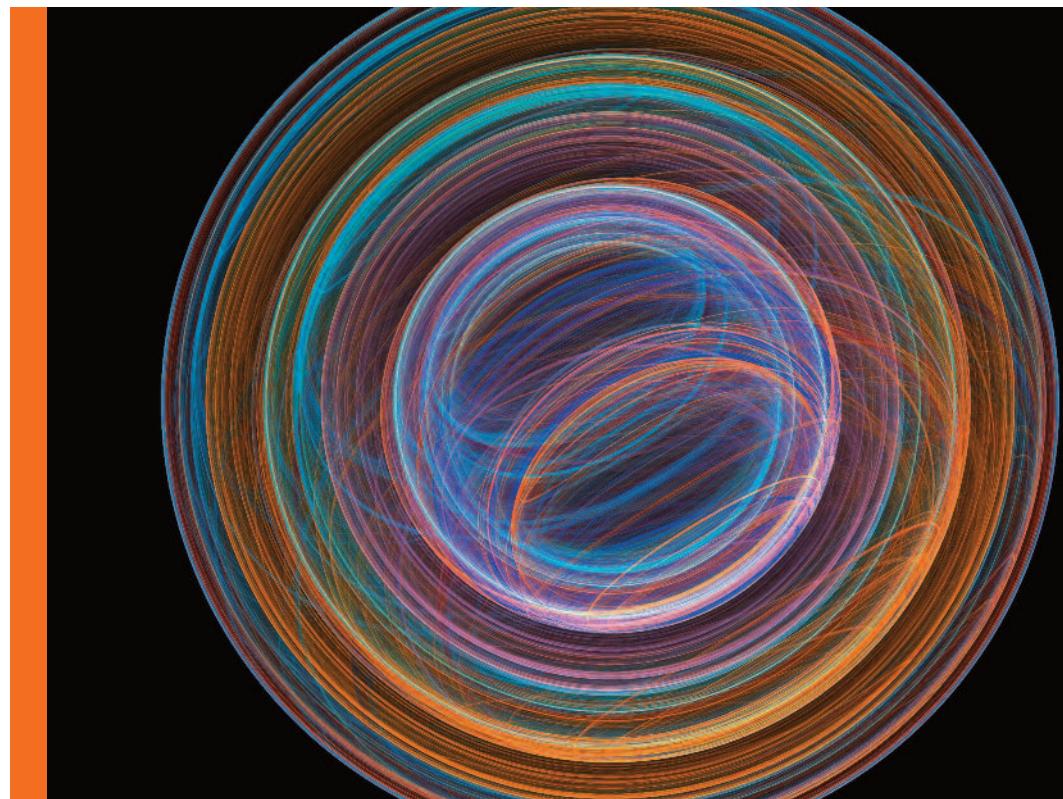


Financial Ecosystems: The Next Horizon for U.S. Banks



Financial Services Practice

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Imagine walking past a local small business and getting personalized coupons not available on the open market, because you and the business owner happen to be customers of the same bank.

Or, imagine a bank could offer enhancements to your financial life based on your actual usage and behavior. For instance, suggesting a credit card with rewards based on the partner merchants you frequent; or automatically identifying gaps in your insurance coverage and sourcing the best solution; or searching your email (with your consent) for receipts and merchandise returns and notifying you if the expected merchant credit does not appear or if a charge is incorrect.

What if a bank could offer your small business a portal to address your banking, tax, accounting, insurance and other administrative needs—all available 24/7 via your mobile device?

In a number of countries, including China, Sweden and Poland, customers are already enjoying just these types of integrated and personalized experiences. Depending on where these services originate, they could disintermediate banks from their customers. Or, they could herald a new kind of bank offering, based not on individual products or even multi-product relationships, but on orchestrating a broader set of capabilities—some from banks, others from partnering firms—to create new sources of value for customers: A “banking ecosystem.”

The ecosystem trend is more advanced outside of the U.S. currently, but U.S. banks are well positioned to capture the opportunity and build it into a real, income-producing business.

Given the relative lack of established U.S. banking ecosystems, and a regulatory environment that makes it difficult for non-bank providers to take a leading role in the space, there is clear opportunity for U.S. banks to seize the initiative. As they do so, a set of global examples can provide lessons on how to expand the set of offerings, cement their primary role in their customers’ financial lives, and tap new profit pools.

Defining ecosystems

An ecosystem is an interconnected set of services through which users can fulfill a variety of needs in one integrated experience. Consumer ecosystems currently emerging around the world tend to cluster around needs such as travel, healthcare or housing. Business-to-business ecosystems generally revolve around a certain decision-maker—for example, marketing and sales, operations, procurement or finance professionals.

Ecosystems typically provide three types of value:

- **They act as a gateway, reducing friction as a customer switches across related services.** Facebook Messenger enables users to shop, check into a hotel, message a friend, read the news or chat with a doctor—all from a single interface. Users do not have to toggle between portals, manage separate logins or spend mental energy maintaining multiple services.
- **They leverage network effects.** Nest, the maker of an ecosystem of smart home products, provides its customers with a monthly report card that illustrates their energy use and compares it to their neighbors' use, to give the numbers context.
- **They integrate data across a series of services.** In the earlier coupon example, a bank is combining data about its retail customers and its small business customers to create value-added offerings for both.

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Some ecosystem orchestrators—particularly in Asia—have shown clear gains in share. Others have seen increased sales conversion rates, decreased churn and improved operating margins. This is particularly common among providers competing with disruptors offering services at

lower cost, such as online lenders and robo-advisors. But the most exciting opportunity for ecosystems is the potential for new, fee-generating businesses that create real value for customers.

Global ecosystems

Ecosystems have evolved much more quickly in some countries outside the U.S. In China, for example, Tencent's WeChat enables users to send messages, make payments, invest, order taxis, buy bus tickets and more, from a single integrated system. The service has more than 700 million users, nearly one-third of whom use its embedded payments functionality.

The Chinese giant Alibaba serves nearly 500 million customers in the e-commerce ecosystem, across payments, financial services and travel, among other domains. Ping An, another Chinese ecosystem orchestrator, focuses on customers' financial needs, including investments and insurance.

Other countries in Asia and Europe have seen smaller-scale ecosystems emerge around financial services propositions—mBank's merchant network in Poland and Danske Bank's real estate endeavors in Denmark are two examples.

In Europe, the emergence of ecosystems is likely about to be accelerated by the implementation of the second payment services directive (PSD2), which will require banks to create more open access to data and payments capabilities.

An inflection point for U.S. banks

The development of banking ecosystems in the U.S. has been limited in comparison. A few U.S. firms have created ecosystems centered on specific cus-

tomer journeys, for example in car-buying, by providing comparison shopping, advice, financing and insurance services. Overall, however, development of financial ecosystems in the U.S. has been much slower than in other geographies, for a number of reasons:

- **China, Poland and other countries reached critical mass in consumer digital adoption later than the U.S.** They were thus able to leapfrog directly to mobile-first models, which are far more conducive to ecosystems.
- **U.S. consumers are accustomed to receiving services from a wide range of financial services providers.** In many other markets, a more concentrated model prevails, and consumers are thus habituated to consolidated services.
- **The U.S. regulatory environment has been less conducive to the development of ecosystems.** Banks in the U.S. tend toward more product-driven customer interactions, partly due to the continuing legacy of Glass-Steagall. In addition, the high level of regulatory scrutiny generally in the U.S. and restrictions on non-banking activities specifically may have constrained ecosystem innovation. At least some of these barriers are now more cultural in nature than purely regulatory.

The U.S. may have reached an inflection point, however. Several trends are converging that could make a robust banking ecosystem a dominant go-to-market model in financial services:

- **Banks' "need for fees":** Retail banks are almost universally desperate for increased fee income, as they strive to offset a challenging interest rate envi-

ronment and build businesses that offer higher returns and lower risk. To do so, they will need to deliver value-added services for which their customers are willing to pay.

- **Scrutiny of sales practices:** Recent events have instigated what will be a long journey to re-engineer the way banks drive product adoption, with significant financial impacts. In the UK, some banks saw as much as a 50 percent decline in sales productivity after cutting incentives for branch sales. Banks will need a new and more effective way to engage customers and demonstrate product benefits, and eliminate any friction in the customer experience that could prevent adoption—something ecosystems can do quite well.
- **Customer expectations are changing:** Consumers and small business clients increasingly expect an integrated banking experience, one that matches the experience they enjoy in other commercial interactions.
- **Bank capabilities are evolving quickly:** Many of the technology advancements banks have made in recent years, such as the building of APIs, transition to agile software development and enhancement of data capabilities, can serve as a foundation for a successful transition to an ecosystem model.

Three ecosystem waves

McKinsey expects the evolution of banking ecosystems in the U.S. to progress through three “waves”: integration of additional services into existing customer journeys; integrated financial services platforms; and expansion into non-banking services.

Wave 2 presents the greatest near- and medium-term opportunity for U.S. financial services firms. Many already recognize the benefits of Wave 1 and have taken steps to realize them. Wave 3 remains a longer-term aspirational goal.

Wave 1: Integration of additional services into existing customer journeys

Wave 1 activity is already underway among leading U.S. banks, with operational examples including car shopping and buying services linked to auto finance and insurance; home search and selection services tied to the mortgage origination journey; and the integration of data to create a holistic view of customer finances in wealth management or small business banking.

But there are limits to the value gained in the first wave. Services tend to be discrete add-ons not directly monetized by the bank or integrated with a broader platform. Many of these services suffer from execution challenges, as well. For example, most data aggregation offerings continue to rely on screen scraping as opposed to APIs, and consequently suffer from low data quality and high customer leakage.

Wave 2: Integrated financial services platforms

In the second ecosystem wave, McKinsey expects the emergence of integrated platforms spanning multiple customer journeys and use cases. In consumer financial services, banks will enable customers to “hand over the keys” to their financial lives. This model will resemble a private banking relationship, but will be delivered through scaled digital tools and engineered for profitability at mass affluent and mass-market levels.

U.S. consumers tend to maintain a high number of active financial relationships, compared to consumers in other countries. In fact, U.S. consumers seem to have largely rejected the idea of a one-stop shop for their financial needs. The financial supermarket turned out to be a banker’s dream, not a consumer’s. However, some segments of U.S. consumers likely rejected the one-stop shop for problems with execution—not because the idea is unattractive to all consumers on its face.

In fact, according to McKinsey’s Consumer Financial Life Survey, some segments of U.S. consumers continue to express a significant desire to simplify their financial lives and consolidate products at a single institution. Across income bands, many consumers crave holistic financial advice that extends beyond basic banking products. However, no financial services firm is presently equipped to provide this view at scale for the mass affluent or mass markets.

In this second wave, banks will leverage ecosystems to integrate disparate aspects of their customers’ financial lives to understand behaviors and deliver solutions and services.

The resulting “virtual private banker” will optimize customer choice; flag potential errors for review (e.g., utility bills inconsistent with past usage); conduct credit underwriting instantaneously based on a real-time view of a household’s balance sheet and income statement; and highlight financial risk markers such as insufficient levels of insurance, or concentration of risk across multiple investment portfolios. It will also provide associated services, like high-security digital storage—a “virtual safe deposit box”—and sophisticated identity protection capabilities.

using credit bureau data as well as real-time financial transactions (Exhibit 1).

For small businesses, banks could create an ecosystem that not only helps clients simplify management of their financial needs, but fosters business growth (Exhibit 2, page 6). This ecosystem could provide business owners with an integrated view of their financial situation, and serve five major functions:

- Addressing administrative tasks, such as connecting into invoicing systems, managing expenses, identifying savings opportunities and routing payments for optimal execution
- Creating customized financial recommendations, such as cash flow, payments and financing options
- Enabling third parties to offer select modules, including full-scale tax reporting, HR tools and inventory management
- Using a bank's own capabilities, such as analytics or marketing, to actually

support the business's growth agenda

- Providing credit at appropriate risk levels and pricing based on data gathered from small businesses in the ecosystem—an area where SMBs are currently underserved

Wave 3: Expansion into non-banking services

Future ecosystems could transcend financial services. For example, banks could partner with firms in the housing market to create a housing ecosystem or an e-commerce ecosystem that links consumers and merchants around core payment services.

Wave 3 ecosystems along these lines are emerging in non-U.S. markets, particularly in China, but they are likely to take some time to develop in the U.S.

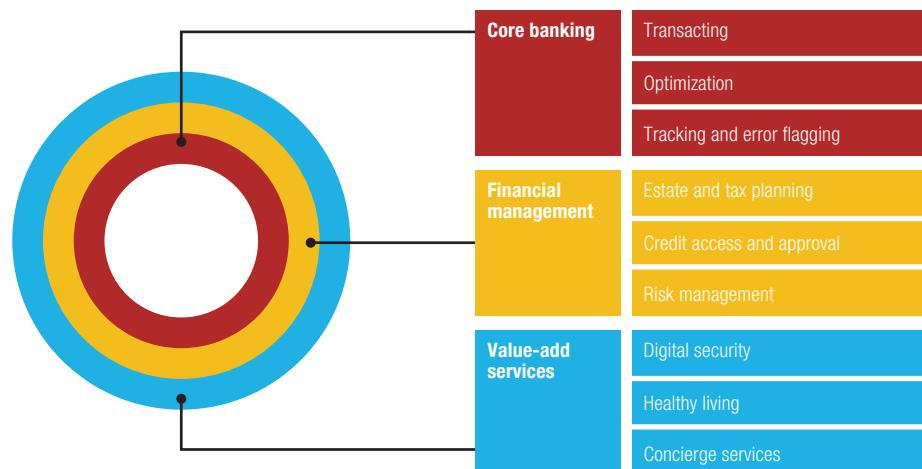
Building blocks for an ecosystem

Many U.S. banks are developing the technology capabilities to support an

Exhibit 1

A “virtual private banker” model will optimize customer choice

Illustrative ecosystem for “virtual private banker”



Source: McKinsey & Company

ecosystem model. Foundational steps include building APIs, creating master data management platforms and migrating data and computing power to the cloud. These technical investments are critical enablers. Some U.S. banks have even launched early ecosystem plays of the Wave 1 category.

There are three areas, however, where almost all U.S. banks, even the early leaders, need to advance to create true ecosystem businesses:

- **Developing a clear vision for meeting customer needs**, and focusing on that vision when stitching together disparate pieces of the ecosystem. Most current ecosystem offerings—both on the drawing board and in market—are discrete add-ons rather than the basis for a new business. In other words, few banks are approaching the development of ecosystems with a holistic and innovative view of customer needs. Most early ecosystem plans lack a clear articulation of how the

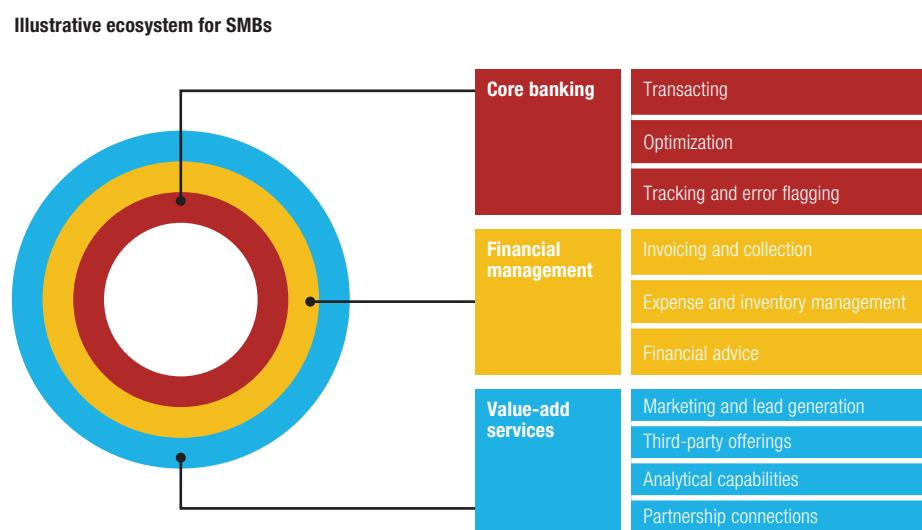
ecosystem will better serve customers and drive bank earnings.

- **Creating roles for integrated ecosystem leaders.** Almost all large banks in the U.S. continue to be organized along product, channel and technology lines. Only a few have broken this mold. Integrated leadership across an ecosystem of offerings will be critical to articulating the ecosystem's goals and building it effectively. The development of integrated leadership roles, and the cross-functional teams they lead, will require significant changes to the organizational models of most banks—including boxes and lines but also the connective tissue that informs how teams do their work.

- **Increasing the speed of development from ideation to delivery.** Banks are not tackling their development agendas fast enough to create the rich ecosystem experience required to build a business. This holds true even for those banks that have

Exhibit 2

An SMB ecosystem can simplify financial management and foster growth



Source: McKinsey & Company

adopted agile development practices. For example, many banks have worked hard in the past two years to implement real-time peer-to-peer (P2P) payments. But few, if any, have moved beyond the initial free P2P use case and into generating incremental payment fees. These second-order use cases are where the real customer value proposition—and the bank's potential economic benefits—are centered.

Banking ecosystems may represent the next frontier of banking innovation and a long-sought growth engine for banking profit pools. For U.S. banks, the road to success is challenging. The component technological pieces need to come into place—and banks will need to overcome some additional cultural and execution barriers. Given the relatively slow pace of ecosystem development, first-moving banks stand to gain an outsized edge.

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