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Best of both worlds: Balancing digital and physical channels in retail banking

Banking distribution needs to account for the evolving interdependencies between channels. Accelerating digital and upgrading the physical experience to "phygital" offers a viable solution.

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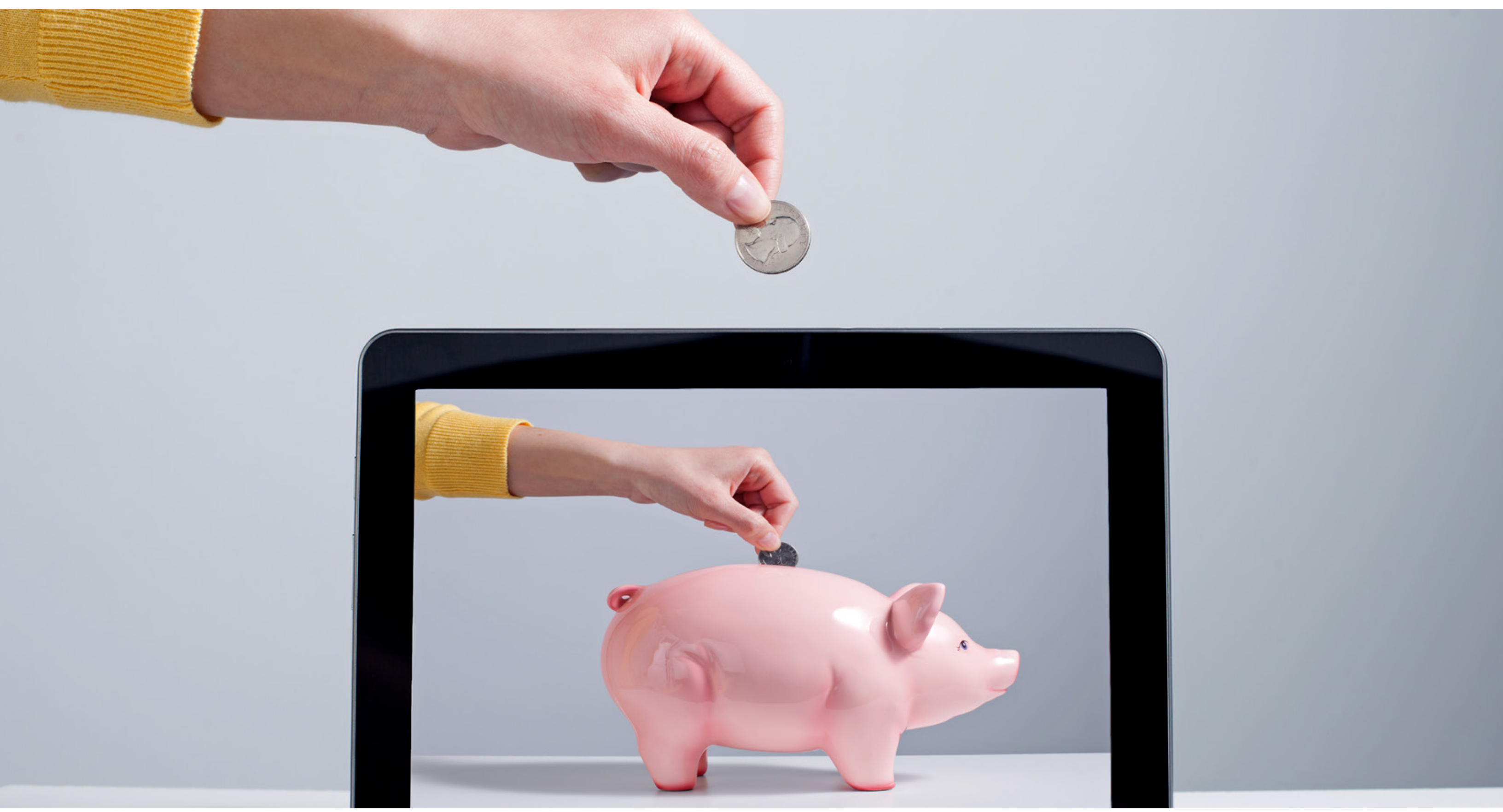

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In developed markets,[1] banks closed 9 percent of their branches in 2021, the largest reduction in five years, as they reevaluated existing approaches to sales and service (Exhibit 1). This reduction was likely a response to pandemic-fueled changes in consumer behavior—specifically, the accelerated shift to digital channels and reduced demand for services in physical channels (branches and contact centers).

However necessary these changes may have been, closing branches and widening digital channels cannot alone constitute an adequate distribution strategy, given the complex dynamics of retail banking. To plot their next moves in distribution, banks should try to answer a few questions: Can digital channels replace branches as the dominant sales channel for financial services? Did COVID-19 really accelerate a permanent channel shift, as many assume? Or will customer behavior trend back toward historical habits when the pandemic recedes?

To guide banks in answering these questions, we probed the responses to McKinsey's Retail Banking Survey and applied proprietary benchmarks (for more, see sidebar, "About the data"), arriving at the following critical findings:

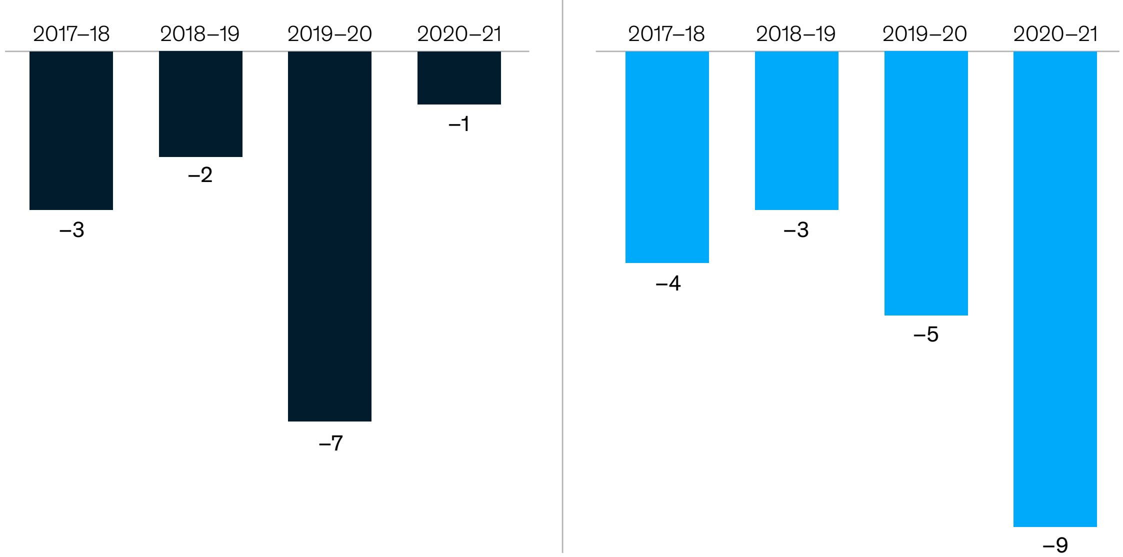
— *The drop.* Retail banking sales declined by 10 percent in 2021, after branch activity collapsed in 2020 and growth in digital channels did not fully make up the difference.

Exhibit 1

A large decline in bank branch users early in the pandemic translated to many branch closures in the subsequent year.

Year-over-year average change in branch usage, developed markets, percentage points

Year-over-year average change in branches per 10,000 active customers, developed markets, %



Source: Finalta by McKinsey benchmarks

[1] "Developed markets" align with Standard & Poor's definition. Finalta's banking benchmark sample for this article includes banks from 21 countries: Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Hong Kong, Iceland, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Taiwan, the United Kingdom, and the United States.

— *The disparity.* Customers report large differences between their *willingness* to use, *preference* for, and *actual use* of digital channels, necessitating actions to establish and maintain customer relationships.

— *The question.* While banks continue to downsize physical channels, the long-term role of branches remains uncertain. At more than a third of banks, branch activity grew by 20 percent in 2021, so are branches still important?

In this article, we examine the state of consumer engagement across digital and physical retail banking channels for both sales and servicing needs. Then we describe the distinguishing traits of banks that are ahead of the pack.

About the data

Our analysis is based on two proprietary McKinsey data sets. Finalta's global banking benchmark compiles and cross-references more than five years of data sourced from more than 250 major institutions that are located in 50-plus countries and serve more than 710 million active banking customers.

The McKinsey Retail Banking Consumer Survey gathers and tabulates the responses of more than 60,000 consumers to nearly 80 questions on banking, financial technology, and insurance. These consumers represent 28 countries, reported in seven geographic clusters spanning the globe.

The drop: Core retail banking sales are down

In 2021, more than 40 percent of core retail banking sales originated digitally, which unsurprisingly represents a new high. At the same time, a combination of micro and macro factors caused total sales to fall by 10 percent globally (Exhibit 2). Digital sales increased 4 percent—not enough to compensate for a 15 percent decline in the still-larger branch channel when facilities became inaccessible during lockdowns.

It is important to note that overall, the widely discussed increase in digital sales as a percentage of total sales owed more to branch declines than to actual digital gains. This was not true for all institutions, however. The growth leaders in developed markets increased total sales 10 percent

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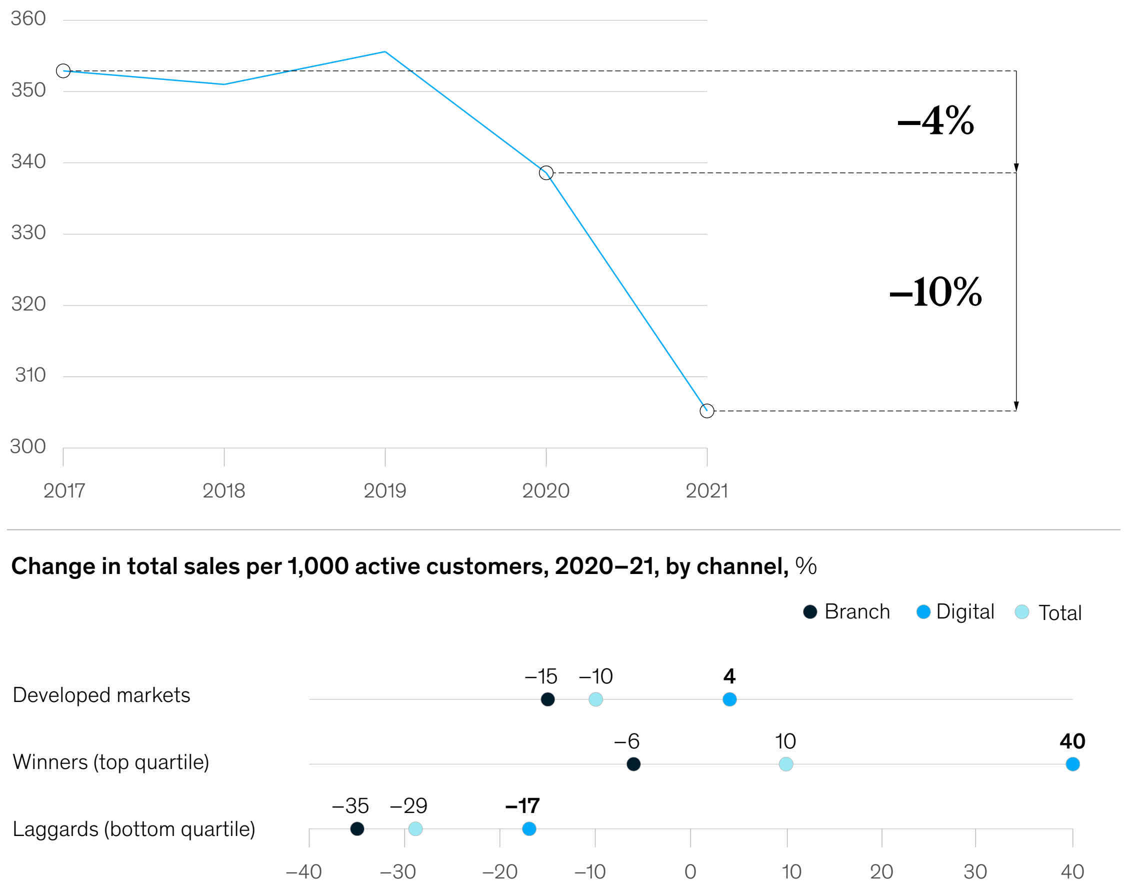
Exhibit 2

Growth in digital retail banking sales is not enough to offset steep declines that coincide with the COVID-19 pandemic's initial systemic shock.

Core[1] sales per 1,000 active customers, developed markets, number of sales units

Change in total sales per 1,000 active customers, 2020–21, by channel, %



[1]Core includes checking accounts, savings accounts, credit cards, personal loans, mortgages, and non-life-insurance products.
Source: Finalta by McKinsey benchmarks

by generating 40 percent growth in the digital channel while holding branch sales declines to single digits. By contrast, growth laggards endured sales declines in both branch and digital, despite having experienced healthy growth of digital in previous periods.

The variation in digital as well as branch performance is striking. Leaders increased their digital-sales penetration by 15 percentage points in 2021, compared with an average annual increase of four percentage points between 2017 and 2020; at the laggards, digital penetration declined marginally. In other words, banks that had already established momentum by building a top-flight digital consumer experience extended their lead in 2021.

Many banks still lag on introducing capability to capture demand for simple and complex customer journeys. Nearly half of institutions globally still do not offer a savings-account-opening journey in their mobile app, while less than a third have introduced investment sales. McKinsey benchmarking data show that the leaders in digital new-to-bank acquisition consistently outperform their peers at every stage of the sales funnel and are rewarded with double the number of account openings. Banks introducing and investing in digital personal lending have experienced sevenfold sales growth through the channel in just 24 months.

Banks' pre-COVID-19 digital investments primarily targeted customers predisposed to adopt such solutions. The focus must now shift to streamlining the sales journeys of mainstream consumers and generating new prospect traffic. Investment in several key areas can help achieve this goal:

— *A full suite of digital-marketing capabilities to drive traffic.* Leading banks create agile sales squads that are backed by a robust marketing stack and use a variety of paid and native channels to increase customer awareness through coordinated, sequenced, and tailored messaging. Analysis of our benchmarking data shows that a multichannel approach is 3.2 times more effective at boosting sales than reliance on a single channel. Banks with effective marketing channel usage, media mix, and messages can enjoy swift results. A bank in Iberia adopted a digital-marketing focus and saw a 75 percent uplift in digital sales in just six months.

— *Funnel optimization to improve conversion.* Banks reduce the cognitive load of an application by presenting fewer screens, using colloquial language, employing an active completion tracker and saving application. In practice, this can boost digital sales of savings accounts, credit cards, and personal loans by 13 percent. Technology such as optical character recognition (OCR) for document scanning and proactive chat further improve conversion.

— *Data and advanced analytics to power personalization.* More than half of banks have begun offering customers new products within the first 90 days, a key period to deepen relationships. Preapproving such offers can generate conversion that is 1.8 times higher than banks see from unvetted solicitations. The most advanced players further leverage life event triggers to realize 3.5 times more success than they get from simple batch campaigns.

The disparity: Actual use of digital trails willingness to use

Customer willingness to consider digital channels exceeds 70 percent in every geographic region and age category. Thus, the market has significant room for further migration. Even if the digital growth rates achieved in 2021 continue, transitioning all "willing" consumers to digital channels would take four to five years.

Results vary across products and regions. For example, although willingness to open a new current account digitally hovers around 75 percent, only 30 to 35 percent of customers express an actual preference to do so digitally, and only 15 percent of such accounts are opened digitally. Banks have yet to fully embrace this demand: less than 30 percent of banks globally have introduced new digital acquisition journeys for their public website or mobile apps.

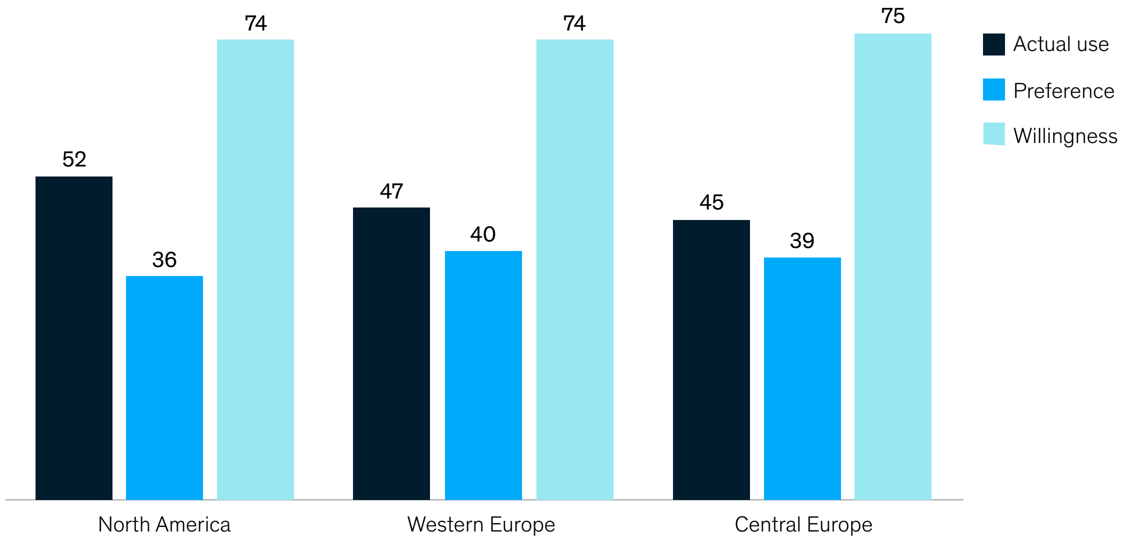
For personal loans, banks in the United Kingdom have achieved a digital-sales penetration of 86 percent—more than double that of their North American peers. Oddly, however, customers in the United Kingdom also have a lower stated preference for buying digitally, at 45 percent, which may indicate a higher risk of reversion to physical channels unless supply is constrained.

Digital servicing rose by three to four percentage points annually over the prior four years, with similar gains across regions. This growth has been fueled by the mobile channel. In 2021, more than half of all digital adopters globally were mobile-only users. Seventy percent of customer service interactions now occur in mobile, nearly double the level seen as recently as 2017. By contrast, online usage is falling across all regions.

Exhibit 3

Customers' use of mobile banking exceeds their preference for it across regions but remains below the willingness to use it.

Mobile banking, actual[1] use vs sentiment, by region, %



[1]Share of total customers active in mobile app.
Source: Finalta by McKinsey benchmarks; McKinsey Retail Banking Consumer Survey

While the mobile growth is impressive, mobile service use exceeded customer preference by nearly ten percentage points during 2021, implying that banks haven't fully won over customers and risk leaving them dissatisfied. Like sales, willingness for mobile is much higher than use (75 percent on average). The disparity among mobile use, preference, and willingness is consistent across regions (Exhibit 3).

With consumer willingness, preference, and actual behavior out of balance, banks should rethink the prevailing "digitize" mindset, which approaches digital by recreating offline journeys online. Banks applying that mindset have achieved substantial success among early adopters. Now, however, they must not only tailor solutions to digital skeptics but also deliver a true unique-to-digital experience to balance the three dimensions by bringing preference and use in line with willingness.

The mobile channel offers a compelling sandbox in which to create and test a differentiating value proposition that can solidify existing behaviors and unlock the next wave of growth. Several strategies have emerged as successful:

— *Ensure that all core servicing functionality exists in app.* Globally, banks have successfully migrated more than 80 percent of core physical interactions (including password resets and card activation), but meaningful opportunity remains. For example, although only 20 percent of transaction disputes are addressed digitally, banks offering such mobile functionality experience 18 percent fewer inbound agent calls and 50 percent fewer calls related to transaction disputes.

— *Create advanced features to increase engagement.* Upgraded tools such as personal finance management (PFM) provide customers with insights on spending patterns and automatic identification of saving opportunities. The banks with the largest share of mobile users active with PFM (30 percent, on average, versus 5 percent among laggards) saw 37 percent more mobile monthly log-ons and 175 percent higher mobile sales per user. Those that are engaging customers through data-driven push notification with meaningful insights, as a large Canadian bank is doing, see similar uplifts.

— *Explore features beyond banking.* Several leading banks are aiming to embed themselves into customers' lives beyond standard financial offerings. A large German bank offers personalized insights on customers' carbon footprint and tailored offset actions to address customers' growing interest in climate change. Some Middle East and Central European banks are establishing marketplace and embedded payment platforms enabling customers to purchase movie tickets, buy technology, pay for parking, and order food, creating new sources of revenue and customer engagement.

— *Innovate the interface.* Banks are revisiting whether a traditional menu-based interface is sufficient to help customers navigate the ever-growing list of features. While short-term solutions such as universal search have proven effective, the boldest players go further. A Western European bank recently launched a virtual assistant to help customers navigate the full breadth and depth of their capabilities in mobile and other devices.

The question: What should banks do with physical channels?

The radical shift in the role of physical channels—primarily branches and contact centers—over the past five years is hardly a surprise. Nonetheless, it can be helpful to quantify these changes, especially as 37 percent of banks saw their share of active branch users jump in 2021 with no meaningful decline in call center active users.

Ongoing branch consolidation has resulted in a 20 percent reduction in the number of physical locations since 2017. While branch employment has declined at a slightly slower pace—lending some credence to the notion that consolidation has been the objective, as opposed to outright elimination of branches—branch staff per customer has fallen by 18 percent over the same period.

Also, the nature of branch roles has evolved. The emphasis has shifted from service to sales and from specialist to universal. Since 2017, the number of advisers and universal bankers per branch has increased by 48 percent.

At many banks, productivity is a sticking point. Sales per staff have declined by 25 percent since 2017, driven by substantial decreases in simple products like savings accounts, credit cards, and personal loans. In contrast, sales of more complex products, such as mortgages, increased. A key differentiator is banks' ability to maximize each location. Our micromarket analysis of the United Kingdom reveals large variations in sales per staff member between competing branches. In one area, the best-performing branch sold seven times more per staff member than the worst-performing branch.

Attitudinally, 28 percent of customers continue to prefer to meet servicing needs at branches—a share that jumps to nearly 50 percent for sensitive and/or complex situations such as fraud and advice on financial difficulties. Although branch usage was lower amid the pandemic, banks must find ways to reinforce current behavior to avoid reversion to the channel for lower-value tasks (Exhibit 4). As an illustration of this challenge, nearly a third of branch users say the reasons they prefer face-to-face service are social considerations—for example, meeting a teller they know—and a heightened sense of expertise.

While each institution must arrive at a unique model for physical channels, a common theme has emerged: the inversion of the distribution pyramid. Branches and call centers no longer dominate as the catchall channels fulfilling customer needs, leaving digital to fulfill a subset of activities for a subset of customers. For an increasingly mainstream cohort, mobile has become the go-to, with physical channels becoming brand ambassadors focused on truly complex, empathy-centric situations.

In this new context, several levers are available to make the most of physical channels:

— *Optimize for microclusters, resisting a one-size-fits-all approach.* In our experience, banks that couple a host of internal and external data with advanced analytics can create optimal strategies at a micromarket level (say, a one-kilometer block in an affluent area of a large city). Further, banks can deploy speech-to-text and machine learning to scan millions of interactions and generate tailored strategies to reduce call traffic and determine which products to promote, which location and format best meet local needs, and which strategies help migrate low-value activities.

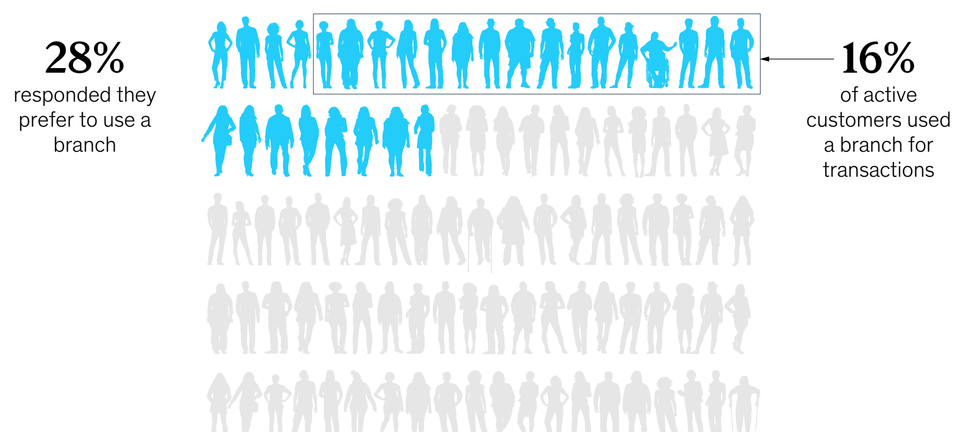
— *Shift from reactive to proactive demand.* While customer education can shift low-value "reactive" transactions away from branches, successful banks need to ensure that branch employees are focused on high-value activities by proactively filling staff calendars. Banks' mobile apps can book appointments, encourage customers to arrive with correct documentation, and help staff prepare to improve meeting efficiency.

— *Digitally enable the human experience.* Over a quarter of developed-market banks now offer remote advisory for some complex products. A large Western European bank introduced remote advisory coupled with cutting-edge digital marketing for investment products, boosting assets under management by 1.5 times and doubling adviser productivity in less than a year. Similarly, banks that enhance

Exhibit 4

For a significant segment of banking customers, sentiment toward branch interactions remains positive.

Customer preference for branch vs actual use of branches, %



Source: Finalta by McKinsey benchmarks; McKinsey Retail Banking Consumer Survey the physical experience with dedicated features in the bank's mobile app (for example, queue management, pre-appointment reminders, in-meeting identity verification and e-signature, and post-appointment feedback surveys) can significantly boost customer satisfaction by 60 percent through a blend of physical and digital.

— *Reset frontline-staff roles.* Leading banks update the roles and organization setup for branches and call centers. A Dutch bank developed a multiskilled, more knowledgeable workforce to solve customer problems across all segments and products. They consolidated roles, transformed basic servicing functions to universal roles, and flattened the organization, significantly increasing productivity and the satisfaction of customers as well as staff.

The dramatic shifts in distribution that occurred during the pandemic are not necessarily an immutable new baseline. Leaders understand that tinkering with individual channels may lead to certain short-term gains, but a holistic approach to distribution is required to unlock the full potential. Banks need a strategy that encompasses the evolving interdependencies between channels. And to ensure that their distribution model satisfies customer needs effectively and efficiently, they need to implement enablers such as data, analytics, and technology.

Institutions that act promptly can expect to reignite growth and distance themselves from slower-moving competitors. Success depends on creating truly unique-to-digital experiences in harmony with improving and enhancing physical channels with digital elements. These banks will provide a "phygital" human experience that contributes significantly to the satisfaction and trust that customers across demographics are still seeking.

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