

Conquering the German retail banking market: The case of ING-DiBa

ANDRÉ GÜTLER

Introduction

In recent years, the German banking market has been characterized by decreasing profitability (e.g., Hackethal, 2004). One reason: Bad loans roughly totaling 300 billion euros had been accumulated and decisive measures were necessary to reduce this huge amount. Thus, over 50,000 German bank employees lost their jobs between 2001 and 2004 as the banks attempted to make a considerable reduction in costs. At this time, the influence of the state-controlled banking sector with its access to funds on preferential terms and conditions was still quite substantial; these public-sector institutions commanded a 40% market share, creating a tough competitive climate for private-sector banks. Moreover, the situation was exacerbated by the fact that the German economy had the lowest growth rates in Europe. At first sight, these facts would hardly seem likely to induce foreign banks to consider expanding into the German banking market. Yet, against this background, we show how ING-DiBa has defied the odds, rising to fourth place in the

ANDREAS HACKETHAL

German retail banking business in terms of customer volume.

Business development

ING-DiBa has prospered more than any other German bank in the last few years, and has become Europe's largest direct bank (according to figures published at the end of 2004). The very pronounced growth, which is most obviously manifested in the amount of call money, began in 2000. Since then, ING-DiBa has advanced to fourth place in the German retail banking business (after Dresdner Bank, Deutsche Bank and Postbank) with more than 4.3 million clients. The primary engine of growth has been the call money account "Extra-Konto". Furthermore, after swallowing up the German competitor Entrium in 2003, ING-DiBa also started to develop its personal loan business, since Entrium, a former subsidiary of the leading mail-order company Quelle, had a well developed customer base in this segment. In addition, Entrium had a strong market position in brokerage. The acquisition doubled ING-DiBa's fee income in

2003 in comparison to 2002. Hence, the different strengths of the two banks, ING-DiBa with its call money account and mortgage business and Entrium with its personal loans and brokerage, complement one another very well.

A comparison with the main competitors yields further insights into ING-DiBa's business development for the years 2000-2004. First, we evaluate the call money market share (see Figure 1). In this period, ING-DiBa became the market leader for call money investments by retail clients. At the end of 2004, it had a 6.27% share of the market in this segment, which is twice the figure for Postbank, the market leader in retail banking

as a whole. CC Bank and Citibank also succeeded in enlarging their market share substantially, but even so, both remained short of 1% in 2004. In contrast, Postbank, Apo Bank and Haspa were not able to increase their market shares.

Second, we compare the ratio of operating expenses to average assets as an important efficiency measure. Due to its very large asset volume, ING-DiBa had the lowest ratio at the end of 2004. Starting at 1.7% in 2000, this ratio improved to 0.81% in 2004 (see Figure 2). Only Apo Bank achieved nearly comparable figures, with 1.13% for 2004. Hence, we find evidence that online banking customers seem to be more profitable than traditional

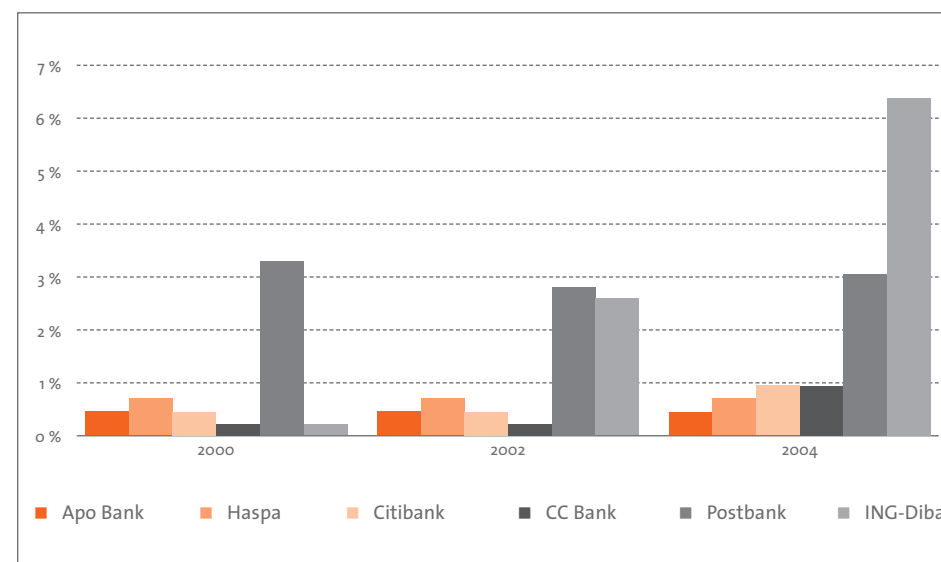


Figure 1: Call money market share

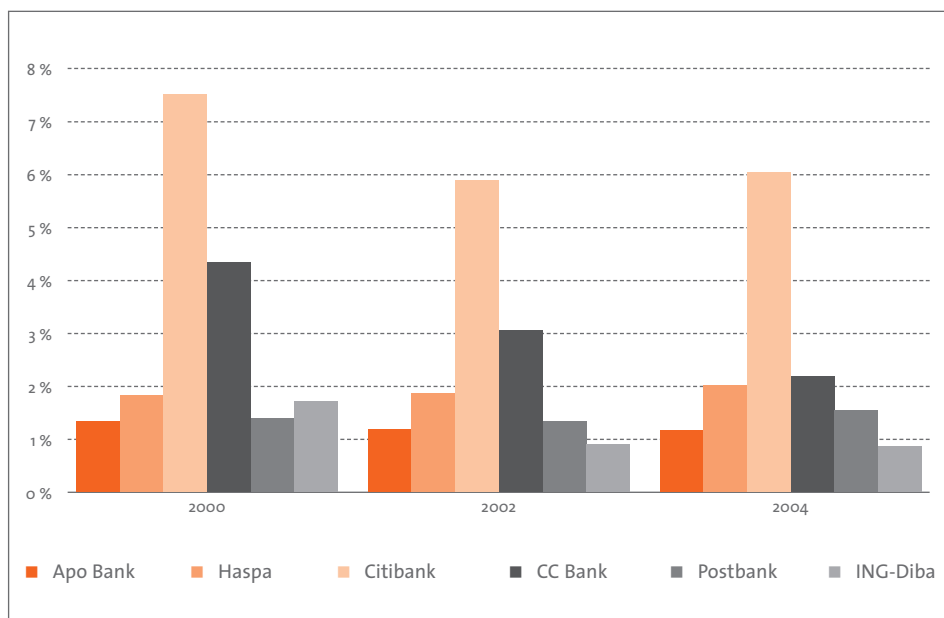


Figure 2: Operative Expenses / Assets

banks' customers, supporting evidence found by Hitt and Frei (2002).

As a consequence, ING-DiBa fulfilled ING Group's internal profitability requirements of 18.5% RAROC (Risk Adjusted Return on Capital) in 2004. Even in the difficult preceding years, and in contrast to the majority of German banks, ING-DiBa always operated at a profit. Thanks to its business model as a direct bank without any branches, ING-DiBa's strong growth was accompanied by only a disproportionately small increase in its staffing levels. Hence, whereas ING-DiBa's assets increased tenfold during our observation

period, it had to take on only four times as many new employees.

Success factors

ING DiBa operates as a pure play direct bank without branches. It concentrates on a narrow range of products with stable pricing schemes for retail investors. This strategy yields low variable costs, thus allowing attractive conditions to be offered. The combination of the direct banking concept, the small number of products, and the stable pricing scheme provides the framework for a faultless, user-friendly service. Moreover, the strategic move to operate as a pure play direct bank

was supported by the increasing acceptance and use of the Internet by retail investors.

However, their effective marketing strategy played a key role in substantially boosting ING-DiBa's market share. First, ING-DiBa greatly increased its marketing expenditures and concentrated this effort on the teaser product "Extra-Konto". This call money account was designed to be a viable alternative to the ordinary passbook savings account, a product which competitors had not previously used as an instrument to attract new customers. Since summer 2001, Extra-Konto has persistently offered a higher interest rate than the overnight interbank lending rate (see Figure 3). It appeals in particular to the many retail investors who have become very risk averse since the stock market bubble burst and who are therefore willing to accept low interest rates for risk-free investments. Customer targeting takes place in the form of mailings, a process which the bank has optimized through state-of-the-art customer relationship management (CRM).

In addition, the challenging demonstration of trustworthiness was strengthened by engaging the reputable sports hero Dirk Nowitzki for advertising campaigns (see Beck et al. (2003) or Suh and Han (2002) (for the importance of trustworthiness). However, it seems that ING-DiBa's success does not stem from the existence of any particular success factors; rather, it is attributable to a favorable combination of its hitherto unique business

model as a direct bank and the boost by the marketing strategy of the teaser product Extra-Konto.

In particular, the new strategic business model has been made possible by technological developments, specifically the Internet and efficient call centers. It is a model which more conventional banks with branch networks cannot imitate because of the heavier burden imposed by their cost structures. ING-DiBa has demonstrated that, with an appropriate strategy, retail banking services in Germany can be provided profitably, an accomplishment previously regarded as unfeasible for German banks – and for the private domestic banks in particular – due to their exaggerated branch networks.

In the area of marketing we detect three main advantages for ING-DiBa. First, CRM marketing approaches require huge databases, both in the cross-section as well as in longitude. ING-DiBa has a database of over 4.3 million customers, e.g. including their past responses to mailings, and can therefore perform its marketing campaigns very efficiently. Of course, competitors can buy extensive databases on the open market. However, the general customer data available might not always be appropriate for the requirements of a direct bank. Second, ING-DiBa has already begun to explore its cross selling potential within its huge customer base and is building reliable customer relationships. Third, ING-DiBa is now one of the most well-known and

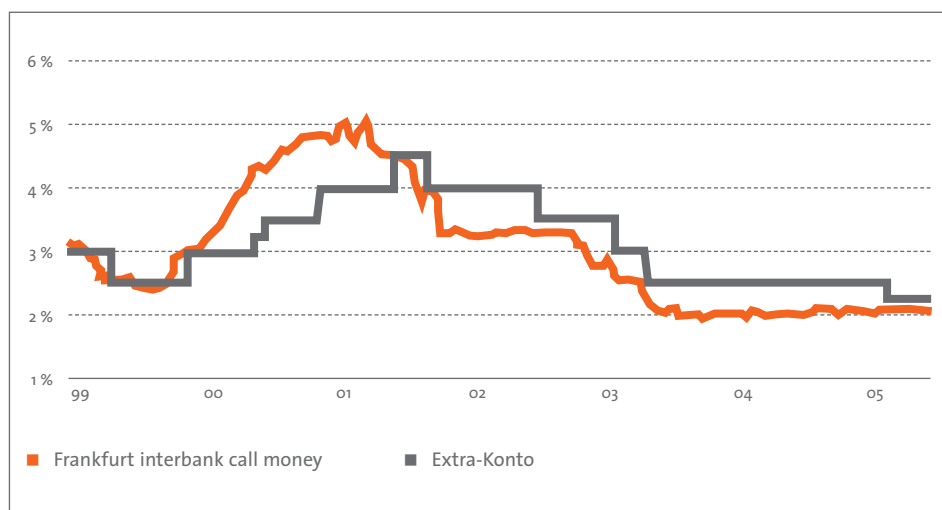


Figure 3: Comparison of interest rates

respected brand names of all financial institutions in Germany. These three advantages are not forever out of reach for other competitors, but on all counts, ING-DiBa has significant early mover advantages.

Business model sustainability

It is questionable, however, whether ING-DiBa's success will be sustainable in the long term. For example, car loan banks such as Volkswagen Bank have successfully copied its strategy. These mostly new banks have the advantage of being able to implement the most modern IT systems from the outset, whereas ING-DiBa is still using relatively old-fashioned IT systems for some of its operations. However, such new competitors must first win a vast number

of customers before they can benefit from scale effects. Traditional banks will also react to the increasing possibilities of the Internet.

Nevertheless, we do not expect these banks to become main competitors to ING-DiBa (and other direct banks) due to their cost disadvantages. Such banks with branch networks have also begun to offer more favorable terms in an attempt to compete with ING-DiBa and other direct banks. However, it would seem impossible for traditional banks to compete with the direct banks' terms and conditions in the long run while continuing to maintain their branch networks with their less favorable cost structures. The direct banks' target

customers, who are exceedingly cost sensitive and "Internet affine", seem to be lost to the traditional banks with branch networks. A major dilemma for these banks is the growing pressure on them to introduce Internet facilities into their services, both due to customer demand and for cost-cutting reasons: doing so, however, effectively trains their customers to use the Internet, which increases the likelihood of their switching to ING-DiBa or another direct bank.

Furthermore, the advantage of a branch network in terms of accessibility and quality of service diminishes with every branch closure. Moreover, the coexistence of direct banks and traditional banks with branch networks could lead to adverse selection: clients might leave only the personnel-intensive business to the traditional banks, where the latter can only lose money. For example, customers seeking standard mortgages might favor direct banks because they offer a better deal, while the more complex mortgages, e.g. those involving some form of government aid, remain with the traditional banks.

Conclusion

ING-DiBa has attained a very strong position in the German retail banking market through a coherent marketing and IT-based business strategy. Since traditional banks with branch networks are not able to imitate the successful business model of direct banks, we expect in the future to see price-

oriented direct banks that offer a clearly defined range of services coexisting alongside advice-oriented banks with branch networks (Howcroft et al., 2002).

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