ABSTRACT

INTRODUCTION

Grabbing some cash for dinner, depositing a weekly paycheck, paying your monthly mortgage payment: most people come in contact with banks and the banking industry on a regular basis. Known for years for the constancy of its branch system, customer service, and lending processes, the banking industry in the late 1990s began to see a change in what customers wanted. Technology, driven by a changing lifestyle, offers new models on which banks can operate, and where there is a need and a new idea, there is the potential for a profitable business.

In 1995, small Atlanta-based Security First Network Bank (SFNB) took the first stab at meeting this need. It had finally finished building the first platform for online banking, a service that would cater to increasing numbers of avid Internet users across the United States. Not everyone felt that consumers were ready for online banking, however, as security concerns and conservative viewpoints abounded. This skepticism made it difficult for SFNB to sell its software. Having faith that its creation was indeed the future of banking, it decided to incorporate the service into its existing organization to provide a demonstration of the viability of the technology. While SFNB attracted a number of early adopters and generated a high level of interest in Internet banking, it struggled with how it could transform banking to the Internet age.

The banking industry had been struggling for thirty years with the issue of how to disseminate information and reduce the costs of the expensive branch system permeating the industry (Figure 1). As many of those costs as possible
had been passed onto customers, but the highly competitive banking industry was changing. Service fees now made up close to half of a typical bank’s revenues, up from just 15 percent 20 years before. It was clear that some serious cost containment was going to be necessary in the near future.

Figure 1: Number of insured commercial banks and branches 1934-2003
Steve Johnson, Chairman of TSJ & Associates, an Atlanta based bank consulting company, believed that the Internet would soon be a major delivery vehicle for banking. Johnson worked with associates in investment banking and with the fast growing Carolina First Bank to organize a bank that could run on the Internet, without any branches, tellers or paper. The beauty of this scheme was that it would allow the bank to offer extremely competitive interest on its (certificates of deposits) CDs and accounts and be profitable (see Table 1). In October 1996, Johnson brought D.R. Grimes on board as a consultant to Atlanta based NetBank. Just three months later, Grimes became CEO, saying that he had “seen the business that would make the Internet successful.” NetBank's mission was: to profitably provide a broad range of banking and financial services to the growing number of Internet users.

Table 1: Average banking transaction costs

<table>
<thead>
<tr>
<th>Channel</th>
<th>Cost per transaction in US dollars</th>
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<tbody>
<tr>
<td>Internet</td>
<td>.01</td>
</tr>
<tr>
<td>ATM</td>
<td>.27</td>
</tr>
<tr>
<td>Telephone</td>
<td>.54</td>
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<td>1.08</td>
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In 1997, there were very few if any Internet success stories and especially none in banking. NetBank had 300-400 accounts but wanted at least 2,000 by the end of the year. The company had about $2 million from angel investors, and its relationship with Carolina First lent NetBank services worth in the neighborhood of an additional $8 million. NetBank’s initial goal was customer acquisition rather than profitability, but it had hurdles to overcome in order to achieve account growth targets. Early on, Grimes hired a CFO, Robert E. Bowers, to help him, and they worked together to attack the problems.

The first hurdle was organizational and mindset: NetBank needed to change its structure and outlook from that of a traditional bank to an entrepreneurial firm in banking. What was necessary to build a successful bank and what was required to build a successful Internet start-up were skills not often found in the same people. What NetBank needed seemed to be an oxymoron: a
group of conservative risk takers, people who knew how to start a bank and how to keep it afloat.

NetBank's second hurdle related to finding the appropriate way to market its accounts and services. NetBank had begun simply, placing tables at CompUSA stores in Atlanta and handing out t-shirts and floppy disks containing AT&T's Internet browser. This form of promotion was a failure because CompUSA customers were mostly first-time computer users who “started calling the bank and asking how to put their computer together.” NetBank then paid $20,000 to advertise on Yahoo. Again, it found its money was not well spent, because people went to Yahoo in order to search, not to read advertisements. The third tactic, a small amount of newspaper advertising in local papers such as the Atlanta Journal-Constitution, also failed to catch the attention of the customer base NetBank was seeking.

The third hurdle dealt with its product offering. Like most banks, NetBank offered tiered account rates, flexible interest rates dependent on the balance of the account. Tiered accounts were problematic because newspapers and other publications like Bank Rate Monitor published only the lowest interest rates for banks issuing money market accounts and CDs, making NetBank's rates look similar to conventional banks and failing to show the better-than-average rates offered as amounts on deposit increased. NetBank made a decision, therefore, to eliminate tiered accounts. Immediately, the higher published rates began bringing in additional business.

Grimes believed that it was critical for NetBank to quickly and quantitatively determine which methods of marketing would attract profitable customers. NetBank decided to modify its marketing strategy by advertising on banking and financial Web sites, where it felt potential customers would be more likely not only to see the advertisements, but to actually take the time to click through and visit the NetBank site. NetBank used a variety of measurement services to determine which sites had the best results and at the lowest cost per new customer. Customers began to find their way to NetBank through advertisements on Yahoo!Finance, for example, in far greater numbers than from the initial Yahoo homepage ads.

To this point, however, growth had remained steady but relatively low. NetBank had started by offering checking and money market accounts. When NetBank introduced CDs, however, Grimes said, “all of a sudden, the dam
broke.” NetBank's operations people began to worry about increasing volume, though volume rather than building a repeat customer base was the current goal.

The larger worry at the time, however, was the continuing struggle to get a bank charter from the Office of Thrift Supervision (OTS) because of its prior experience with SFNB. Instead of the traditional savings and loan model that allows banks to make a little money every day on every dollar, SFNB's revenue and cash model looked more like that of a software company, with high up-front development expenses recovered over time as software licenses were sold; regulators worried that NetBank's business model was similar to SFNB’s. Grimes recalls, “Regulators get very nervous when a bank is not making money. Regulators want to preserve the capital in the company to protect the depositors rather than see it paid out in salaries to developers.” Grimes had to try to clear up the confusion: “I said wait a minute. We’re not developing software. We have acquired licenses and we are using software and technology as a tool to operate our business more efficiently. We are a bank. We’re not an Internet software or technology company. We will make money.” Johnson and Grimes went to Washington, where they sat down with the Head of OTS to lobby NetBank's case, trying to convince the regulators that NetBank had learned from the initial troubles of SFNB and had a profitable business model that would keep deposits secure. While it took months to convince the Office of Thrift Supervision of the soundness of its plan, NetBank eventually received a charter.

U.S. banking regulations stipulated that banks could not be sold during the first five years of their life. Furthermore, organizers cannot receive stock at a value different from that of the initial public offering (IPO). These regulations are designed to discourage entrepreneurial investors from entering banking for short-term gains. Grimes urged the OTS regulators to understand that NetBank differed from other banks, because the founders' equity was really in the service company that was becoming a bank. OTS relented and allowed NetBank to skirt the stock value regulation. It did, however, require shareholders to hold NetBank shares for three years following the IPO, significantly longer than the six-month average for other companies.

In July 1997, Grimes and Johnson went on the road to successfully sell over $40 million in NetBank stock. After deducting the costs of the stock offering and other organizational expenses NetBank had a capital base of approximately $35 million. NetBank used the interest it earned on those funds to finance its operations and an aggressive online marketing campaign.
By August 1997, NetBank had six Consumer Banking Associates, online banking's version of tellers, who entered all new account information and did all customer service work. In late 1997, new accounts were growing so rapidly that account entry and customer service were too much for only a half dozen workers. NetBank had also hired a lending officer, whose job it was to buy loans and pooled mortgages so that NetBank could earn revenue on its deposits.

After six months, NetBank was, with assets of over $90 million, the size of a five-year old traditional community bank. It had 11,000 customers by March 1998, its first quarter of profitability. NetBank now faced the problem of what to do with the money that was flooding in at a breakneck pace. NetBank decided that the costs of the infrastructure to enter lending itself were too much, and it would rather give up some of the possible loan business it could gain in order to avoid the infrastructure costs and additional required managerial talent. Mortgages, which are relatively low risk compared to other type of loans, were where NetBank decided to concentrate.

NetBank partnered with First Mortgage Network to give customers quotes on interest rates and to allow them to apply for home loans. NetBank would use its cash inflow to buy mortgages from First Mortgage. At the same time, it decided to introduce a securities brokerage service. While this and other partnerships created a more robust product line, NetBank continued to invest primarily in large pools of mortgages available in the secondary market. This allowed NetBank to continue at its current level of growth without spending thousands on additional infrastructure to support lending.

Grimes continued to meet quarterly with regulators in Atlanta, building a relationship of trust. They shared quarterly results, problems, opportunities and information in order to keep the regulators fully informed of the development of the fast-growing bank and to allow the regulators to help NetBank foresee problems. These meetings became a learning environment, both for the regulators and for NetBank. The regulators cautiously watched NetBank's performance as a test of the online banking model, and new Internet banking charter applications slowed down. The regulators seemed intent on seeing proof of the profitability of online banking before granting other charters. The banking regulators’ conservativism aided NetBank since it had one of the few charters for Internet banking. The desire to keep regulators and investors from seeing online banking fail was so great that NetBank offered to acquire the banking component of SFNB, which continued to have poor performance. Royal Bank of Canada,
however, stepped in and bought it in an effort to become NetBank's U.S. competitor.

NetBank was having problems of its own. It was still growing at phenomenal rates, between 300-400 percent annually, and NetBank needed more retained earnings to sustain capital growth. It was also having hiring issues, as growth forced it to continue hiring more customer service and operational employees. NetBank began planning to add additional capital by 1999, but the market collapse in the second half of 1998 forced them to hold off until December to file for its secondary offering.

The other question plaguing NetBank during the summer of 1998 was whether to forgo revenues earned through the current $3 per month checking account fee in favor of free checking. Analysts felt that the company could stimulate even higher growth levels through free checking, but the potential change had significant ramifications. NetBank believed that if it eliminated its service charge it would be difficult to reinstate at a later time. The bank was wrestling with the problem of being too driven by CDs; because CD customers are so price-sensitive, it was hard to develop loyalty. NetBank wanted to increase the number of checking account customers but was concerned that profitability would suffer because of the higher costs associated with checking accounts. Because new clients are significantly less profitable\(^1\) than returning ones, a high growth rate would hurt profit margins.

NetBank decided to “test-drive” free checking in the fall of 1998. Within 72 hours, checking account applications tripled. It took more work to establish checking accounts due to the verification process required, but NetBank found the retention rate on its checking account customers to be five times higher than with CDs. It discovered that, as Grimes put it, “The word 'free' meant more to customers than high interest rates.” NetBank knew, however, that it had to shift its focus, and a transition began from leading with money market rates to leading with free checking accounts. This also meant developing a greater focus on building customer relationships and growing a loyal customer base.

Meanwhile, Carolina First, NetBank's first “home,” was worried about the 20 percent interest it still owned in NetBank. Banking regulations state that if a company owns more than 10 percent of a bank, it has to step in before the Federal Deposit Insurance Corporation (FDIC) to save a bank in the event of

\(^1\) A NetBank study at the time estimated they were around \(1/15\)th as profitable
bankruptcy. If NetBank failed, Carolina First realized it could suffer significant financial losses as well. Carolina First and NetBank went to the regulators to explain the problem. Regulators decided to allow Carolina First to sell its share down to just below 10 percent to resolve the concerns, and the change had no effect on NetBank and its continued growth.

While the market remained down in the fall of 1998, a secondary offering was prepared and the bank waited for the market to turn around. By mid December it appeared that it had. The application was submitted and quickly approved by the Securities Exchange Commission (SEC). Grimes believes the quick turnaround was essential to the success of the NetBank offering, allowing it to hit the ground running the first week of January. After a whirlwind 73 presentations in 23 cities in 13 days, it raised $100 million, double what it had hoped. “We were the first ones out the door in ’99,” recounts Grimes, “These are people that haven't seen anybody looking for money in three months...we're the first deal they see, and they are eager to invest money.”

With four quarters of profitability, NetBank stood apart from other Internet startups, many of who were far from going into the black. NetBank had achieved the promise of profitability it had given to the Office of Thrift Supervision two years previously. As a result, NetBank was perceived by investors as a less risky investment than other Internet-related businesses seeking capital. This meant that it paid a lower cost for capital than others seeking funds at that time.

Growth problems, however, quickly manifested themselves in the area of new account acquisition. Despite its high-tech online interface, NetBank was still processing all new accounts manually through customer service representatives. The stress and strain on customer service employees, who comprised 50 percent of NetBank's employees, to both enter new account information and handle routine service calls were driving caller wait times as high as 40 minutes. NetBank decided to implement two new initiatives. First, it developed an automated interface for new accounts that connected directly to credit bureaus and other banking information services. Second, it made a decision to outsource first-level customer service calls to another company: those calling with simple questions would no longer tie up NetBank's service lines, leaving them open for more complex calls from customers requiring more proficient customer service representatives. Customer service lines were open only during normal business hours and a few hours on Saturday, as NetBank found the majority of its
customers did their banking while at work. Until it became necessary, NetBank elected to forgo 24/7 customer service support.

NetBank continued to experiment with other forms of advertising. While targeted radio ads brought in twice the customers in the selected markets the expense per account was five times as high. NetBank decided to focus marketing efforts solely on acquisition through Internet marketing, as this lowered new account costs. It also felt a need to dramatically increase its marketing budget as soon as possible, again using the interest earned on the $100 million raised to fund its efforts.

Part of improving customer loyalty included gaining users through already loyal bank members and giving consumers more options for how they wanted to deal with their accounts. NetBank began its Tell a Friend program in 1999, a marketing effort advertised solely through its Web site that gave current customers money for referring their friends. It also entered into an agreement with Yahoo to offer the option of allowing NetBank customers to view their account information on MyYahoo. The expansion of rewards and options added to NetBank's 279 percent new account growth for 1999.

NetBank's improved customer service initiatives had a positive effect on customer loyalty. NetBank expanded its own call center from six to twelve employees. As a result of the outsourcing and hiring efforts, the wait time before speaking to a customer service representative decreased to less than 15 seconds. NetBank also installed new enterprise servers and completed two platform upgrades to accelerate site access and reliability.

NetBank also felt it needed to work harder at expanding its product offering. It decided to bring in Michael Fitzgerald as President because of his successful efforts in product development with the Internet service at another traditional bank. In 1999, NetBank added 30/7 home equity loans\(^2\) and Visa cards to its offerings. It also created the world's first virtual safe deposit box, a secure place for electronic documents and other electronic items.

In terms of IS strategy, NetBank's philosophy was: “Focus on what we do best and partner where it makes the most sense.” It decided that the best approach was to find products in the market and customize them, developing internally only when it felt restricted by the “cookie cutter” approach of the

\(^2\) As the Web site states “You'll get a decision in 30 seconds and your money in as few as 7 days.”
available offerings. This led NetBank to look to other sources for innovative products like the virtual safe deposit box, enabling NetBank to remain cutting edge while keeping its development costs at a minimum. This philosophy had served NetBank well throughout the previous three years and would remain a staple of the NetBank decision-making process.

While NetBank had sufficient capital to grow for quite a while the market for fundraising remained strong through the spring of 1999. Another offering would set up the company for years. In May of 1999, the opportunity came. The day the road trip began, the market started falling. NetBank was able to raise $100 million in common and $100 million in preferred stock before the market collapsed. Grimes recalls NetBank's incredible good fortune in 1999, saying, “We were the first and the last ones out in 1999.” As the market began a long decline in the second half of 1999, NetBank had an opportunity to buy back the convertible debt at seventy-five cents on the dollar, record it as capital gains and use that money to finance marketing for 2000.

In November 1999, however, NetBank experienced a blow to its credibility. A customer reported to the press that he received access to another customer's account, social security number, and other personal information. He recounted that it took five calls to NetBank to get the problem resolved. In fact, it was a mailing error, and had nothing to do with Internet, yet the press treated it as symptomatic of security issues surrounding Internet commerce. Some questioned whether NetBank’s high rate of growth was the cause. Ultimately the mini furore blew over when word got out that the problem, though a real error, had absolutely nothing to do with growth or the Internet.

By the summer of 2000, NetBank was still experiencing annual growth of 145 percent and extremely successful customer retention. This growth, however, was dragging down NetBank's profitability. New accounts were nowhere near as profitable as longer-term customers. Grimes felt it important to focus on return on investment (ROI) and increase profitability by slowing growth.

NetBank also felt it was losing out on valuable fee income. Traditional banks generated 40 percent of their income from fees, while NetBank's fee income remained in the single digits. To increase fee income, NetBank began charging for labor-intensive, non-Internet services. This included charging for additional check orders, which had originally been free. NetBank felt it could drive more customers to use its online bill payment system instead of regular checks. Online bill processing was much cheaper for NetBank than paper checks. It also
contemplated charging for account inactivity. The strategy to increase fees successfully caused NetBank's fee income to increase four-fold over 2000.

NetBank continued its online marketing efforts by engaging in two new affinity alliances. A partnership with Ameritrade allowed customers to use Ameritrade for brokerage services while using NetBank for banking. NetBank also developed a partnership with personal financial software leader Intuit, which added an icon to its lead product Quicken that links interested customers to NetBank's Web site. NetBank began using Open Financial Exchange (OFX) to allow its customers to download their account information to Microsoft’s Money or Intuit’s Quicken. These enhancements cost very little in added marketing expenses but provided NetBank with constant exposure through two other major financial media.

These efforts were just one part of NetBank's strategy to convert its efficiency into profitability. NetBank embarked on a three-year plan to bring its financial measures (ROA, ROE, et cetera) to comparable levels with other banks.

The first approach was to begin purchasing asset-generating firms. NetBank began acquiring mortgage companies; it did not matter to Grimes whether the majority of the transactions of the acquired businesses were Internet-based, as long as they were profitable. NetBank did make an effort, however, to concentrate on investing in single-family residential loans with adjustable rates to manage the interest rate risks. The past due rates on these types of mortgages were one-tenth the industry average, also fitting for NetBank's conservative strategy. NetBank’s first acquisition in this area was Market Street Mortgage, a retail mortgage lender that enabled the bank to originate over $3 billion in loans annually. Market Street contributed positively to NetBank’s earnings the first quarter after the acquisition, validating the concept.

NetBank also continued to extend its strategic alliances by outsourcing its check imaging services to NCR Corporation. NCR already hosted NetBank's banking site using NCR's “Common Platform Strategy.” NetBank saved thousands in developing the capabilities to capture check images while providing customers with a service to further encourage them not to use the costly process of receiving copies of paper checks.

In the spring of 2001 NetBank was approached about the possibility of acquiring another Internet bank that was close to failing. Though online marketing efforts were still drawing large numbers of customers, NetBank saw this as opportunity to significantly and quickly increase its customer base without
a large increase in marketing efforts or service offerings. As a result, NetBank agreed to buy CompuBank's deposit accounts. Almost immediately, problems emerged. CompuBank had very weak fraud prevention technology and as a result had many suspect accounts. NetBank identified accounts that required updated or valid information and asked CompuBank to contact those customers to resolve any outstanding issues. CompuBank was nearing bankruptcy; however, and elected not to communicate with these account holders. As a result, a small number of CompuBank’s customers were unable to use their ATM cards for a short period of time while NetBank attempted to verify their account information. These customers felt they were being denied access to their money. Customer service lines were flooded with calls. When customers were able to get through, they were frequently on hold for extended periods. Within a few days, the account and customer service problems were resolved. Though most people had no trouble at all, those who did were very vocal, and concerns emerged as to the reliability of Internet banking with NetBank.

While quelling the small wave caused by the rocky CompuBank acquisition, NetBank added a few new products to its service offering, as a part of its strategy to offer greater product depth. Through customer segmentation, NetBank worked to identify its most profitable customers and the options those customers would like to see from their online bank. New 2001 product options, therefore, included foreign currency sale, travelers' checks and VISA travel money.

The next step was to find a way to significantly increase the mortgage-lending capabilities of NetBank while minimizing the costs involved with infrastructure creation. After careful consideration, in early 2002, NetBank merged with Resource Bancshares Mortgage Group, Inc. (RBMG). RBMG had a nationwide network of correspondents and brokers, and generated close to $12 billion in mortgages annually. An already-developed proprietary origination system combined with the established national network gave NetBank substantial new mortgage capabilities in one fell swoop.

By the end of 2001, NetBank had nearly a quarter of a million accounts, net income of $6.6 million, and total deposits of $1.5 billion. The number of accounts had grown exponentially at an annual compound rate of 275 percent since the end of 1997, when there were not quite 5,000 accounts. In other words, the number of accounts doubled roughly every six months during the first five years.
When Grimes departed NetBank in early 2002, it had just identified its four areas of focus for achieving its three-year plan: product depth, world-class customer service, customer segmentation and strategic alliances. As Grimes exited the profitable online bank he had helped to build, a new CEO, Douglas K. Freeman, a veteran banker, stepped into the ring to continue the battle. Should he try to maintain the same high rate of growth, and, if so, how would he do so? Would the strategy that had worked in the past few years be just as successful in the next five years? Should NetBank grow to be one of the major U.S. banks? It was already the second largest Atlanta based bank. Why are banks still opening branches, when Internet banking has obvious cost advantages? With all the current competition, does NetBank still sustain a first mover advantage? Is NetBank missing something? How could NetBank get the greatest value from its expertise in Internet banking?
ADDITIONAL RESOURCES:

- The Internet Will Shake Banking’s Medieval Foundations
- 1998 NetBank Annual Report
- 1999 NetBank Annual Report
- 2000 NetBank Annual Report
- 2001 NetBank Annual Report
- Assets and Liabilities of Commercial Banks 1997-2002 [xls]
- Commercial Bank Deposits by State
- Net Income of Commercial Banks by Year
- FDIC Stats At A Glance