate their products and services from those of their competitors and to create a distinctive competency, they evolved toward a more attractive and empowering Internet strategy. As banks continue to experience competitive success in this movement, it will continue. The more conservative banks still pursuing a brochure strategy will experience increasing pressure to provide their customers with the advantages of a successful Internet banking experience. Those banks pursuing supermarket strategies will be logically pushed by the same forces to create increasingly personalized sites.

The future will not stop there. The market for financial products and services will become increasingly competitive. This competitive pressure will force banks to evolve increasingly powerful Internet banking strategies. Ironically, these more powerful banking strategies will increasingly educate and empower existing bank customers, further intensifying competitive pressures in the industry. The movement toward portal status Internet sites is exemplified by banks like Everbank (www.everbank.com) which allows for complete financial account aggregation and offers its customers a “Bill of
Rights” that includes a $50 gift if you close (!) your account with them; Citi Bank (www.citibank.com) which offers a web site beautiful in its simplicity, provides an immediate option for Spanish language uses, immediately provides viewers with a number of attractive incentives for using their products or services (not the least of which is a Mini Ipod for opening an online account), and is so responsive that within two days of the disastrous tsunami event in S.E. Asia, they posted the Red Cross appeal for funds for that situation; and BankAmerica (www.bankamerica.com) whose whole online banking experience is dedicated to “giving you control over your money.” Bank America, given its prominence in the Southern California market, not only offers its web interface in Spanish, but prominently features an option to send “safe money to Mexico.” The evolution of online banking continues.
References


