Digital banking: Winning the beachhead

One in three people in developed markets now carries a smartphone, and few doubt that banks will rely increasingly on digital channels to serve the fast-growing population of consumers who rely on multiple devices to conduct daily business online. In the United States, where smartphones account for more than half of mobile subscriptions, one-third of consumers are using their phones to make payments. Unfortunately for banks, many of these payments are transacted through mobile apps controlled by online payments specialists and digital merchants. Payments represent the beachhead for the entire banking relationship, and this beachhead is under attack. Offering a strong payments plan as part of a comprehensive strategy for digital banking is therefore an imperative for banks. But to compete in this emerging arena, banks must meet the expectations of digital natives, delivering diverse tools to help customers make smart decisions across a range of financial services. They should begin by capturing their customers' most frequent transactions with the new mobile channel and then proceed toward a fully digital relationship.

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Beachhead under fire

The average customer interacts with their bank at least twice a day for payments-related matters such as buying a financial product, checking on a payment or paying a bill. These interactions represent more than 80 percent of customer interactions with banks, making payments a superb platform, or "beachhead," for cross-selling other financial services.

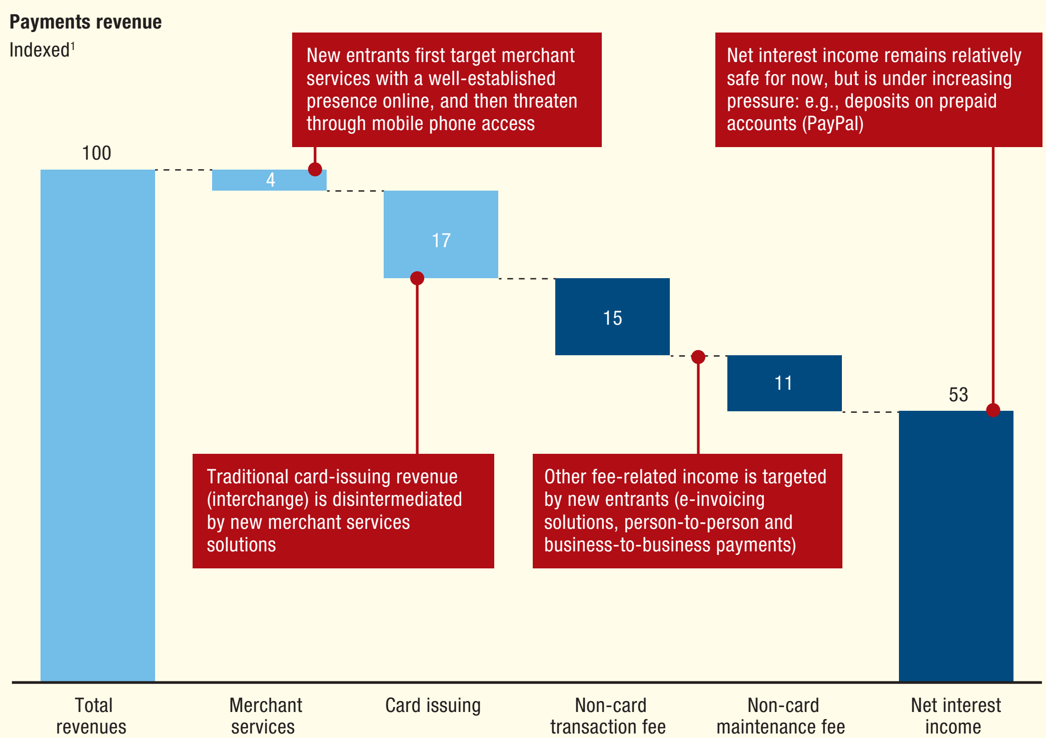
But the contest for the beachhead is intensifying, particularly in the area of *mobile payments* (any payment initiated with a portable handheld device) and *digital payments* (transactions initiated with a digital device—phone, tablet, computer—in which the service provider's business model relies to some degree on leveraging the data around the transaction for added commercial value). Armed with deposit accounts, lending relationships, an enduring reputation for security and a robust infrastructure for clearing and settling, banks are currently the only players with the ability to achieve the scale required for mobile payments. They also enjoy huge advantages as digital payments service providers, to the extent that they leverage these strengths against digital attackers.

While banks such as Danske Bank (with Mobilpay) or Barclays (Pingit) are reaching substantial new customer communities, it is nonbank attackers, ranging from large telecommunications companies to small and nimble technology players, that are defining the standards for digital banking. They have blurred the lines between media content, product merchandising, order and payment, all the while tailoring cross-functional offers to individual, real-time needs. In addition, nonbank digital players enjoy some important advantages, including fewer regulatory constraints, a higher risk appetite and greater leeway from customers. For now, the payments business remains squarely within the core bank franchise, but attackers such as Google, Apple and PayPal threaten critical sources of revenue (Exhibit 1).

Nonbank challengers are operationally built for continuous innovation, and frequently upgrade their arsenal. They leverage the existing banking and payments infrastructure and can maintain a narrow focus on their value-added offerings by virtue of the marginal role they play within this infrastructure. They are thus often more agile and

Exhibit 1

Attackers are targeting banking revenue sweet spots



[1] European bank example

Source: McKinsey Global Payments Map

efficient, launching updates with remarkable speed. Adyen, for example, releases updated payments software every three to four weeks. Nonbank challengers also serve their customers much faster; for example, Square or PayPal can onboard a new merchant within one day, almost a week faster than most banks (Exhibit 2).

Crafting a compelling digital payments offer

If the payments beachhead falls into the hands of cutting-edge banks and nonbank competitors, the losers will remain in a defensive posture, burdened with chronic slow growth and thinning margins. Banks need to drive traffic to their digital banking channels with new customer experiences, starting with payments capabilities.

As it happens, the absence of a new and distinctive value proposition for the mobile channel has become a common barrier to consumer adoption. Offering little more than a view of balances and transactions and transfers between accounts, many of the mobile banking applications available today actually offer less functionality than online banking. The alignment of product development with the traditional silos of deposit accounts and cards has failed to deliver the new service experiences that digital natives crave.

Digital payments as high-growth opportunity

Not only does the digital channel multiply customer interactions, but mobile and online payments—which together form the bulk of "digital payments"—are the beach-

Exhibit 2

Emerging nonbank competitors operate at a higher level of operational productivity

adyen	New software every 3 to 4 weeks
Square	Onboards new merchants within 1 day
PayPal™	Sizeable group of dedicated anti-fraud professionals on closed-loop solution
Google™	Invests $200 million annually on big data solutions
globalcollect™ international payment services	Provides 24/7 global shopper support integrated across phone and digital
sage	Offers payments services integrated with small and medium-size business financial supply chain
WESTERN UNION WU™	Has dedicated unit focusing on business development and innovation, with direct access to operational resources

Source: Dealogic Search

head from which banks can extend their commercial territory and grow revenue. Digital payments give banks the platform to:

If banks cling to the traditional, narrow view of the payments ecosystem, the attackers now charging the beachhead will not only take the additional revenues described above, they will also enjoy prime access to the "digital trail."

- **Boost fee and interest income:** On the retail side, mobile payments solutions, including mobile peer-to-peer (P2P) money transfers, international remittances and small-merchant mobile card readers, not only increase the frequency of consumer interactions but also boost both the number of charged transactions and the cash flowing through bank systems (e.g., prepaid, current accounts, consumption-related lending). On the corporate side, transaction banks that execute well on digital cross-selling stand to increase their market share of corporate deposits and lending.
- **Reach a broader set of customers with more diverse services:** By tailoring payments solutions to underserved segments, including small and informal merchants, the youth market, international travelers, migrant workers and low-income customers, banks can shift a bigger share of payments to bank-owned channels. Banks can develop applications for small payments, unattended vending and ambulant sales to extend the reach of electronic payments and reduce the costs associated with less efficient payments instruments such as cash.
- **Extend the value proposition.** Banks own rich reserves of raw behavioral data. The mobile channel enhances this data pool with location and search data, which can provide valuable insights into future customer choices. Banks should leverage their data strengths to create new services along the full span of the consumer decision journey, reaching beyond payments transactions to manage the customer's entire digital wallet (by, for example, optimizing loyalty awards and special offers, payments terms and instruments).

If banks cling to the traditional, narrow view of the payments ecosystem, attackers will not only take the additional revenues described above, they will also enjoy prime access to the "digital trail," including essential transaction information, and direct traffic to preferred service providers within the digital sphere. Having entered the payments space through profitable, underserved niches such as P2P and cross-border commerce, attackers are now venturing into adjacent segments, which are at the core of banks' offerings, such as point-of-sale (POS) lending and financial planning. From there they are in a position to modify the actual value chain, targeting new revenue sources and reducing existing ones, such as interchange and transaction fees.

On the other hand, by leveraging the data surrounding digital payments, banks could potentially double their payments-related revenue, beating new entrants at their own game. This new thinking about the core value proposition of banking will require an

Supporting the digital experience

To secure the mobile payments beachhead, banks must stay at the forefront of payments innovation, developing digital weaponry to respond to their rivals. This will require significant changes in operations, organizational structure and culture.

As a general goal, banks must integrate data instantaneously across disparate systems for immediate insights that increase choice and equip the customer to make smart, highly informed decisions—all while maintaining security and privacy. Whether a bank is a follower, catalyst or leader, the drivers are the same: operational skills, the commercial value proposition and organizational culture must be focused on continuous innovation and incremental development. The emphasis on each driver, however, will vary according to the bank's market stance.

First, aiming for continuous innovation, banks should use payments as the testing ground to develop new digital operations, as payments offer the benefit of frequent interaction and repetitive behavior. As the migration to online services has shown, payments provide access to rapid, live market testing. For fast followers, the emphasis will be on a flexible platform and clear innovation investment process. Leaders will necessarily take a different approach to solutions innovation, moving to a "launch first, then evolve" process. If performance of a new solution falls short, the trial should be abandoned promptly to make room for the next.

Second, the new operating model will require new skills and capabilities. Digital operations require a combination of IT systems and human skill and proficiency that is substantially different from systems designed for batch-based processing. New levels of interoperability across systems must support not only the instant manipulation of diverse types of structured and unstructured data for actionable insights but also 24/7 real-time responsiveness.

Building these skills within the existing bank infrastructure is possible, but even for banks that position themselves as leaders, increasing speed to market and streamlining client onboarding are challenging. Banks should explore alternative ways to capture the needed operational skills, speeding up innovation with new talent from outside the industry, joint ventures or acquisitions of smaller companies already mastering the new skill set. Another route particularly suited to—but by no means limited to—catalyst banks would be to establish innovation labs to develop solutions outside existing bank silos. As a third alternative, banks can invite others to bring the needed skills to the bank, creating a platform from which independent "trusted" app developers can collaborate within the control of the bank.

Finally, adapting a business model and service architecture that are fully centered on the digital expectations of customers will require changes in organization and mind-set. For example, banks should integrate channel management across silos and combine digital access and branch networks in a single delivery strategy, drawing customers to the digital interface with online and in-store/in-branch tutorials, just as the bank used staff to educate clients on ATMs.

These far-reaching changes in solutions innovation, operational skills, and organizational culture will not only help banks secure the digital payments beachhead but may also become the decisive lever for banks facing increased regulations, cost pressures and demand for transparency.

entirely new approach to operations and solutions innovation (see sidebar, page 7).

Beyond the beachhead

Each bank must reflect on its evolution along the digital banking continuum: from mobile payments to a unified access strategy for all channels, and, ultimately, a consolidated digital platform to manage and deliver the full range of financial services. This reflection will necessarily span the entire organization, from front-end commercial activities to back-end technology and operations and across all business silos.

Banks should plot the incremental launch of increasingly robust tools to help customers make smart financial decisions. For example, while the initial digital payments application would include at a minimum POS payments, bill payment and P2P transfers, a "digital wallet" would go further, optimizing transaction and funding costs, the use of loyalty points and special offers, and so on. The next level of digital integration could support a digital financial planner to manage monthly income, recurring bills and savings and investments, bringing the bank truly to the heart of the consumer's portable device and increasing interaction even more. Taking advantage of further multichannel, cross-silo integration, a portfolio app for liquidity and investments might include preset thresholds for buy/sell alerts, special offers triggered when current account balances reach a certain level and periodic reports and market alerts benchmarking portfolio holdings against standard and custom indexes.

As they reevaluate their core value proposition and contemplate the digital-banking continuum, banks face a choice between three strategic postures (Exhibit 3):

- As *fast followers,* banks need to track the progress that other banks are making and develop service models that can react to customer needs when a new concept is stable. These banks can invest in "competitive innovation centers," picking up ideas as they hit the banking market.
- Some banks will prefer to act as *catalysts* for growth, inviting others to innovate while they ensure client security, account management and system stability. One way of doing this is by opening the bank's IT platform to a select community of de-

Exhibit 3

Banks can adopt one of three strategic postures in digital payments

	Fast follower	Catalyst	Leader
	Enable solutions only if concept is stable Focus on selected improvements to existing system Adapt systems and services to increase frequency of interaction	Enable innovators to develop solutions Build upon a revenue model that monetizes data and customer access Ensure client security, account management and system stability	Take the lead in providing innovative solutions, making a real difference for clients Cover banking as well as non-banking services
Current EMEA examples	**Most banks across EMEA**	**Crédit Agricole** **Danske Bank**	**Barclays** **BBVA**

Source: McKinsey analysis

velopers or allowing others to provide services under their client platform.

- Other banks might seize the opportunity to *lead,* competing on innovation not only with other banks but also with digital leaders such as Google or Facebook, on banking as well as some nonbanking services. Such leaders stand out as delivering comprehensive digital solutions, and while they bear the risk of market adoption, they maintain a reputation for innovation and industry leadership.

Customer in-store payments choices are far more accurate than conventional profile data in predicting future needs. Banks are therefore well placed to identify key transaction pain points and adjust channel priority, pricing, service levels and other levers for each segment.

Behavioral segmentation as a spur

Regardless of a bank's posture, it will need to define customer life-cycle itineraries, mapping incremental milestones and the proper allocation of resources for each stage of the customer's journey through the digital revolution.

As with each previous transformation, banks must design hands-on education campaigns to expose the broadest cross-section of customers—from *cash users* to *check writers* to *early adopters*—to the advantages of digital banking. This means changing the way consumers shop, pay their bills and manage their finances. Banks will need to outline a set of journeys to bring occasional users into the circle of loyal digital customers. Internet powerhouses such as Google and Facebook excel at this; why would banks, with all their customer knowledge, do worse?

To capture this opportunity, banks will need to consolidate data across deposits, consumer finance and other transaction accounts for a unified view of customer activity and a clear understanding of the specific behavioral patterns that distinguish various customer segments. Customer in-store payments choices, for example, are far more accurate than conventional profile data (e.g., age, income, geography) in predicting future needs (Exhibit 4, page 10). Banks are therefore well placed to identify key transaction pain points and adjust channel priority, pricing, service levels and other levers for each segment. In mapping these incentives and milestones, banks should consider the full journey toward digital banking, rather than targeting a single digital solution.

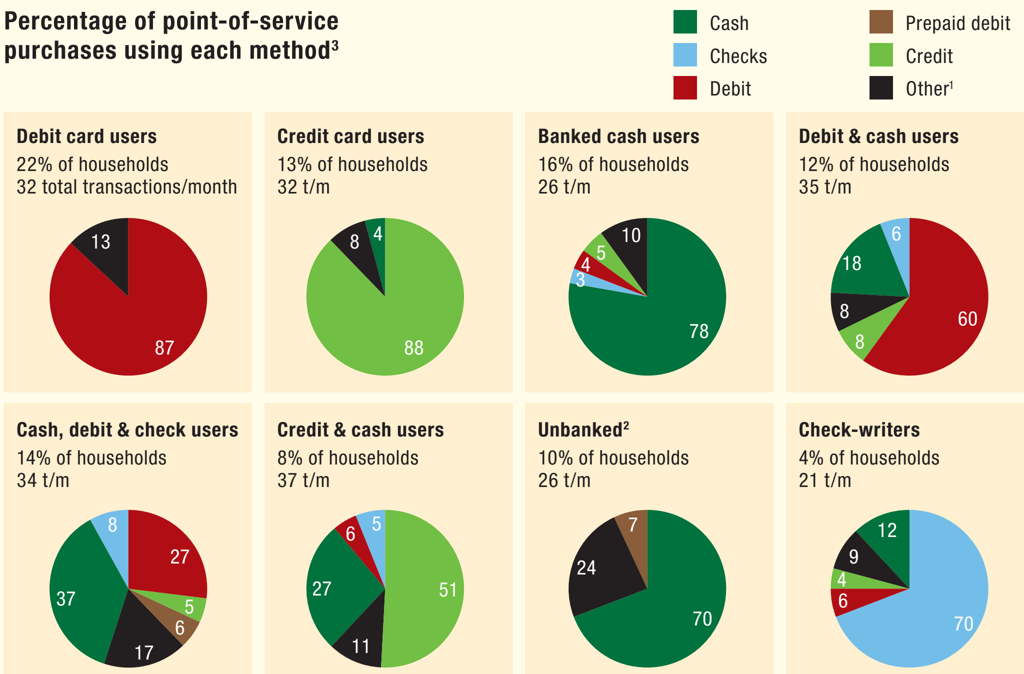
Promote the evolution of industry infrastructure

Beyond the transformation of individual financial institutions, the industry as a whole must also reflect on the new requirements for payments infrastructure and how to benefit from change.

In many geographies, regulators have been instrumental in driving payments infrastructure, such as automated clearing houses (ACH), to adapt to new customer requirements (for example, 24/7 multichannel access, real-time execution and interoperability). These initiatives have triggered the creation of upgraded ACH solutions, including Faster Payments in the United Kingdom, Express Elixir in Poland and the New

Exhibit 4

Based on point-of-service payments preferences, consumers fall into one of eight profiles



[1] In all clusters except unbanked and cash, debit & check users, "other" includes prepaid debit cards

[2] Includes consumers with neither checking nor credit accounts. Consumers without demand deposit accounts who use credit cards are included in other clusters.

[3] U.S. example

Source: McKinsey Consumer Financial Life Survey, 2012

Payment Platform in Australia. Infrastructure developments have also generated a series of new mobile solutions, such as Pingit in the United Kingdom, IKO in Poland and Kaching in Australia. These solutions seem well adapted to the digital world and serve the needs of many customers in P2P, B2B and POS contexts. More important, they are deeply embedded in the deposit account services of incumbent banks.

To maintain and raise control over the essential payments part of the financial ecosystem, the banking industry should review its legacy infrastructure to ensure that it continues to strengthen the industry's position in the digital world.

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Banks are the natural owners of the payments space, as payments are the gateway into the financial relationship. However, attackers are developing payments service capabilities and operational skills superior to those of banks. They are not smarter, just more focused. Banks' customer relationships, structural security, multichannel capabilities and stability should ultimately combine to win the game. But banks can succeed only if they can match the solutions, operational efficiency and client service skills of attackers. And they must get there quickly. In the digital world, tomorrow is already too late.

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