

Building a digital-banking business

McKinsey Digital April 2016

Banks have been using digital technologies to help transform various areas of their business. There's an even bigger opportunity—go all digital.

The digital revolution in banking has only just begun. Today we are in phase one, where most traditional banks offer their customers high-quality web and mobile sites/apps. An alternate approach is one where digital becomes not merely an additional feature but a fully integrated mobile experience in which customers use their smartphones or tablets to do everything from opening a new account and making payments to resolving credit-card billing disputes, all without ever setting foot in a physical branch.

More and more consumers around the globe are demanding this. Among the people we surveyed in developed Asian markets, more than 80 percent said they would be willing to shift some of their holdings to a bank that offered a compelling digital-only proposition. For consumers in emerging Asian markets, the number was more than 50 percent. Many types of accounts are in play, with respondents indicating potential shifts of 35 to 45 percent of savings-account deposits, 40 to 50 percent of credit-card balances, and 40 to 45 percent of investment balances, such as those held in mutual funds.¹ In the most progressive geographies and customer segments, such as the United Kingdom and Western Europe, there is a potential for 40 percent or more of new deposits to come from digital sales by 2018.²

Many financial-technology players are already taking advantage of these opportunities, offering simplified banking services at lower costs or with less hassle or paperwork. Some upstarts are providing entirely new services, such as the US start-up Digit, which allows customers to find small amounts of money they can safely set aside as savings.³

A new model: Digital-only banking businesses

While it's important for banks to digitize their existing businesses, creating a new digital-only banking business can meet an evolving set of customer expectations quickly and effectively. This is especially true in fast-growing emerging markets where customer needs often go unmet by current offerings. The functionality of digital offerings is limited, and consumers frequently highlight low customer service at branches as a key pain point.

¹ "Digital Banking in Asia: What do consumers really want?," March 2015, McKinsey.com.

² "Strategic choices for banks in the digital age," January 2015, McKinsey.com.

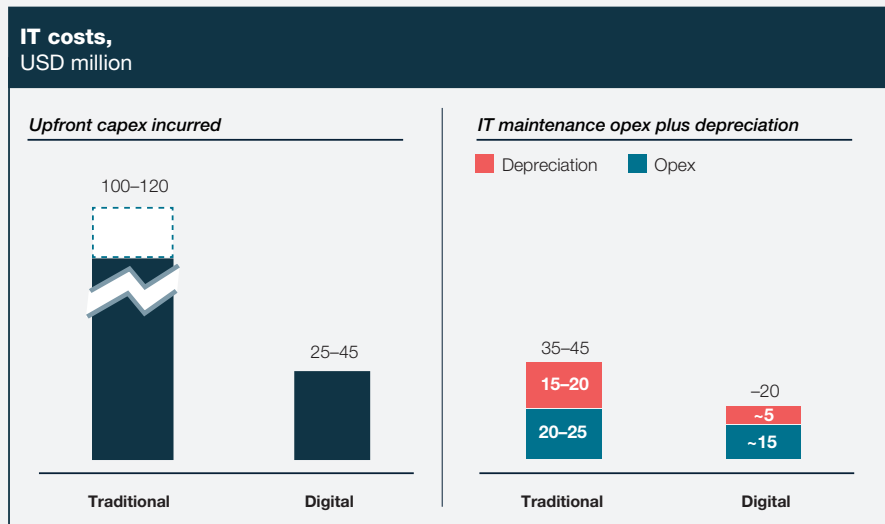
³ "The fight for the customer: McKinsey Global Banking Annual Review 2015," September 2015, McKinsey.com.

So how should banks think about a digital-only offer?

Because banking is a highly regulated industry and a stronghold of conservative corporate culture, there are tremendous internal complexities that need to be addressed. These include the cannibalization risk to existing businesses and the need to foster a different, more agile culture to enable the incubation and growth of an in-house “start-up.” The good news is that our work shows it is feasible to build a new digital bank at substantially lower capex and lower opex per customer than for traditional banks. This is due not only to the absence of physical branches but also to simplified up-front product offerings and more streamlined processes, such as the use of vendor-hosted solutions and selective IT investment, that reduce the need for expensive legacy systems.

Exhibit 1

IT capex and opex is expected to be significantly lower to set up the digital model versus a traditional operating model.



Six success factors to build digital-banking businesses

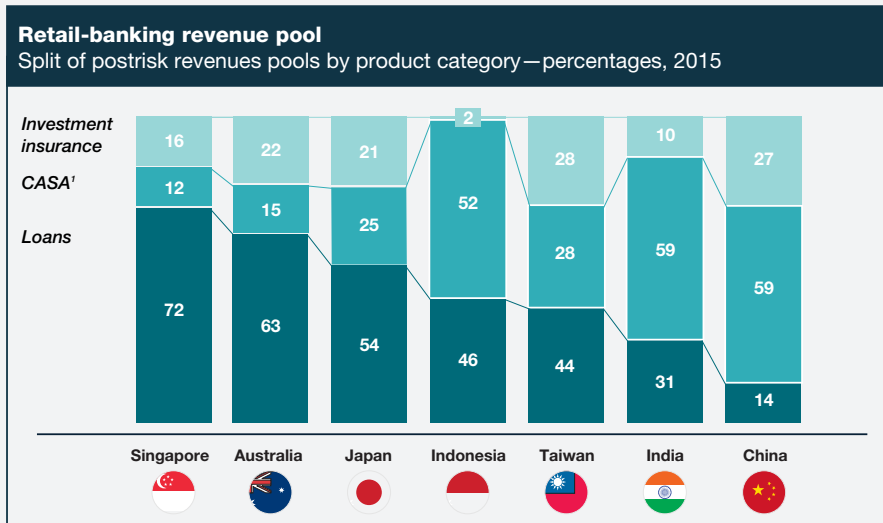
Based on our experience helping more than 20 institutions evaluate, design, and build new digital-banking businesses, we have identified six critical success factors that banks will need to address to ensure a quick and successful launch.

1. Focus on where the real value is

Launching a successful new business requires complete clarity about what its value drivers are. While this might seem like an obvious point, we find it is often overlooked. Instead, there is a temptation to copy or replicate existing models. For instance, mBank, Poland's first digital bank, has succeeded by offering consumers access to unsecured personal loans and other simple products. It's a model that works in countries like Poland and the Czech Republic, where credit cards aren't popular, but may not be successful in some other markets.

Banks also tend to take the view that one solution can work for an entire region. Unfortunately, this approach misses significant value opportunities. A granular, country-by-country analysis of revenue per retail banking customer, for example, reveals significant differences in product opportunities (Exhibit 2). Breaking it down further by different customer segments or sub-segments highlights even starker differences that can inform a business strategy. Some 43 percent of banking customers in Taiwan, for instance, are open to digital-investment options versus just 17 percent in Australia.

Exhibit 2



¹ CASA: current account and savings account.

Another critical element that varies by country is the state of regulation (for example, the requirements for paper-based documents and forms) and the associated infrastructure (such as the availability of a universal national ID). China, for instance, has become a leading innovator in digital banking in part because of a favorable regulatory environment.

2. Constantly test to refine the customer experience

Launching a successful new digital-banking business requires a marriage of traditional consumer research and a deep, real-time understanding of the behavior and pain points of individual customers. This means a constant and rapid stream of prototypes starting with the Minimum Viable Product (MVP) and subsequent iterations in order to figure out what will make the customer experience superior across all touchpoints. This sort of “real life” testing is critical for identifying what customers actually value as opposed to what they might say they value. It also yields up to 70 percent fewer defects and errors.⁴

One company, for instance, approached the creation of a digital-banking business targeted at emerging-markets millennials with a hypothesis that it would be critical to allow customers to sign in with their social-media accounts. Deeper interviews with customers and many versions of the prototype (100 to 150 screens for structured consumer research and feedback loops) revealed this was not true. On the contrary, urban and educated millennials have significant security and privacy concerns about any link between their finances and social networks. So instead of the social media sign-in, the team embedded visual security cues into the customer-onboarding process.

3. Organize for creativity, flexibility, and speed

Building a business using a constantly iterative approach requires a way of working that banks typically aren't used to. There are three areas where a different way of operating needs to be nurtured.

- a. *Cross-team collaboration.* The core group building the digital bank should have a solid understanding of not just the new technology architecture, but also of the bank's design and brand and the economics of its business model. This includes full-time members, as well as temporary talent in critical areas, such as compliance. From here, the team can gradually scale up to include more staff from technology departments. Portugal-based digital bank Activobank, for example, started with a management team of six to eight people during the design of the digital business model and then scaled up to more than 30 during implementation (excluding line/operational roles).
- b. *A 'garage like' working environment.* While an actual garage isn't necessary, a physical space that provides a nurturing environment for creative thinking and prototyping is. This means open spaces, plenty of whiteboards and worktables where people

⁴ Numetrics industry software database.

can congregate and work together, as well as habits that foster innovation, such as so-called sprints. In a sprint, all the individuals involved in the development of a digital bank—developers, IT-security, compliance, risk-assessment, and marketing staff who understand the needs of the customer—get together in one room for several live brainstorming sessions. Instead of the lengthy back and forth that normally happens between departments, this allows for quick and efficient decisions about the technical specifications of the product. This process can truly deliver acceleration to working results. Sprints—from whiteboard to working version of the product—can happen in as little as four weeks. On average, companies see a 27 percent higher development productivity.⁵ For example, Orange Bank took approximately eight months from strategy to launch of version 1.0 of its digital offering, prioritizing time to market and limiting changes required to their core banking system. Additionally, they were able to quickly scale up, acquiring up to 800,000 customers in the first eight months of operations. One critical requirement and advantage of this approach for banks is the way it allows compliance and risk-assessment staff to get in the room early and take on the roles of enablers and problem solvers, instead of gatekeepers who are often looped in only after plans are well under way or even completed.

- c. *A central 'control tower' team.* Launching a digital bank is a juggling act, with multiple miniprojects running at the same time, such as a new credit card, decisions about hiring, development of the organizational structure, and the creation of a brand. It is the job of the control-tower team to make sure all these projects are coordinated by moving resources to necessary teams quickly or prioritizing initiatives so that timeline targets can be met. The team must work to identify bottlenecks—such as vendors who don't respond rapidly enough to requests or IT not having enough storage capacity for data—and then either quickly resolve them or refer the problems upward to the CEO or the board.

The members of this team should be exceptional project managers with experience running large-scale projects, a high comfort level with agile development and sprints, a good working knowledge of the big picture, and a clear understanding of relevant regulatory issues.

4. Create an ecosystem of partnerships

Successfully launching a new digital-banking business requires quickly acquiring a critical mass of customers. Two industries with large amounts of digital customers who can help the process are e-commerce marketplaces and telecommunications. E-commerce players can be useful partners because they present an opportunity for banks to create lending services for the site's existing customers, both consumers and small and medium-size merchants. There's a clear benefit for the e-commerce player, too, since easy access to financing on

⁵Numetrics industry software database.

an e-commerce site is an enticement for working-capital-constrained, rapidly growing small businesses to keep selling on that site. Likewise, if consumers know there is financing available, decisions to buy large-ticket items such as refrigerators or TVs become much easier.

The success of Alibaba's Ant Financial in China, which serves small businesses and has grown into a \$20 billion business in two years, illustrates the value of a bank/e-commerce union. Offering simple ways to get loans, Ant Financial has rapidly become one of the biggest lenders to small businesses in China. Although now owned by Alibaba, it originally started as a partnership with CCB and ICBC in 2007.

5. Build a two-speed IT operating model

To implement the test-and-learn approach and short release cycles that are so critical for launching and operating a competitive digital bank, two different yet integrated IT systems are needed: the traditional, slower, secure and stable, transaction-focused legacy back end and a rapid, flexible, customer-centric front end.

The customer front end should be designed by small, nimble product teams (usually fewer than ten people) using an agile, sprint-based development approach. Software release cycles for these customer-facing elements should be modular and designed for quick deployment, prioritizing a minimum viable solution that will evolve over time.

To reduce the time needed to build the two-pronged system, a combination of customized and out-of-the-box functionalities can be used. One new digital player combined existing functionalities from their front-end provider, such as peer-to-peer payments, with new features that consumers care about but to which they don't have a lot of access, such as personal-finance modules where they can track their expenses and set savings goals.

To the extent that the existing IT architecture and regulatory framework allow, a variable-cost model should be considered, such as cloud-based system or data-storage solutions. A number of solution providers are expanding into emerging markets to offer competitive alternatives to traditional high-capex investments in data centers. Adopting a cloud-based solution allows a new digital player to scale up its cost structure along with revenues, thus achieving a faster breakeven point. It also adds further flexibility, especially if the architecture is designed with open APIs to enable collaboration with potential financial-technology partners who already operate from a cloud-based environment.

6. Get creative with marketing

Since digital-only banks don't have the same customer-acquisition opportunities as legacy banks with branch networks, marketing is a major cost, representing 25 to 35 percent of total

operating expenses. This is true even for legacy banks that create digital start-ups, since the new entities must clearly differentiate their brand and value proposition from the parent operations' if they want to be successful. Digital-only banks will likely be targeting a younger, more digitally savvy customer than incumbent banks. AirBank, for instance, which launched in the Czech Republic without the backing of an existing bank, tagged itself as the “first bank you will like” and promised that all customer communications would be jargon-free and all fees clearly outlined in one simple document.

To communicate such distinct selling points cost-effectively, banks must cultivate word-of-mouth recommendations and feedback through social media. This entails going after customers in a much more targeted way than banks are used to, both with an understanding of how to maximize value according to geographic distinctions (focusing on Twitter in Jakarta and WeChat in China, for instance) and specific customer niches (for example, buying ads on Facebook for millennials who play golf).

One particularly creative marketing example is a promotion that China's successful messaging app Tencent's WeChat ran during the Chinese New Year holiday in 2014. To promote its WeChat Payment service, which allows peer-to-peer transfer and electronic bill payment, the company launched an app that allows users to send a specific amount of money to a certain number of friends, with the app randomly assigning the money. To redeem and see how much money you were sent, recipients had to sign up for a WeChat account. WeChat's virtual envelopes went viral because they added an element of suspense to the tradition of giving gifts of money in red envelopes during the New Year. In two days, the company got 200 million of its existing and new users to link their bank cards to their account, a feat that took Alibaba's Alipay eight years.



Launching a new digital-banking business enables banks to rapidly drive value creation. A combination of leveraging smart technology solutions and incorporating the critical success factors outlined above can help banks do this in an accelerated manner. □

Sonia Barquin is a consultant in McKinsey's Kuala Lumpur office, and **Vinayak HV** is a principal in the Singapore office.

The authors would like to acknowledge the contributions of Somesh Khanna, a director in the New York office and a global leader of McKinsey Digital.