Designing a sustainable digital bank

Learning from the digital pioneers

In an era of unprecedented change, technology offers banking clients greater access to information than ever before. Out of this revolutionary advance, a new class of smarter and more demanding customers has emerged. In tandem, new financial players are moving quickly to offer new compelling digital services. As with every major change triggered by technological advancement, there are clear winners and those who are unable to adapt. Banks that embrace digitization have an opportunity to generate new business value and better engage with their customers.

The surge of new entrants riding the digital wave

Banking has traditionally been a conservative industry that enjoys relatively high barriers to entry due to regulations that restrain access for non-bank competitors. New digital technologies—driven by cloud, mobile, social and analytics—have drastically lower entry barriers. Regulators in many countries have also relaxed regulations to encourage innovations in the banking industry. As a result, many new all-digital financial services firms, unencumbered by older less agile systems are aggressively pursuing customers by addressing their needs in new and distinct ways. For instance, Chinese internet giant Tencent created WeBank hoping to capitalize on its vast user base of microblogging and peer-to-peer chatting services. E-commerce leaders such as Tesco in Europe, Rakuten in Asia-Pacific and Walmart in the US have also entered the banking sector. Globally, entrepreneurs and even traditional banks are creating digital-only banks or neobanks. BankMobile, Number26, Atom, ZenBanx and NuBank are just some of the names appearing in recent financial news. These neobanks have something in common—digital technology is at the core of their value proposition.

A scan of the digital bank landscape

We see interesting characteristics in both the entrants and the more established digital banks. They can be divided into four models as seen in figure 1:

- Model A, a digital bank brand: Many established, full-service banks find it difficult to appeal to millennials. Wary of alienating existing customers, they do not want to alter their current branding. Setting up a new brand with unique value proposition and products designed to attract the target customer segments is a safer strategy. These digital brands may be marketed as a new bank, but they usually leverage infrastructure from their parent banks whenever possible. Examples: FRANK by OCBC in Singapore and LKXA of CaixaBank in Spain.

- Model B, a digital bank channel: Many entrepreneurs and forward-thinking bankers see the gaps between the experience demanded by consumers and the experience offered by traditional banks as promising business opportunities. Unlike model A digital banks, digital endeavors of model B organizations believe that superior user experience must go deeper than branding and can be achieved by delivering new mobile and online apps that are focused on user experience. In the back end, rather than build a bank from the ground up that can be burdened with the overhead that a regulated bank would incur, these firms often resell a real bank's products and must redeposit customer funds into a real bank's insured accounts. Examples: Simple and Moven in the US.

- Model C, a digital bank subsidiary: Many banking innovators intend to create not only differentiated digital user experiences, but also a true end-to-end business model. They may find that the existing organization is either incapable of creative thinking or resistant to change. Larger banks may also find that their existing banking systems are too rigid and siloed to power a digital bank. A separate organization is then created and established as a new digital bank. In addition to brand new digital channels, model C digital banks also rely on more agile and modular back end systems to provide customers with a streamlined end-to-end experience. New back end systems also allow these digital banks to innovate at the product level. Example: Hello Bank by BNP Paribas.

- Model D, a digital native bank: These are full-fledged banks that build their core value propositions around digital technologies. Digital native banking does not necessarily imply branchless banking. However, customers of these banks are expected to interact with the bank primarily through digital channels. Some digital native banks are entirely branchless, while others choose to complement the digital channels with face-to-face interactions either in financial centers, in cafes or through video chat over mobile devices. Examples: Fidor Bank of Germany and Tangerine of Canada.

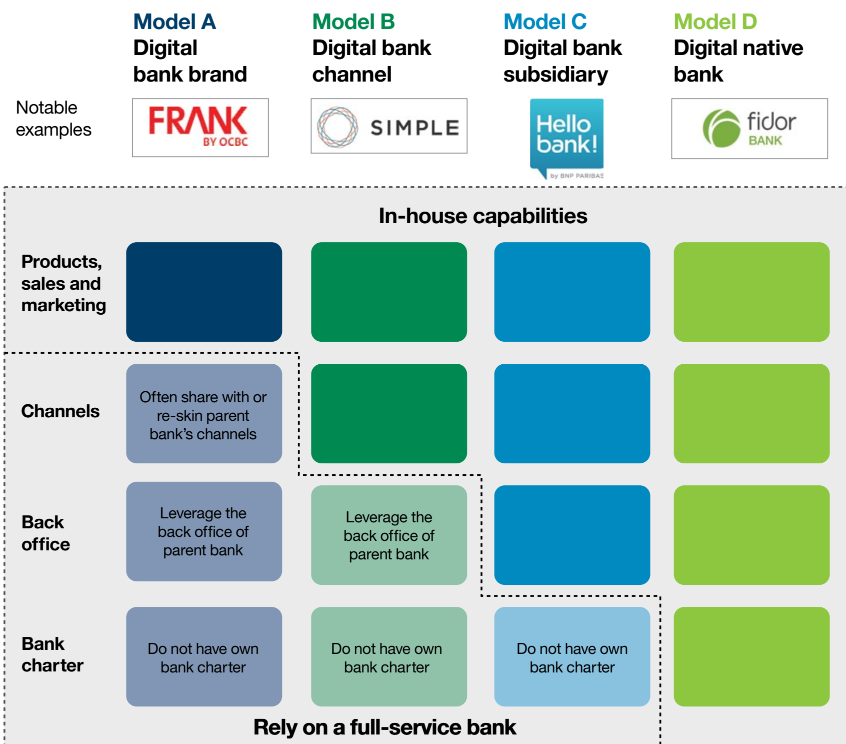

Figure 1. Digital bank models.

Lessons learned from the digital pioneers

A deeper look into the finances of some of these new entrants reveals several important lessons. The digital bank business model has proven that economies of scale are currently the single most important critical success factor. New entrants that have achieved scale tend to be subsidiaries of traditional banks, many of them model Cs, such as ING Direct and First Direct of HSBC. A successful banking business needs scale not only to lower operating cost but also to build confidence to win customers. Not many customers will trust their life savings to an unknown internet company. This is the reason that it is much easier for a traditional bank's digital subsidiary to grow. Lacking an already well-known brand and the reach of a strong parent bank, most independently operated digital banks struggle with customer acquisition.

The second most important success factor is the ability to design the right experience for target customers. There is no shortage of direct banks—some started by entrepreneurs and others backed by major traditional banks—that failed to take off due to low customer adoption.

Finally, the third success factor is the ability to make profit by extending the initial success in basic deposit products into more complex products and fee-based income. Mortgage, investment and wealth management products are often very profitable, but at the same time can be difficult to sell without face-to-face interactions. Customers purchase these products infrequently, therefore digital convenience is less important than personal trust. The direct banking behemoth ING Direct USA had a loan-to-deposit ratio of around 47 percent before it was acquired by Capital One in 2012.[1] As successful as Tangerine Bank is in Canada, its loan-to-deposit ratio is a low 20 percent.[2] Despite much fanfare, the struggling Zuno Bank in Europe reportedly was only able to lend out seven percent of its deposits.[3] In its audit report looking into the failure of NetBank in 2008, the US Department of the Treasury concluded the Internet was a useful means of raising cash for NetBank, which obtained a large number of deposits because of the high interest rates offered. However NetBank was unable to generate loans and other earning assets through the Internet.[4]

After examining the rise, fall, thrive and struggle of digital banks, we believe that the traditional banks, as incumbents, still hold a slight advantage over the newcomers in the digital banking endeavor, mostly because of their scale, brand, reputation and branch network. However, scale and the resultant corporate inertia could also mean an inability to innovate and longer time to respond to disrupting technologies. Bankers must stay on high alert. History has taught us that it only takes one disruptor to revolutionize an entire industry, just as electronic commerce company Amazon singlehandedly sealed the fate of many once-mighty retailers. The newer generation of digital bankers are learning and adapting too. For example, the newly launched digital-only bank BankMobile will provide each customer access to a live personal banker and a financial advisor. Fidor Bank in Germany has built a loyal customer base on top of its social community and has already become profitable after a mere five years in existence.

Defining the true digital bank

A digital bank is not defined by the number of branches, apps or user experience. Launching a new mobile app does not necessarily turn a traditional bank into a digital bank. Nor does closing down a few or even all branches. A true digital bank is built on the value proposition that most products and services are delivered digitally. Its customers expect to use digital channels for their day-to-day banking activities. The digital bank's infrastructure is optimized for real-time digital interactions and its culture embraces the rapid change of digital technologies.

Designing a sustainable digital bank

A true, sustainable digital bank business model means that the bank optimizes its customer interactions, products, processes and data around digital technologies. Successful digital banks are appealing on the front end and are also digitally efficient on the back end. They use mobile and digital technologies to lower the costs to serve and, at the same time, these technologies are also used to enhance higher touch services.

For instance, the multi-national ING Direct operates cafes so that the bank can reach out to a wider audience. Similarly the multiple award-winning USAA does not operate branches for routine transactions, but gives clients banking advice in its financial centers. The rapidly growing small business lender Live Oak Bank decided on the branchless model but operates private jets to allow its bankers to personally meet with clients prior to closing a loan. Hello Bank offers multiple ways for a customer to contact the bank, including real-time mobile text chat. The same customer who loves paying bills by mobile phone may insist on help from a live person when an issue arises. Convenience is important for routine transactions, but does not matter as much for more complex financial decisions. Digital channels are ideal for some activities while face-to-face interactions are required for others. Banks need to excel at both by providing the convenience of digital channels when convenience is needed and engage with customers intimately when a personal touch is valued more.

12 ways banks can exceed customer expectations

Customers want a great experience from their bank, but what makes that experience great? It is not a better checking account, but the way in which banks engage their customers. The interaction between the bank and the customer is the product. Customers want their bank to:

1) Find me. Customers want to be found not based on some broad demographic, but on very specific characteristics. Use visualization and analytics to discover new customer segments.

2) Ask me. Customers want to be asked about financial products and given suggestions about services. Consult them on products, services and social issues.

3) Advise me. Customers want their bank to provide advice based on transaction data, social data and on all the different pieces of information they have given their bank. Bring expertise to every client interaction by consolidating data.

4) Know me better. Customers want to feel like their bank has a 360-degree view of their relationship with the institution. Bring new services based on an understanding of their wants and needs.

5) Stick with me. Customers want a relationship with their bank that covers them and their family throughout their lives. Connect customers and households using data and insight.

6) Excite me. Customers want their financial institution to show interest, educate them using their preferred channels and to delight them with special services. Surprise your customers with unexpected services.

7) Compare me. Customers want comparison data. Who is buying what in their category of customer and what should they be thinking about? Provide peer analytics in virtual channels.

8) Trade with me. Customers will give the bank information if the bank gives something in return. Retailers do it, banks can too. Offer better products and value in exchange for customers sharing data, location and even new ideas

9) Educate me. Customers want to understand things and expect the bank to use mobile channels to educate them. Offer digital online education and financial tips.

10) Alert me. Customers expect their bank to know what is going on in the world, and if something changes in the market, to bring them information that will help. Use real-time predictive analytics and personalized customer communication.

11) Let me choose. Customers want multiple choices in payments, investments, services, channels and how the bank treats them. Offer them options instead of prerequisites and roadmaps rather than checkboxes.

12) Protect me. Customers want to feel that the security and protection the bank offers are not painful or irritating. Provide multifactor security that protects instead of punishes.

Designing a digital bank requires optimization of the following five areas:

Digitally optimized interactions

Digital channels are where customers conduct most of their basic financial transactions and should be at the center of every bank's distribution strategy. When convenience is valued, banks should provide security-rich services through digital channels. When a personal touch is more effective, banks can also use digital technologies to aid in the interactions. For example, leading banks today differentiate themselves by offering customers the ability to communicate with their bankers or contact center agents over video chat on customers' own devices. The combination of digital convenience and personal touch is what sets these leading banks apart.

Digitally optimized products

A digital bank's products should be designed so they can be easily purchased and serviced on digital channels, which is often radically simpler than similar products offered by traditional banks. The key to designing great products is to think like a retailer. Banks must examine their product lifecycle and ask questions such as:

- How would customers first hear about the product?
- Where do customers conduct research?
- Is it possible to purchase the products digitally?
- Can after-sale services be conducted digitally?
- How can issues and questions be resolved?

Digitally optimized processes

High operating costs contributed to the failure of early digital-only pioneer Netbank. Despite the digital front ends, many of the processes were still handled manually behind the scenes. Customer experience suffered from inconsistency and fragmentation because business processes took too long, were prone to errors and lacked transparency. Because banks need an end-to-end view of the customer journey beyond digital interactions, they should invest in digitizing the processes that support the journey. Banks can start by digitizing user signatures and forms for a paperless environment. On the back end, the leading banks consolidate and streamline business processes onto an enterprise business process management system and eventually achieve straight-through processing. Banks can then create even greater business value by integrating with ecosystem partners including real estate agencies, accounting firms and notaries.

Digitally optimized insights

Direct contact and a handshake are still the most effective way to deepen the customer relationship, but not all banks can afford to offer that level of personal touch to all customers segments. Through customer insight, banks can get personal and intimate even without the expensive in-person interaction. Customers value personalized services that are tailored to their needs because they want their bank to "know me better." Banks need to develop the capacity to sense and rapidly respond to their customers' increasingly eclectic demands and unpredictable patterns of banking behavior. With the ability to use customer insight in real time, banks can devise truly differentiating banking experiences and solutions to deliver the right product at the right time through the appropriate channel.

Digitally optimized organization

Becoming a digital bank also means transforming the bank's own culture and organization. A digital native organization is more agile in adapting to ever-changing customer behaviors. Many traditional banks create a subsidiary with new teams and fresh minds when starting a digital brand. They hire talent or look for advice from more customer-oriented industries like retail. It is believed that BBVA acquired neobank Simple as a catalyst for change while Canadian banking giant TD built a social platform for better collaboration internally and more active participation in customer conversations.

Conclusion

A digital bank is branding to some banks. For others it is the digital channels. The transformation into a true digital bank is much broader and deeper. Across all channels, banks must weave face-to-face intimacy into digital interactions as well as add digital convenience to personal engagements. Digital banking also requires a deep transformation of the entire banking organization including the digitization of processes and extraction of insights from data. Even the bank's strategy, business model and mindset should become more digitally oriented. Those that are most adept at harnessing digital technologies can become industry leaders. The wave of new entrants, game changing technologies, and customers moving to digital services and platforms represents challenges and opportunities. Banks must evolve and adapt or be left behind. Fortunately, they are well-positioned to take advantage of this opportunity.

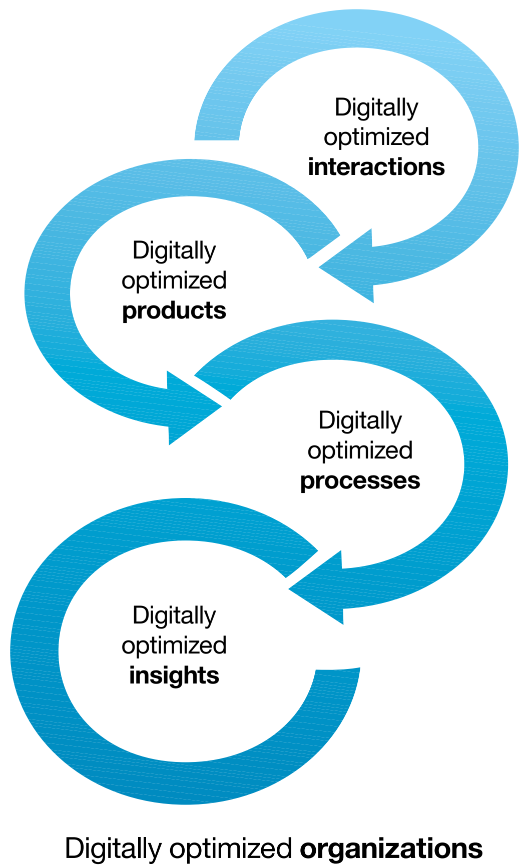

Figure 2. Digital bank building blocks.

For more information

Becoming a digital bank requires a complete view of strategy, technologies, processes and customers. IBM has the end-to-end vision, skills and assets to help you accelerate this process. To learn more about becoming a digital bank, please contact your IBM representative, watch the "What Customers want from their Bank" video, or visit: **ibm.com**/banking

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[1] Capital One Annual Report, 2012.

[2] Scotiabank Canadian Banking Investor Day, April 24, 2014.

[3] Raiffeisen looking to sell Czech internet banking unit, January 20, 2015, Reuters.

[4] Safety and Soundness: Material Loss Review of NetBank, FSB, Office of Inspector General, Department of the Treasury, April 23, 2008.

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