Do Community Banks Gain Competitive Advantage with Online Banking?*

Deborah Salus, Radford University

Mary Weeks, Radford University

ABSTRACT

Parameters involved with e-banking are: customer acceptance and satisfaction, service rendered, value added for both the organization and consumer, privacy issues, profitability, operational risk, and competition from non-banking institutions. Implementation of the online strategy is a given for large banking institutions, but still being considered by smaller community banks. Issues that concern not only the industry as a whole but also small community banks in particular are addressed.

Background

The Internet has changed the face of many businesses. Initially many bricks and mortar (traditional) businesses did not feel the need to change their current strategies by entering this technological revolution. The banking industry has followed first mover retailers into Internet strategies.

Electronic delivery systems currently utilized by banks include automated teller machines (ATMs), phone centers, and online banking. ATMs were initially an effort to reduce costs. Telephone call centers were developed to handle simple transactions and provide added customer service. Of course, the next progression was to online service delivery. In the Radecki, Wenniger, and Orlow survey, many banks with assets of over $2 billion planned to invest in remote banking technology. Of the surveyed institutions, 66% were going to invest in telephone banking and 34 % in PC banking (Radeki, Wenniger, and Orlow (1997), p. 1).

Conducting business with e-commerce has its own unique set of problems. These problems potentially include both consumer and business privacy, consumer acceptance and satisfaction, risk reduction, technology structure, and value adding strategic positioning decisions. This research identified two primary models for online banking services. One model is to establish separate (no bricks and mortar storefront) Internet banks with *all* transactions being transacted online. The second model is to *add* online banking to services already being offered. Each model has resulted in dilemmas for the industry to address. Some are shared problems and some are unique to the particular model. Shared problems include privacy, security issues, consumer acceptance and satisfaction. Unique problems are primarily strategic and value adding.

This paper will address problems associated with adopting an online banking strategy from the perspective of community banking institutions and the consumer. The research included a literature review of industry practices and consumer concerns. Several studies noted in this paper appear to indicate that customer base volume can create economies of scale for large banking institutions (Furst, Lang, Nolle (2000), p.49). Therefore, this paper does not question that large national and regional banks with huge customer bases can attain operational savings using online banking. However, this study addresses the main question: Is online banking strategically advantageous for community banks to pursue?

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Consumer Concerns

Banking consumers have three primary concerns regarding the online method of delivery. They are privacy, security, service and added value.

Privacy

According to the Federal Deposit Insurance Commission (FDIC), Consumers have three primary concerns about the privacy of personal information in the online environment:

1. how personal information is being collected;
2.) how the information is used by the entity collecting the information, particularly for purposes other than the original transaction; and
3.) whether personal information is transferred to third parties, and how third parties will use it (Federal Deposit Insurance Corporation, para. 4).

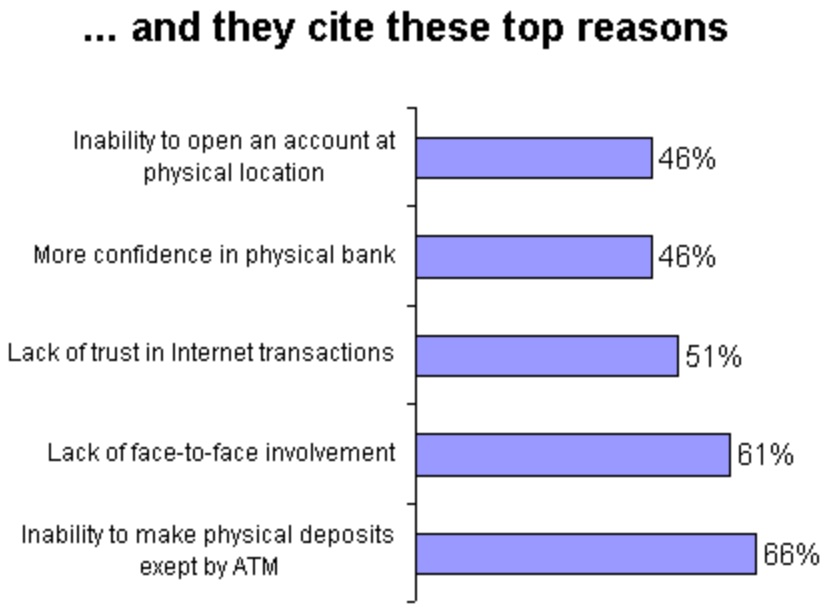
The FDIC feels that in order to provide the transaction security desired by the online banking customer, the bank must develop policies and educate their customers about privacy policies (Federal Deposit Insurance Corporation, para. 7). In the fall of 1997, the banking industry adopted a set of privacy principles. These policies include:

1. Recognition of a Customer's Expectation of Privacy.
2. Use, Collection, and Retention of Customer Information.
3. Maintenance of Accurate Information.
4. Limiting Employee Access to Information.
5. Protection of Information via Established Security Procedures
6. Restrictions on the Disclosure of Account Information.
7. Maintaining Customer Privacy in Business Relationships with Third Parties.
8. Disclosure of Privacy Principles to Customers.

(Industry-Adopted Privacy Principles, para. 2-9).

Besides addressing the privacy policy issues, the Banking Industry Technology Secretariat (BITS) developed recommendations for website development. These recommendations stated a bank should post privacy information on their website and this information should be consistent with the "Industry-Adopted Privacy Principles". The website should also provide educational material regarding the use of customer information by third parties and recourse available to customers for misuse of this information (Web Site Recommendations, para. 1-9).

Although the banking industry has formally addressed consumers' concerns, a recent article published in McKinsey Quarterly found that bank customers remain skeptical regarding the safety of virtual banking. The following graphic re-enforces customer concerns and outlines the primary reasons for their reluctance to switch to online banking (Boss, McGranahan, Mehta (2000), p. 72



Privacy issues and the 'faceless' transactions of online banking give the consumer an uneasy feeling. There is peace of mind when a consumer physically handles the money transaction. Fear of electronic banking is a difficult issue for online banks to overcome (In Brief: Poor Service drives 60% to Switch Banks (2000), p. 1).

Security

Another issue that goes hand in hand with privacy issues is security. The Banking Industry Technology Secretariat launched the Financial Services Security Laboratory in 1999 to address these issues. The laboratory developed a security criteria framework to be initiated by online banks and issued a white paper discussion of security issues and threats currently facing the industry. It stated that banks are actively moving to incorporate current technology into their online banking websites (Financial Services Security Lab Background: Security Issues and

Threats, para. 6-7). The white paper also provided "Tips for Consumers of Financial Services", which is located in Appendix A.

Compliance and enforcement of the privacy acts is crucial to security. Consumer confidence is lost if private information becomes public or is accessed by hackers (O'Connell (2000), p.3). This puts the bank at risk with inability to recapture the lost business but also for damage resulting from accessed information.

Service

Delivery of successful service is a perception of the consumer. Consumer perception is that online banking constitutes add-on services, not substitute services (Stoneman (2000, p. 2). The products have been there in the past, what is changing is how the banks will deliver the products (Morrall (1995), p. 1). Current 'bricks and mortar' banks spend up to 68 percent of their time solving customer problems and answering questions (Healy, para. 18). Consumers accustomed to personalized service won't settle for sub-standard service online.

As a result, many online banks discovered they had to spend additional funds in support activities, i.e. call centers or 'bricks' storefront (Stoneman (2000), p.1). One example of this trend is E*Trade. In January 2000, E*Trade purchased Telebank. By April E*Trade had also bought 8000 automated teller machines to support customer service (Timmons (2000), p. 1)

What is the perception of 'bad service'? Why would a consumer switch methods of product delivery or switch banks altogether? A survey complied by *Cyber Dialog*, for American Banker noted that there was two primary reasons consumers do not adopt this medium. They are complicated site navigation and poor service (ABA/ BMA., para7). According to a survey conducted by NetSmart, 78 percent of users said it took too many clicks to get to the desired area and 65 percent said they were confused by the homepage (Fugazy, para. 15).

Customers of online banks also complained about difficulties in resolving problems with pure Internet banks. Complaints regarding the time it took to resolve simple issues were problematic (Timmons (2000), p. 2). This poor service caused customers to either limit their banking transactions to savings instruments or to switch back to 'bricks and mortar' banks. Further evidence of customer dissatisfaction is reflected in the Timmons' article. She states that less than one percent of online customers consider their virtual bank their primary bank (p. 2).

Value Added for Consumer

The perception by the consumer of value added ties directly with the perception of service added. For one consumer, the value added may be the ability to access check copies directly (O'Connell (2000), p. 2) or it could be the availability of additional services coupled on the website. These collaborative services might include discount travel arrangements or

discounts offered on other products (Healy, para 24).

Banks also offer tailored services and advice based on the consumers' online habits (Hirst (2000), p.2-3). These could include financial advice, expense management services, and even virtual safe deposit boxes. (Georgakopolulos, para. 4). Online banking allows for consumers to move out of physical service areas and still keep the same banking services (Hackett (2001), p. 3).

Boss, McGranahan, and Mehta (2000) recommend several items to enhance current services and add value. They felt that building a customer relationship capability can be achieved by adopting aggregate services. Of the people they surveyed, seventy-five percent would choose a bank where the customer could consolidate their financial accounts (p. 76). Additionally, the banks should offer products such as TurboTax to entice customers to switch to online banking. Hence, one possible factor contributing to success may rest in the online bank offering more than just traditional banking products (p. 76). This would help explain why many national online banks are bundling products to include checking, savings, insurance, mutual funds, and sometimes, online brokerage services.

In order to attract customers to online banking services, banks often price products competitively. Thus, customers can take advantage of prime rates and convenience of online service (Graven (2000), p. 133, and Klinkerman (2001), p.2). It appears that online banking has the potential to add dollar value to the customer's experience.

Consumers have so many choices in the banking services field that consumer loyalty is low (ABA/BMA. para. 14). Study after study shows that banks are slipping on every measure of relationship quality: brand loyalty, share of wallet, and customer satisfaction (Alternative Delivery (1998), p. 1). Non-banks have taken the lead in establishing value added services for the consumer as compared to traditional banks. They offer a wide array of products, payment systems and services (Furash, para. 6).

Business Issues

Traditional banks considering the development or management of online banking have several concerns. These include operational risk, competition from non-banks, value adding ability and increased competitive advantage.

Operational Risk

The technology issues alone have multiple facets from business interruption, failures, fraud and system failure (The Best Defense (2000), p. 1-2). The nature of the beast and the rapid progression of software applications has not only increased the level of risk but also brought new challenges to auditors, whom must maintain the integrity of the system (Halperin, para.10).

Results from a survey conducted by the Computer Security Institute in conjunction with the Federal Bureau of Investigation found that there were four major types of attacks to e-commerce websites. In 2000, these attacks were vandalism, financial fraud, denial of service, and theft of transaction information (Power, p.11). The online banking industry has due diligence responsibility with regard to consumer privacy and system integrity. This would include use and adoption of new technology as it is developed. Feinman, Goldman, Wong, and Cooper state the three main aspects of effective IT security include: confidentiality, integrity, and availability (para. 7). They further define confidentiality as the aspect where a customer's information is not available to unauthorized individuals. Assurance that information cannot be tampered with is known as integrity and availability means that information cannot be deleted and is accessible when wanted (para. 8-19). Although some banks may realize lower transaction costs, lack of proper care in systems design places the bank in jeopardy (Halperin, para 6-9, 34-36).

In order to reduce risk, the Banking Industry Technology Secretariat outlined in a Financial Security Services Lab report that financial institutions should continue to secure their online environments. The recommended guidelines are in Appendix B

Competition from Non-Banks

Consumers wanting online banking services are looking to non-traditional institutions to provide these services. Institutions associated with finance, (i.e. insurers and brokerages), are offering these options (Costango, para.1). These institutions have put additional pressure on the traditional bank to perform (Morrall (1995), p. 1-2). It is commonly believed that service will be the differentiating factor for success (Johnson (1999), p. 2)

Competition can also come from pure Internet banks. Traditional banks failed to recognize opportunities to collaborate in developing e-commerce strategies (Klinkerman (2000), p. 2). The end result is a passivity that has allowed Internet banks to couple with n almost other industry institutions to develop the type of online banking services consumers want (Klinkerman (2000), p.2). An example of collaboration is with netb@nk. They partnered with ChannelPoint.com in offering insurance services from the banking site (www.netb@nk.com, Homepage). Unfortunately, the widespread adoption of 'one-stop' shopping is still in the development stage.

Timmons' article quotes a Salomon Smith Barney analyst who believes the Internet bank stand-alone model is flawed because of the additional premiums the Internet bank has to pay to attract the consumer (p. 2).

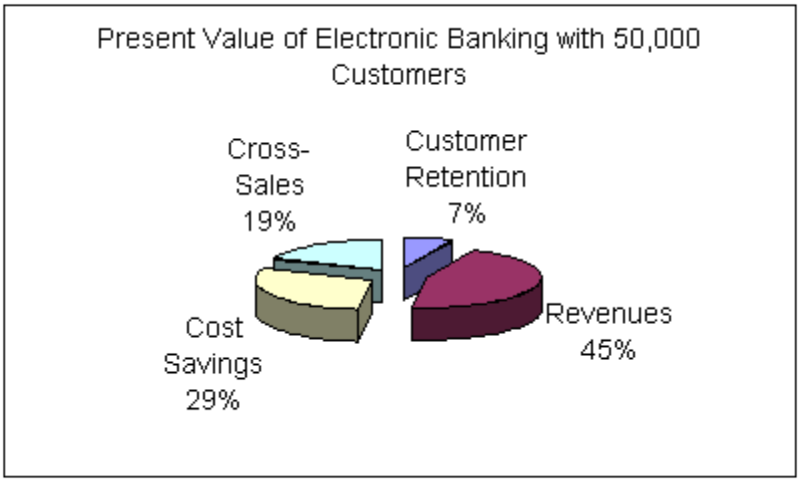
Value-Added for Banks

Profitability is probably the number one reason for a bank to provide online banking. Tom Ebling provides a hypothetical example:

In-Branch	$2.50
ATM/Call Center	$0.50
Web Based	$0.05

Source: "The Economics of Online Banking"

This hypothetical example illustrates the cost savings possible by enticing more customers to bank online. According to Ebling, the effect of customer migration to online banking, provides the bank economic advantage (p. 1).The Celent Research White Paper found that banks with large customer volume (over 50,000) can gain economic operations advantage with online banking. These values are measured by the present value of benefits derived by the customer (Marenzi, Hickman, Dehler, p. 13).



On the other hand, findings in the Marenzi report note that smaller banks must reach a 17 percent customer usage of Internet services to achieve profitability (p.18). Coupled with initial site cost, profits may be negligible (Furst, Lang, Nolle, p.50).

The banking industry has also developed demographics about the online user. The following graphic provides a demographic overview of the online banking customer. The McKinsey Quarterly collected this information (Boss, McGranahan, Mehta (2000), p. 72).

Online Customers are Attractive

Households that Bank online	**Households that don't bank online but have Internet access**	**Households without Internet Access**

Percent of households	15%	25%	60%
Average Annual Household Income	$86,000	$66,000	$47,000
Average age	43	46	52
Sex F	47%	55%	55%
M	53%	45%	45%

Attractive Balances **Composition of Primary Checking Accounts**

	Households that Bank Online	**Households that don't bank online**
>$10,000	5 %	9 %
$5,001 - $10,000	9 %	10 %
$1,000 - $5,000	54 %	38 %
<$1,000	32 %	47 %

These demographics suggest that households with high income are the online banking market. Tapping into this market, coupled with online cross selling could lead to increases profitability (Marenzi, Hinckman, Dehler, p.10).

Conclusion

The most recent articles find that pure Internet banks and online banks have realized a hybrid model for product and service delivery. This hybrid model is a combination of physical and web presence. Typically, in order to draw customers, the Internet-only model entices customers with high interest rates and convenience. Unfortunately, this model cannot compete with a community bank at the most basic level—customer contact and service. Community banks still have customer appeal because they have 'real' people to speak to regarding loans and financial planning. Customers still demand face-to-face interactions when resolving a problem. This desire for interaction can result in additional sales of products and services. In extending customer service at community banks, for example, a suggestion was made to add free coffee in the lobby alcove. This simple service promotes a perception that the customer is important to the bank (American Banker 2000).

The literature review finds that research expounds on potential profitability and reduced costs. However, the figures reported vary in profit range. One possible limitation is that some studies reviewed were commissioned by the banking industry and thus could be biased. Also, statistics obtained in many cases were based on small sample sizes and may skew the results. Thus, potential profitability may be doubtful.

In order to potentially realize operational savings, research suggests that the critical mass necessary is bank customer bases of over 50,000, (Merenzi, Hickman, Dehler. p.8-25). Although the number of customer households (in millions) projected to bank online may sound impressive, when compared with the total number of banking households, only one-third will bank online in the next several years (Furst, Lang, Nolle, p.47). The Gardner Group and Piper Jaffray paper project much along the same line. They note that the termination of online accounts is as high as 33 percent (ABA/ BMA, para.5-9). Thus further reducing critical mass necessary for the potential of operational savings. Bliar also notes that currently only 2 percent of the market is online (p.74). Therefore, further research is needed for accurate statistics of online use.

What was noted extensively in this research was that the industry is currently grappling with the parameters of this environment. Parameters include: customer retention and satisfaction, operational risk, due diligence risk, and legislative changes. Due to rapid changes in this environment, managers must be wary of the costs outweighing the benefits when adopting an online banking strategy. This dilemma has deterred many banks from developing an online strategy. In the Furst, Lang, Nolle (2000) study, they report that 46 percent of 'small banks' have no current plans to offer transactional Internet banking services (p.46-47).

There may be an advantage for community banks to develop a multi-channel service strategy with the aforementioned hybrid-banking model. Young (2000) argues a multi-channel strategy can provide differentiation from competitors and new entrants by leveraging the bank's branding and providing accessibility through branches, ATMs, call centers, and online banking while still maintaining a close customer relationship (p. 2). Cross selling is a primary method to increase the website's customer appeal. Therefore, smaller banks maybe at a disadvantage if product offerings are slim as compared to the larger institutions (Furst, Lang, Nolle, p.15). Community banks may gain competitive advantage by developing alliances with companies with complementary products. For example, partnering with companies like Digital Insight (www.digitalinsight.com) banks can not only increase product offerings but also share in generated fee revenues (Treadwell 2001).

In light of the most recent findings, banks should not make the assumption that online banking would be acceptable to their customers. Community banks should conduct a services survey in order to determine if customers desire any online services and which services are desired.

The industry is in rapid change with legislative and consumer pressures to develop acceptable industry practice and securities. The nature of the Internet environment is that instability is short-lived. As the industry achieves equilibrium and customer acceptability is increased, community banks may take advantage of these factors and initiate additional online services for consumers.

Appendix A

"Tips for Consumers of Financial Services"

1. Use a current browser that supports secure and private transactions.
2. Install and regularly update virus detection software.
3. Do not allow unauthorized access to your PC.
4. If using cable modems for Internet access, don't keep the connection active when not in use; also install "mini Firewall" software.
5. Do not open e-mail attachments from unknown sources.
6. Conduct financial transactions first in any online session and logoff before continuing other online activities.
7. When applying online for any financial account, ensure that you are dealing with a reputable, federally insured institution with secured Web pages.
8. Learn about your financial institution's capabilities and policies for secure online financial services.
9. Notify your financial institution immediately of any changes in your account information (Financial Services Security Lab Background: Security Issues and Threats, p. 2-3).

Appendix B

Financial Security Services Lab Recommendations

1. Making security information easy to find on Web sites through hotlinks of FAQs about security.
2. Educating consumers and employees on security vulnerabilities and ways to create more secure online environments.
3. Using updated virus scanning software packages on all file servers and PCs. Ensuring all network connections are properly secured.
4. Ensuring desktop modems used by employees are secured and properly registered. Using real-time, in-bound scanning systems for electronic mail and attachments.
5. Employing strong internal password processes and control password changes.
6. Masking customer account number information from online banking screens.
7. Providing remote access security systems for those employees and business partners that would dial-in to corporate networks.
8. Conducting periodic tests of security from the viewpoint of someone trying to "hack in".
9. Continuing to work to ensure the highest in industry security standards (pg. 4.)

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