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Banks and the digital flywheel: An engine for ongoing value capture

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For the past five years or more, banks have invested billions of dollars in efforts to digitize operations. However, some financial institutions are aware that their digital efforts are underperforming. Nearly 50 percent globally say that their latest digital investment is failing to generate returns greater than the cost of capital (Exhibit 1). And few banks are generating $1 billion—or even $500 million—in annual bottom-line impact from their digital transformations.

We reflected on banks that are generating significant returns from digitization—call them the "benchmark banks"—to understand how they achieved what others could not. We found that they share three relatively straightforward characteristics:

1. They consistently harvest the idle capacity that results from ongoing digitization—and fund new initiatives with the savings.
2. As they digitize the front-end customer experience, they capture the resulting productivity unlocked in their legacy operations.
3. They extend digitization beyond the customer experience and apply it to non-customer facing operations (e.g., finance, HR, other corporate functions).

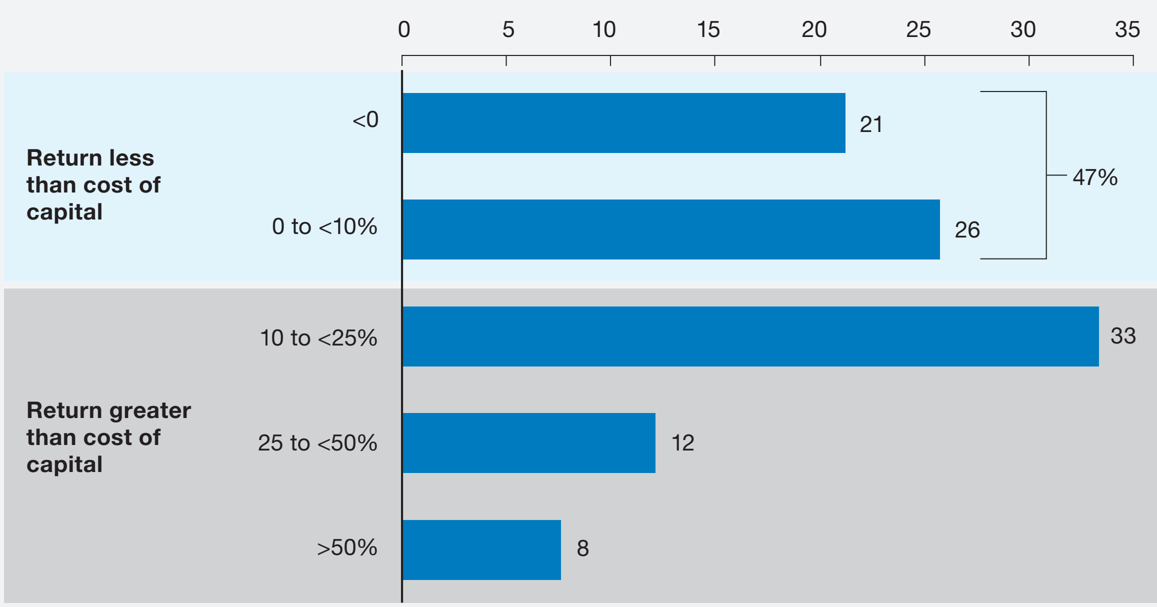
Benchmark banks are further set apart by their relentlessness and discipline in applying these tactics, to the point where they cohere into an ongoing capability for capturing value from digitization. We think of this as the digital-economic

Exhibit 1

Nearly 50% of financial institutions say that their latest digital investment is failing to generate returns greater than the cost of capital.

Consider your organization's most recent digital initiative that relates to its most important strategic priority, and for which the outcome is largely known. Please give your best estimate of the initiative's return on invested capital.

Financial institutions globally (n = 164)



Source: "The case for digital reinvention," Digital McKinsey survey (financial services responses only), February 2017.

Exhibit 2

Three turns of the digital economic flywheel can lead to significant bottom-line impact.

For an illustrative bank with $10 billion in annual revenues and $5 billion in expenses

	Turn 1	Turn 2	Turn 3	
	Harvest idle capacity resulting from ongoing digitization—and fund new initiatives with the savings	Capture productivity benefits in legacy operations as the front-end customer experience gets digitized	Extend digitization to non-customer facing operations (e.g., corporate functions)	
Annual productivity opportunity $ million	~150	~500	~350	$1 billion in cumulative annual run-rate
What benchmark banks do (select examples)	Remove idle teller capacity in branches Close branches that are no longer attractive Redeploy sales staff to high-growth micromarkets Optimize managerial spans Reduce third-party spending through proactive demand management Tighten expense management	Deploy time-saving digital tools to free front-line capacity Digitize applications to improve completeness and reduce reconciliations, mismatches, etc., in legacy operations Streamline and digitize workflows Institute front-to-back work cells Cut spending on paper statements Accelerate transaction migration Optimize the product portfolio Streamline roles and revisit compensation structure	Rationalize demand and ramp up digital self-service Streamline and automate repeatable, manual processing tasks (e.g., in finance) Identify and eliminate shadow corporate functions in business units Centralize like functions and optimize onshore-offshore mix Optimize outsourcing arrangements	
Time to capture	~1 year	2-3 years	2-3 years	

version of a flywheel—the mechanical device that stores and distributes energy—in this case to the tune of a potential $1 billion in recurring bottom-line impact or 10-percentage-point improvement in cost-efficiency ratio[1] (Exhibit 2).

1. They consistently harvest the idle capacity that results from ongoing digitization—and fund new initiatives with the savings

Digital initiatives are expensive. They require a cash outlay upfront, and returns—when they

[1] For an illustrative bank with $10 billion in revenues and $5 billion in expenses.

come at all—are typically deferred. Funding is usually the first challenge bank executives address before they kick off a digital transformation.

Benchmark banks start by self-funding—at least in part—their digital initiatives. Specifically, they go after productivity benefits already unlocked by digitization and latent in their system. For example, although branch usage in the United States decreased by 16 percent between 2011 and 2016,[2] not all banks reduced teller staffing levels meaningfully. This productivity benefit—a by-product of customers' growing acceptance of digital channels—is sizeable and ready to capture now. A North American bank recently discovered that 15 percent of its branch teller workforce had become idle; by swiftly reducing teller staffing levels network-wide, it freed up cash to fund future digital investments.

There are other, more traditional, non-digital opportunities to quickly find digital investment dollars, including tighter expense management, reduced third-party spend, and optimized spans and layers. To be clear, these sources are unlikely to fully fund a bank-wide digital transformation, but they can be a meaningful source of funding and a quick way to set the digital flywheel in motion.

2. As they digitize the front-end customer experience, they capture the resulting productivity unlocked in their legacy operations

According to new McKinsey research, banks are predominantly applying digitization to the front-end customer experience—through customer-facing tools, interfaces, and the like. Only 16 percent of banking executives consider productivity and cost reduction to be a priority for their digital strategy (Exhibit 3, page 6).

Digitization of the front-end customer experience is of course an important part of any bank's offering today; but alone it will not be a source of long-term competitive advantage.

Benchmark banks are taking a different approach. As they digitize the front-end customer experience, they consistently tap the productivity benefits unlocked in their legacy operations. In a recent example, a global bank had developed a new digital onboarding tool for online customers. Not satisfied with just customer experience improvements, the bank looked for where else this tool could unlock productivity. It made a modified version of the tool available to its more than 4,000 sales advisors in branches and provided intensive coaching and front-line training to drive adoption. The result was a 25 percent lift in sales advisor productivity.

Another bank, this one in Asia, invested heavily in bolstering its online capabilities, but went a step further to maximize the returns: it instituted a "no tolerance" mindset for paper statements. Within eight weeks, it signed up two million customers for e-statements, resulting in a 45 percent reduction in paper statement spending.

A third benchmark financial institution redesigned its call center interactive voice response—with embedded digital tools—to increase customer self service. But it didn't stop there. As customers started resolving most simple inquiries unaided, the financial institution pivoted its back-office operations to complex inquiries. It streamlined the complex inquiries workflow front-to-back, freeing up more than 40 percent productivity in addition to improving customer experience.[3]

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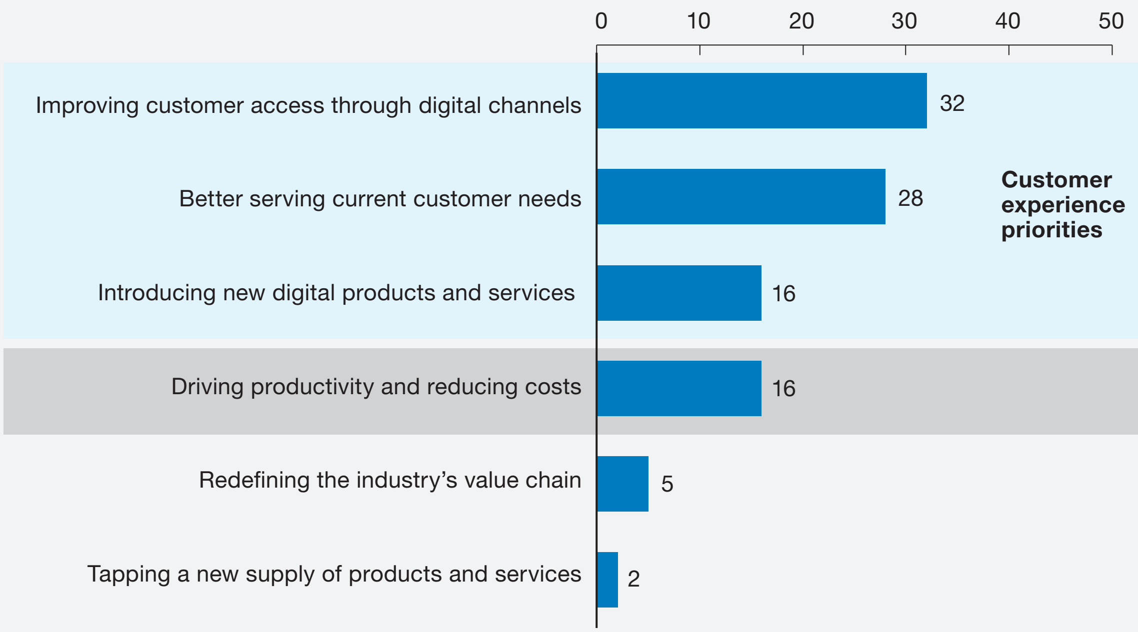
[2] McKinsey US Consumer Financial Life Survey, 2009-16.

[3] Albert Bollard, Ewan Duncan, Petko Rangelov, and Marta Rohr, "Accelerating the shift to a next-generation operating model," December 2017, McKinsey.com.

Exhibit 3

Banks are systematically digitizing the customer experience; productivity is not yet a priority.

What are the most important priorities of your organization's digital strategy?
Financial institutions globally (n = 244)



Source: "The case for digital reinvention," Digital McKinsey survey (financial services responses only), February 2017.

This is decidedly not low-hanging fruit. These banks had to meaningfully reconfigure their ongoing digital efforts to go after the productivity benefits. They had to invest resources and take risks. But as they continued to pursue these opportunities, they became more disciplined in their execution, and more confident about the ROI of their next digital investment.

3. They extend digitization beyond the customer experience and apply it to non-customer facing operations

A staggering 85 percent of executives at financial institutions say that their middle and back offices do not support the front office in meeting customer expectations.[4] Benchmark banks are challenging this trend, using digitization to unlock significant productivity benefits. A North American bank identified more than 30 percent in productivity improvements in its finance function, powered by robotic process automation, natural language processing, and machine learning. A global bank is using digitization to uncover and eliminate shadow HR functions in its business units.

More broadly, benchmark banks are taking a step back and rethinking the operating model for their non-customer facing operations. What is the minimum efficient scale for digitally enabled corporate functions such as finance and compliance?

[4] "Accelerating the pace and impact of digital transformation," Harvard Business Review and Genpact Research Institute 2016.

How can HR redesign the employee onboarding journey for the digital age? These are critical design questions which will shape the future of productivity in middle- and back-office operations.

Organize to win

Banks that have seen significant returns from their digital investments use the common-sense strategies we detailed above. But they also go a step further, working at consistently and repeatedly applying these capabilities. The result is a kind of muscle memory for getting the most out of their digital initiatives.

In addition to the three strategies, benchmark banks share common organizational practices that ensure success:

1. **Full potential approach:** Arbitrary 3 to 5 percent annual cost reduction targets are no longer applicable. So how should a bank set productivity levels for their individual units? Successful banks benchmark productivity based on facts, and set aspirational targets so that every unit—front, middle, and back office—aims for top-quartile performance.

2. **Gold standard scale-out:** Benchmark banks deploy a robust, test-and-learn methodology, and construct intensive, full-scale pilots that test the true productivity potential of their efforts. They apply adult-learning principles to bring change to the front lines, and set up mechanisms to ensure that pilot successes are sustained at scale.

3. **Productivity war room:** A transformation nerve center measures cost and productivity bank-wide. It focuses on how digital initiatives in one area of the bank can unlock productivity in another. It challenges lines of business on their productivity aspirations and ensures that those benefits do not leak away. One bank's productivity war room was staffed with more than 30 highly skilled employees led by a senior leader who was assigned by the CEO.

4. **Flywheel mindset:** Benchmark banks don't treat productivity as a one-time project. They think of it as an evolving capability—a flywheel that can be turned for the next 10 years or more. And it shows in how they run the bank: business cases for digital investments have productivity benefits built in; employees are trained in productivity disciplines and reskilled as jobs evolve; and leaders all speak the productivity narrative and consistently role model the right mindsets and behaviors.

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Banks that earn significant returns from their digital investments have a broader conception of what digitization can achieve. For these leaders, success is more than a slick new customer interface or a one-time productivity boost. They recognize that real gains come from applying digitization as broadly as possible across the organization, and from building an ongoing capability for capturing digital value.

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