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Strategic choices for banks in the digital age

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Consumers around the world are quickly adopting digital banking. Incumbents only have a short period to adjust to this new reality or risk becoming obsolete.

If the last epoch in retail banking was defined by a boom-to-bust expansion of consumer credit, the current one will be defined by digital. This will include rapid innovation in payments and the broader transformation in systems enabled by digital technologies. The urgency of acting is acute. Banks have three to five years at most to become digitally proficient. If they fail to take action, they risk entering a spiral of decline similar to laggards in other industries.

Revenues and profits will migrate at scale toward banks that successfully use digital technologies to automate processes, create new products, improve regulatory compliance, transform the experiences of their customers, and disrupt key components of the value chain. Institutions that resist digital innovation will be punished by customers, financial markets, and—sometimes—regulators. Indeed, our analysis suggests that digital laggards could see up to 35 percent of net profit eroded, while winners may realize a profit upside of 40 percent or more (exhibit).

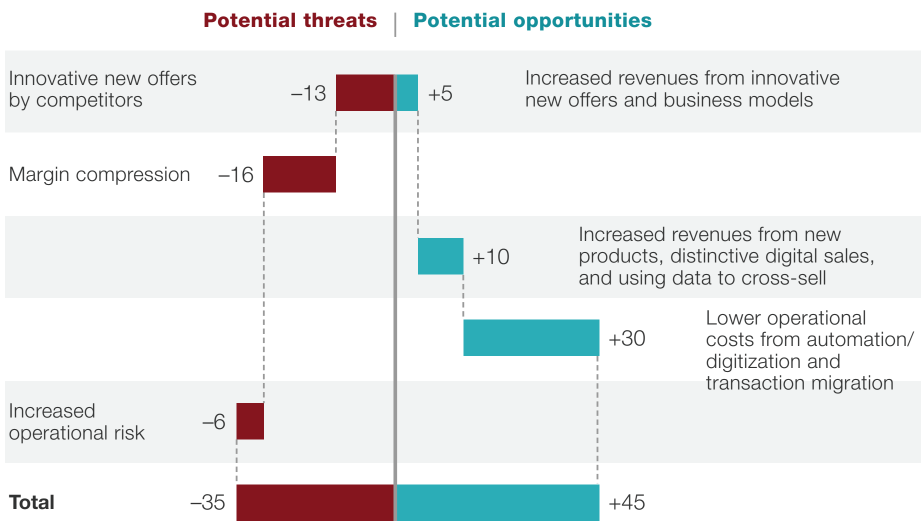
Where banks stand

Globally, more innovative incumbent banks and financial institutions are moving rapidly to embrace digital. Most have invested heavily in transaction migration. They have also significantly upgraded web and mobile technologies and created innovation and testing centers. In addition, banks increasingly realize that to succeed with digital, they must adopt the habits and culture of digitally native companies: for example, opening up the banks' application programming interfaces, pursuing agile development, or hosting hackathons to foster intensive digital collaboration.

We expect no letup in the pace of change. Within the next five years, digital sales have the potential to account for 40 percent or more of new inflow revenue in the most progressive geographies and customer segments. By 2018, banks in Scandinavia, the United Kingdom, and Western Europe are forecast to have half or more of new inflow revenue in most products coming from digital sales. Those in the United States are expected to trail them but are still forecast to see significant new inflow revenue come from digital. Among bank products, savings and term deposits, as well as bank services to small and midsize enterprises, are expected to see more than half of new inflow revenue coming from digital by 2018 (see sidebar "Digitally disrupted revenue").

Exhibit Digital innovation in banking offers potential rewards and losses.

Impact from digital, % of net profit for retail bank



Source: McKinsey analysis

Although these forecasts may take longer to materialize than expected, we believe the digital transformation is at an inflection point. Banks have just a few years to adapt. Appreciating the magnitude of the opportunity—and the gravity of the threat—is vital, but it is just the first step in formulating a winning digital strategy. Digital will touch every aspect of bank operations, from product development to risk management and human-capital management. Successful strategies need to be based on a clear understanding of how digital creates value, granular perspectives on consumer behavior and market dynamics, and careful prioritization by top management among hundreds of potential digital investments.

Meanwhile, new entrants are moving into the broader financial-services sector in many markets. In China, Alibaba has captured some $100 billion in assets in the second year since its launch of a wealth-management platform, while online giant Tencent is building a financial ecosystem around a large-scale online platform. The realm of payments, already digitized, is seeing more innovation from Apple Pay's contactless-payment technology.[1] In response, banks must also use digital to innovate and prosper.

[1] Olivier Denecker, Sameer Gulati, and Marc Niederkorn, "The digital battle that banks must win," August 2014, mckinsey.com.

Digitally disrupted revenue

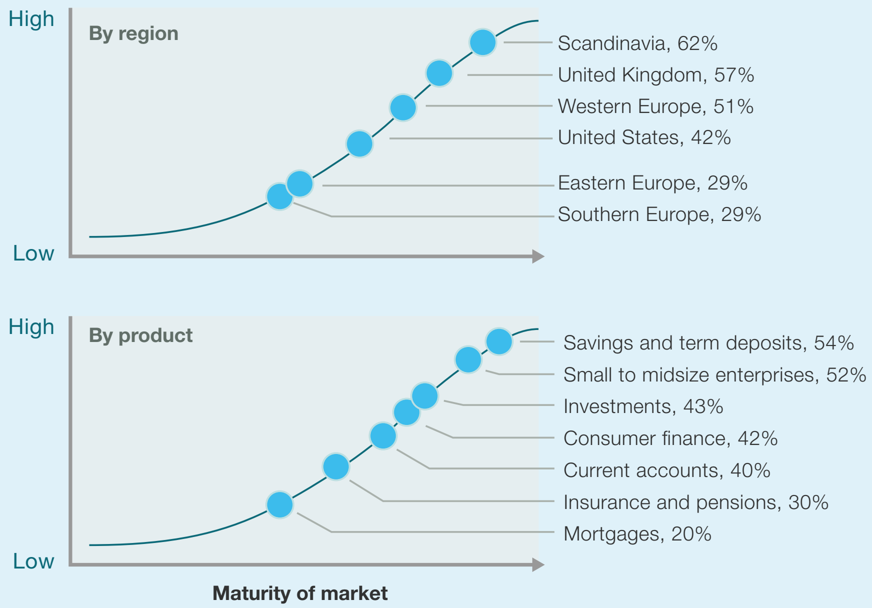
In Europe, we estimate that only about 10 percent of retail-banking revenue today is "digitally disrupted," defined as a majority of new revenue being captured via online or mobile channels. By 2018, our high-level estimate of digitally disrupted revenue is forecast to be around 50 percent or more in many major markets (exhibit). But the pattern of disruption will vary significantly by country and product category.

In Southern Europe, for example, less than one-third of revenue is forecast to be from digitally disrupted sales by 2018, but in Scandinavia that figure is 62 percent. In other areas, the forecast for digitally disrupted revenue ranges from 29 percent in Eastern Europe to 42 percent in the United States and 51 percent in Western Europe.

With products, the speed of expected disruption will also vary. Savings and term deposits will lead, with digitally disrupted sales revenue forecast at 54 percent in 2018. However, digital sales disruption in insurance and pensions (30 percent) and mortgages (20 percent) is forecast to emerge less rapidly due to long product maturity, a consumer preference for in-person advice, and the slow development of online refinancing.

Exhibit By 2018, digital disruption in banking is expected to reach its inflection point.

Share of new inflow revenue from digital sales in 2018



Source: Analysis of data provided by McKinsey Panorama (a McKinsey Solution)

Capturing the value of digital

There are four fundamental ways in which digital capabilities can be used by banks to create value. First, digital technologies increase a bank's *connectivity*—not just with customers but also with employees and suppliers. This extends from online interactivity and payment solutions to mobile functionality and opportunities to boost bank brands in social media. Second, digital draws on big data and advanced analytics to extend and refine *decision making*. Such analytics are being deployed by the most innovative banks in many areas, including sales, product design, pricing and underwriting, and the design of truly amazing customer experiences.

A third way that digital creates value is by enabling straight-through processing—that is, *automating* and digitizing a number of repetitive, low-value, and low-risk processes. Process apps, for example, boost productivity and facilitate regulatory compliance, while imaging and straight-through processing lead to paperless, more efficient work flows. Finally, digitization is a means of fostering *innovation* across products and business models. Examples of this include social marketing and crowdsourced support, as well as "digitally centered" business models.

For CEOs, the good news is that each of these ways of creating value through digital can be applied to every bank function. However, developing a digital agenda and driving a digitally centered transformation is a complex task. It requires an unusually high level of coordination of cross-bank initiatives spanning prioritization, resource allocation, and collaboration in execution. Moreover, most banks are only in the early stages of developing the capabilities and culture of digitally native organizations, which include several elements:

- User-centered customer-journey design. Customer journeys should be compelling and highly differentiated, combining personalization, speed, and ease of use for all processes, including applying and getting approved for a loan, opening and understanding how to make full use of an account, and reconciling payments. To make this leap in the delivery of customer journeys, banks need to act quickly to acquire deep capabilities in user experience and user interfaces.

- Personalization, leveraging data, and advanced analytics. Most data still go unused. Yet there is significant value in applying advanced analytics to create targeted offerings for cross-selling and up-selling. This is achieved by making data usable in real time, such as at the point of sale, and combining the data with analytical tools to generate insights provided by "next product to buy" models or risk assessments, for example.

- Rapid experimentation and agile development. Banks need to learn to rapidly acquire or imitate high-value initiatives, while showing tolerance of failures in trials. Banks often struggle with this trialing and testing culture. In addition, they need to move to "agile delivery," with weekly sprints, from a "waterfall" approach in which there are months between releases. They must achieve this agile model at scale but still recognize that agile isn't the right answer for every development effort.

While developing these capabilities is crucial, an equally critical part of the digital transformation is the need to develop a different culture (see sidebar "Habits for an effective digital transformation"). That requires adopting a mind-set similar to that found in successful digital enterprises when it comes to everything from establishing a challenging and coherent digital vision to acquiring new data capabilities and adopting a test-and-learn approach with rapid iterations.

Habits for an effective digital transformation

A successful digital transformation requires instilling the following habits in a bank's culture, as described in "The seven traits of effective digital enterprises"[1]:

- **Be unreasonably aspirational.** Set up a challenging and coherent digital vision (think of Netflix developing video streaming in addition to DVD rental), including steps such as assigning a board-level digital owner and creating a digital profit-and-loss statement.

- **Acquire capabilities.** Hire staff with the skills needed for digital transformation rather than only considering banking-industry experience. The best people in digital product management of user-experience design may not work in banking: search adjacent markets and hire them anyway.

- **'Ring fence' and cultivate talent.** Nurture digital talent with its own environment and tools, taking care to protect it from existing web operations. After false starts, Walmart ring fenced @WalmartLabs in 2011 and began to outpace Amazon's rate of growth.

- **Challenge everything.** Never settle for the status quo. Bank leaders must aggressively challenge all aspects of their business—both customer-facing and back-office systems and processes.

- **Be quick and data driven.** Move to a cycle of continuous proposition iteration and improvement, adopting methods such as agile development and "live beta," supported by big data analytics, to increase the pace of innovation.

- **Follow the money.** Invest in digital across the value chain. Quickly zero in on the digital investments that create the most value and then double down.

- **Be obsessed with the customer.** A healthy obsession with improving customer experience and learning from every customer interaction is the foundation of any digital transformation, even for banks. This must extend to all channels: customers expect the same frictionless experience in the branch as they do online.

[1] Tunde Olanrewaju, Kate Smaje, and Paul Willmott, "The seven traits of effective digital enterprises," May 2014, mckinsey.com.

Across the value chain—from operations and IT to marketing and sales to product development and finance—the data and technology required to realize this vision in the bank often already exists. What's missing is the organizational orientation and mind-set to have small, cross-functional teams working together through rapid testing and improvement programs. Indeed, we have noted that many of the new capabilities required cannot be found in banks but instead need to be imported from other industries.

Becoming aware of the need for change is the first challenge that bank CEOs face. The next challenge is to take leadership in the development and execution of a holistic change program that simultaneously addresses the culture, systems, and capabilities required. Invariably, a number of issues will arise to test CEOs (see sidebar "Confronting digital dilemmas").

Confronting digital dilemmas

Every banking CEO should weigh the six digital dilemmas described in the *McKinsey Quarterly* article "Strategic principles for competing in the digital age"[1] and make decisions that provide the best fit for their bank. Below we adapt these issues to apply them specifically to banks.

Decision 1: Disrupt or defend?

Disruptive plays can be the best option when a bank has little to lose in a geographic area or product segment. Take mBank. It has been so successful as a direct bank in Poland that BRE Bank, its founder, switched its name to mBank. Now the entire operation has 4.2 million customers. Defensive strategies can be a better option for incumbents to avoid cannibalization and margin erosion—at least for a time. Itaú Unibanco in Brazil chose this strategy, investing heavily in next-generation technologies and digital channels while at the same time innovating in traditional channels, experimenting with new branch formats, and using ATMs for cross-selling and up-selling.

Decision 2: Cooperate or compete with new attackers?

Some new attackers can be thwarted, but cooperation in certain areas can make sense. This could be the best way to access new customers or to offer innovative capabilities to existing clients more rapidly. GarantiBank in Turkey chose to compete against Google Wallet by building its own "iWallet," and it considers the product integral to the iGaranti offering. However, Citibank instead cooperated with Google on the same offering to get more rapid access to new capabilities.

[1] Martin Hirt and Paul Willmott, "Strategic principles for competing in the digital age," *McKinsey Quarterly*, May 2014, mckinsey.com.

Decision 3: Diversify or double down?

A portfolio of digital initiatives can reduce risk through diversification, but genuine game changers require time, money, and leadership drive. Sometimes banks seed multiple ventures and then double down on scaling up those that deliver impact. Australian bank Westpac, for example, unveiled a mobile strategy in 2012 made up of many small projects. With mobile and online banking proliferating, Westpac recently launched a new integrated online and digital platform—in doing so, it consolidated and focused its digital investments.

Decision 4: Keep digital businesses separate or integrate them?

Integrating digital operations can quickly provide bank customers with multichannel capabilities. Lloyds Banking Group is keeping digital integrated with its traditional business, but it created a digital hub to support the rest of the group in adopting new technologies to improve the customer experience. Other banks choose to completely separate the digital business. Millennium bcp followed this approach when it set up ActivoBank as an own-brand digital bank with separate commercial and operating functions.

Decision 5: Business-led or operations- and IT-led digital transformation?

A business-led digital transformation can be very successful, particularly if the CEO directs the digital agenda. At Ping An, the CEO boldly used digital to transform a large insurer into a leading Chinese financial institution. Similarly, there are compelling value-creation reasons to have IT and operations lead a digital transformation. Banco Bilbao Vizcaya Argentaria (BBVA), for example, began its digital transformation by developing a state-of-the-art technology platform driven by the operations and IT function, which served as a stepping stone to transform the rest of the business.

Decision 6: Buy or sell businesses in the portfolio?

Sometimes digital transformation will lead a bank to shuffle the businesses in its portfolio through deal making. BBVA, for instance, bought Simple, an attacker and noted technology leader. The aim was to acquire talent, and use Simple as a catalyst to enhance BBVA's marketing and digital culture. On other occasions, it can make sense to sell a business. In 2013, for example, ING sold its Eastern European securities-services businesses to Citi rather than continue to invest in process and transaction automation.

The scope of these changes demonstrates that digitization is a tough, complicated journey. Capturing the opportunities it provides will require investment, painstaking planning, and coordinated decision making spanning the whole bank. Digitization is rewriting the rules of how banks compete. Incumbents that fail to grasp this risk damaging franchises built over generations. But if CEOs manage to address the multiple strategic challenges posed by digital advances, they can position their institutions to compete effectively and capture an emerging, long-term growth trajectory.

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