The future is open:

Reshaping the banking experience

Does banking's future outweigh its past?

On the surface, at least, it's a conundrum. How do banks face profound industry changes driven by rapidly evolving customer expectations, emerging technology and new digital challengers when millions of dollars are invested in inflexible, though robust, legacy systems that served them in the past but are not fit for future needs? Given the dominant market share of incumbent banks and the relatively small inroads made by digital challengers, how quickly do traditional banks need do move? Should changes be piecemeal, transformational or totally greenfield?

To companies in the banking industry, the story is a familiar one. Customers with connectivity at their fingertips are demanding cheaper, faster, and better banking experiences. A plethora of challenger banks and new market entrants are emerging to meet these demands — armed with innovative technologies and unencumbered by the legacy infrastructure that restricts traditional financial institutions. Yet, traditional banks still have the lion's share of the business, enviably strong brands, large customer bases and high visibility.

In the face of this many banks are investing heavily to drive innovation, enhance agility, and become more customer centric. For the majority, these investments comprise patchwork upgrades to legacy systems and incremental change. Organizations are reluctant, indeed, to walk completely from these systems owing to substantial investments in them, concerns for reliability, and the simple fact that these systems have been so central to past successes. Other financial institutions are taking different paths to reposition themselves.

One thing is clear. Traditional banks cannot afford to apply patchwork upgrades to their legacy systems. Nor can they assume that system upgrades, even bold and ambitious ones, will translate to a sustainable competitive advantage over the long term. While the pace of technology change in financial services has been more gradual than in other industries, in part due to regulatory restrictions on new market entrants in many jurisdictions, the ability of companies to rapidly adapt will only become more critical over time.

The degree of industry change is such that banks need to think more radically about what they want to become and how they want to get there if they expect to thrive.

What will the banking industry look like in 2030? Business models, just like the industry as a whole, will be transformed by technology. New models will emerge in the years ahead putting a halt to the band-aid approach to legacy systems. Banks will look to new architecture that is digital to the core, and, more chose to build and migrate to new systems.

Under pressure: digital banks making inroads

Challenger banks — such as Starling Bank, Atom Bank and Tandem — have existed in the UK for a number of years. Fidor and N26 were the first of the European digital banks. The model is now emerging in other parts of the world. Indeed, there are approximately 100 challenger banks worldwide, including:

— SolarisBank and N26 in Germany

— MyBank, WeBank and Kakao in Asia

— Nubank in Brazil

— Chime in the US

— 86400, Volt and Xinja in Australia.

In March, 2019 the Hong Kong Monetary Authority announced that banking licences had been granted to no less than three digital banks in the territory. These entities are expected to go live later this year[1].

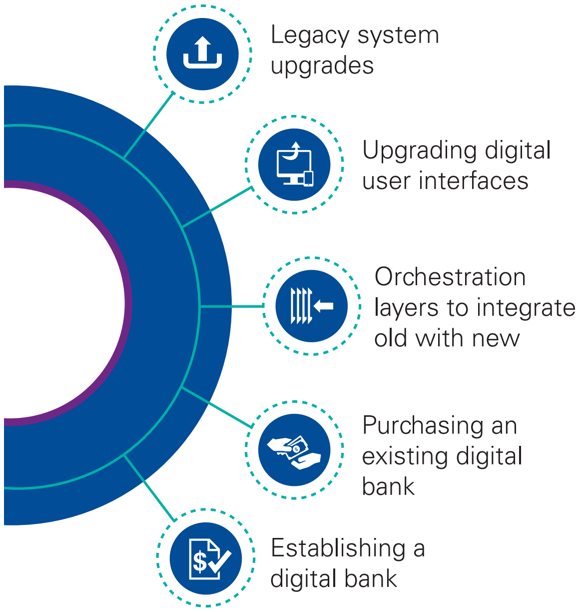
[1] https://www.hkma.gov.hk/eng/key-information/press-releases/2019/20190327-3.shtml

Though still dwarfed by their traditional counterparts, digital banks are growing fast, leveraging their adaptability, customer-focus, and ability to make data-driven decisions. While they might not, as yet, have customer bases to rival traditional players, they are starting to make inroads. Traditional financial institutions should not overlook the growth potential of new digital challengers who could, over time, win share of market segments, in particular the growing cohort millennials.

Responding to a new reality

Over the past five years, many financial institutions have invested millions in innovation programs focused on enhancing their technological capabilities, as well as trying to become more agile. The approaches they've taken to make these changes have varied based on their existing strengths, business strategy,and identified gaps.

Approaches include:



Legacy system updates

Numerous traditional banks, as noted, have invested heavily in updating their legacy technology in order to remain competitive. These investments include upgrading credit systems in order to approve loans more swiftly, making systems compatible with application programming interface (API) and open banking regimes, or finding ways to integrate more robust data analytics. While good, these incremental changes are unlikely to give traditional institutions the competitive edge they need to stave off new competitors.

Purchasing a digital bank

A number of traditional banks have purchased digital banks as a way to make rapid changes. Canada-based Scotiabank acquired digital bank ING Direct (Canada) back in 2012[2]. This trend has become much more pronounced in recent times. For example, Nordic bank Nordea reported in March, 2019 that it had acquired Gjensidige Bank[3] and the Royal Bank of Scotland (RBS) recently purchased a 25 percent equity stake in digital start-up Loot[4]. RBS made the investment through its digital bank, Bó, which is currently under development.

Purchasing an existing digital bank gives the incumbent the flexibility to change or retain the purchased brand name. They can also either migrate existing customers over or grow the offering's existing customer base organically and through cross promotion. Banks that elect to migrate customers, however, run the risk of incurring significant expenses as a result of a need to write off aging legacy systems more quickly than they might have otherwise.

Establishing a digital bank

A number of traditional banks have established their own digital banks. As mentioned above, RBS, in addition to investing in an existing digital bank (Loot), is developing retail bank Bó and just last year launched Mettle[5], a digital bank targeting small and medium enterprises (SMEs). Other well-known examples range from Marcus (Godman Sachs) to Finn by Chase (JPMorgan Chase) in the US to Pepper (Leumi Bank) in Israel.

Establishing a digital bank provides legacy banks with similar flexibility in regards to branding and building a customer base. The time and investment required, however, to develop a new business model and build the brand can be exorbitant. Significant resources are needed to erect the five pillars of any digital bank: senior management, licensing, funding, technology, and customers. To deal with this, some banks are turning to digital banks for assistance. RBS for example have partnered with Starling Bank for help with their digital foray[6]

Starting a bank can provide a successful defense against new challengers with improved services and open capabilities. The new, more competitive business model provides for lower costs, greater agility and greater modularity. New technology stacks put incumbents on a level playing field with upstarts and customers can be readily migrated over.

Digital banks are also often referred to as "lifeboat" banks. Should the digital bank prove operationally resilient, traditional banks suggest "will consider" migrating their legacy customer books to the new entity. This both helps replace legacy infrastructure with new, as well as solving the agility and customer experience issues that banks struggle with.

[2] https://www.cbc.ca/news/business/scotiabank-to-buy-ing-bank-of-canada-for-3-1b-1.1160516

[3] https://www.nordea.com/en/press-and-news/news-and-press-releases/press-releases/2019/03-01-09h52-nordea-completes-acquisition-of-gjensidige-bank.html

[4] https://www.finextra.com/newsarticle/33169/new-rbs-digital-bank-invests-in-loot

[5] https://www.bankingtech.com/2018/11/rbs-tests-its-sme-digital-entity-mettle/

[6] https://www.finextra.com/newsarticle/32581/starling-to-help-rbs-develop-digital-bank

The elephant in the room: change isn't all about technology

If banks are to successfully face the challenges posed by new digital competitors and changing customer expectations, they need to think beyond technology. Whatever path of change a bank undertakes, whether organic or inorganic, it must be partnered with a willingness to entirely rethink their strategy and business processes in order for their transformation to be successful. This means objectively considering the use of mobile apps, the cloud, customer accessibility, the use of big data — and defining how any decisions will contribute to the organization's overarching business strategy.

To be successful long-term, a major cultural shift is required, one in which employees at all levels come to appreciate and even value a company's transformation. While many financial institutions know they need to change, few recognize the magnitude of change required or the degree of internal resistance they might face to change. To manage this resistance, change management needs to be an upfront, ongoing and persistent component of any bank transformation initiative. Additionally, any associated communications program should be aimed at attracting converts, even evangelists, to the effort right from the get-go.

Forging a path forward: Questions to ask

There is no one path to success for financial institutions that want to increase their competitiveness and better respond to the needs of their stakeholders or the dynamic changes expected to continue to reshape the financial services industry in the years ahead. Companies need to determine their path based on a strong understanding of where they are today and what they want to become in the future.

Defining a digital banking strategy starts with a clear business model

What are your key objectives/ambitions?
Identify objectives and determine path forward with the right strategy to get there.

- Reinvention through newco
- Attract segment/cohort
- Gather deposits/extend credit
- Extend virtual footprint

What markets and clients do you want to target?
What demographic(s)?
What type: e.g. direct-to-consumer, marketplace, banking as a service?

- Personas
- Channels
- Propositions & brands

What approach will you take?
Prioritize and act on best approaches based on your portfolio and ambitions.

- Build
- Invest/acquire
- Partner

Source: KPMG International, 2019

As a starting point, companies should consider a number of pivotal questions that can help them define what they need to do. These questions include:

— How will you create and monetize value in the future?

— What changes are required to bridge the gap between where you are today and where you want to be?

— What is the cost-benefit associated with making necessary upgrades?

— Will modifications to legacy systems be sufficient to give you the flexibility to compete in the future?

— If not, how might brand new technology stacks be built at the bank?

— What are your time constraints and how long will different options take?

— What systems, structures or partners can you leverage as part of your transformation?

Acting today to thrive tomorrow

Banks that recognize the profound shift required and act now to transform their organizations to keep pace will emerge more competitive and successful than ever. It is our belief that patchwork upgrades may seem like enough to stem the tide in the short term, companies willing to make more radical changes will be better positioned to lead the financial services industry in the years ahead. Those that adopt new business models and build and migrate to new technology stacks will be best prepared for digital competitors.

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About the authors

Ian Pollari
KPMG Australia
T: +61 2 9335 8408
E: ipollari@kpmg.com.au

Ian leads Banking for KPMG Australia and is Global Fintech Co-lead. He has over 16 years' experience in financial services and works with local and international banks, payment providers and fintechs in strategy development, market entry and digital innovation.

Anton Ruddenklau
KPMG in the UK
T: +44 20 7694 2224
E: anton.ruddenklau@kpmg.co.uk

Anton is Head of Digital and Innovation for Financial Services at KPMG in the UK, and Global Co-lead for KPMG Fintech. He specializes in business, corporate and institutional banking, and has extensive experience working with large global companies in consumer and technology.

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