Banks Brace for a New Wave of Digital Disruption

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AT A GLANCE

Banking has seen a resurgence since the 2008 financial crisis. Although the rebound has been stronger in some regions and businesses than others, revenue pools are robust and growing, and returns on equity have improved. However, the industry has entered an era of change that will test banks for much of the next decade.

Shifts in Market Share and the Rise of Digital Giants

The competitive agenda will likely be set by banks that are already strong and able to use their superior scale and digital capabilities to take market share from vulnerable peers. But banks must steel themselves for competition from a new source: digital giants that will take aim at some of the industry's most attractive profit pools. The disruption could be far greater than that created by fintechs.

The Imperative for CEOs

Bank CEOs need a bold action plan. They must set forth a comprehensive digital transformation in place of the incremental, disjointed initiatives common at many banks today. Elements of the transformation should include rationalizing business portfolios, building scale in advantaged businesses, and digitizing end-to-end customer journeys. Banks also need to develop agile ways of working, attract top digital and analytical talent, and simplify their technology and data environments.

WHEN BANK EXECUTIVES EXPERIENCE a moment of worry, it is because of the changing behaviors of their customers, including one from the future whom we call Maximilian.

The year is 2025, and Maximilian is a 35-year-old corporate treasurer in London. In both his personal and business lives, Maximilian operates in a way that betrays no loyalty to the banks he used when he was growing up. He handles all his personal financial needs—paying for his morning coffee, reimbursing a friend for theater tickets, securing a mortgage for the new condo he plans to buy—with services he accesses through his iPhone. Apple may be working with his previous personal bank on the back end, but Maximilian isn't focused on that and doesn't need to know the details. He has not stepped into a bank branch in almost a decade.

At work, too, Maximilian's modus operandi is to look for fast and reliable digital solutions in his area of responsibility—investing his company's cash overnight and ensuring that the company has enough cash for its daily needs. Maximilian's employer used to rely on four multinational banks for help with these services, but now Maximilian and the department he runs rely heavily on a digital cash management service that is part of Google's enterprise offering. The four banks now have nowhere near the same share of the company's business that they once had. Instead, those fees are, in large part, going to Google and a handful of different banks that have higher rates and better technical integration with Google's cash management service.

Banks have to redefine themselves and change how they operate. Anything else would be a mistake.

Welcome to a not-so-comforting view of the future. If you are a bank CEO whose job is to figure out where things are headed over the next five to seven years, chances are that scenarios like this enter your mind at least periodically. But maybe they don't stay in your thoughts for long. After all, the fintech revolution has produced less immediate disruption than had been anticipated, and massive customer defections haven't materialized.

To some degree, we share the renewed confidence that banking executives are feeling. Indeed, given the fundamental strength of many leading multinational banks, banking's inherently high barriers to entry, and the extent of the industry's recovery since the 2008 crisis, we've concluded that many traditional banks—far from fading into the background—will actually gain strength in the coming years. But to be among the winners, banks will have to redefine themselves and change how they operate. Anything else would be a mistake.

Breathing a Sigh of Relief

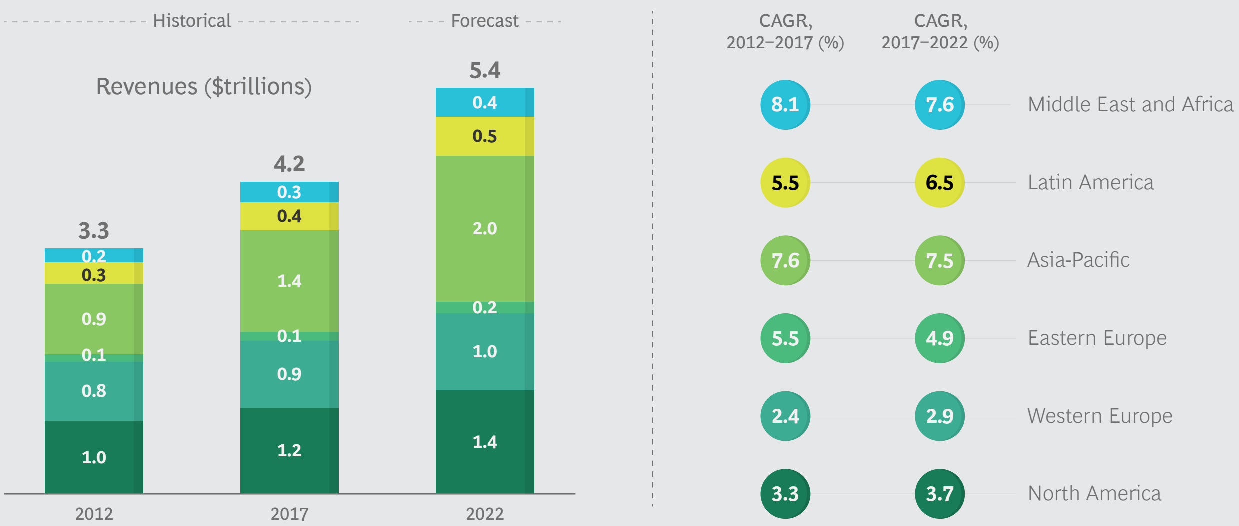
Let's start with the good news: the banking industry has rebounded since 2008. One clear sign of this is the industry's revenue growth. By 2022, global bank revenues will have climbed to an estimated $5.4 trillion—some 75% higher than their level in 2011. That includes a revenue pool increase of roughly $1 trillion between now and 2022, according to Boston Consulting Group estimates. Asia-Pacific will have 37% of the banking pools in 2022, by far the largest share of any region in the world. Revenues in North America will also grow, helped by a strong economy. European bank growth will be the weakest. (See Exhibit 1.)

Another positive sign is the rebound in bank profit pools. Returns on equity remain below precrisis levels, but this is mostly because of new regulations and the higher capital requirements they have led to. (See Exhibit 2.)

The businesses that are enjoying this growth in profitability are not, for the most part, in imminent danger from outside attackers. By and large, traditional banks—compared with nonbanks—have held onto their market share. Their customers, in other words, are not going the way of our imaginary Maximilian and switching to new providers. Instead, these customers are inclined—because of the nature of their banking relationships—to trust banks more than nonbanks and remain loyal.

But banks that give in to a renewed feeling of security are flirting with disaster. Bank profits are just too big for today's digital giants to ignore. Jeff Bezos's oft-repeated quote "Your margin is my opportunity" may not have been specifically about banking. But the sentiment should not be forgotten.

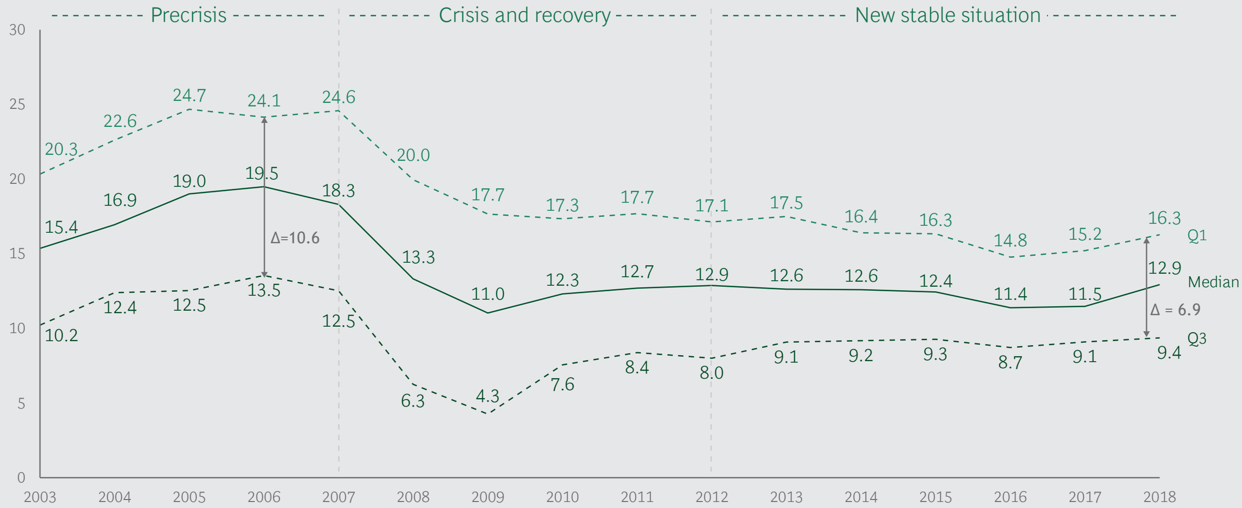
EXHIBIT 1 | Global Banking Revenue Pools: Robust and Growing



Source: BCG Banking Pools, 2018.
Note: The global banking revenue pool includes revenues from retail, corporate, and other businesses. "Other" includes bank-distributed insurance, business with public households and financial clients, proprietary and pure trading, and interest earned on securities portfolios, dividends earned, and other nonallocable income. Because of rounding, not all numbers add up to the totals shown.

EXHIBIT 2 | Banks' Returns Have Rebounded Since 2009

Return on total capital employed (%)



Sources: Capital IQ; BCG ValueScience Center.
Note: Return on total capital employed = net income to shareholders before extraordinary and unusual items / end-of-period tangible book value.

A Battle Royale Is Taking Shape

To be sure, the most likely scenario for the near term is a ratcheting-up of existing competition between and among full-service banks. The potential for a share shift is greater than ever before, with most of the gains going to banks that lead in scale, customer data, and digital expertise. This includes banks that understand how their customers want to transact banking services in a digital age and banks that jump ahead in areas such as analytics and artificial intelligence (AI).

All of that will pale in comparison with the potential disruption from digital giants. Before long, these companies—already a presence in many other industries—will be beating at the ramparts of banking, too.

The US digital giants with the broadest ambitions in the consumer space (including Amazon, Facebook, Google, Apple, and Microsoft) have largely stopped short of moves that would directly challenge Western banks.

Elsewhere, the presence of digital giants in financial services is further along, sometimes in the form of partnerships with banks. Alibaba has had huge success in payments with Alipay and has leveraged its customer relationships to further expand into lending and money management. ZhongAn and Tencent are developing digital solutions for insurers and banks. In parts of sub-Saharan Africa, M-Pesa—set up by Vodafone—has become a widely used everyday payment platform.

One could make the case that US digital giants—certainly those that have been under siege for their business and privacy practices in the recent past—may prefer, for now, to avoid any new initiatives that could attract government attention or regulatory scrutiny.

However, it's wishful thinking to expect these companies to lay low indefinitely. This became clear recently when Facebook said it was planning to introduce a new cryptocurrency called Libra. And certainly no one should discount the long-term disruptive threat that the digital giants pose. Facebook, Amazon, and their ilk have great brands, peerless capabilities in analytics and AI, and seemingly infinite quantities of data. There isn't a bank that knows more than Facebook about people's social influences or a bank that knows more than Amazon about people's shopping habits. This information has a richness far beyond that available to banks.

Furthermore, the customer reach of digital giants matches, or exceeds, that of most banks. Alibaba, for instance, has an active customer base that is bigger than China's largest banks. Amazon has more than 100 million Prime customers in the US, far more customers than even the largest US banks. This scale gives digital giants a significant advantage in customer access and data.

The Imperative: Banks Must Act Quickly

The challenge for banks is analogous to the one that Netflix described a few years ago when it plunged into the business of developing original content. "The goal is to become HBO faster than HBO can become us," Netflix's leaders took to saying.

No bank should discount the long-term threat posed by digital giants.

That moment in Netflix's history has parallels for today's banking industry. If the digital giants are going to invade the banks' turf, the banks must start to act more like digital giants. The imperative to do this, of course, will vary by region, largely because of different regulatory protections and levels of consumer sophistication. But almost all banks will need to speed their move into the digital future. If they don't, they risk being boxed into a set of risky, capital-intensive, and low-return businesses, while digital giants, or more aggressive traditional competitors, snare the most attractive businesses for themselves.

We know that senior management teams at many banks think that they're already serious about digital transformation. But we are skeptical about how much their initiatives have actually accomplished.

For instance, we have seen some efforts at banks to digitally reimagine certain services, such as the approval of home equity loans and the onboarding of new customers. But these efforts haven't moved beyond the design phase: they are still conference room discussions built around process maps annotated with yellow stickies. Likewise, we've seen more banks moving toward agile ways of working—an approach that should speed up the delivery of new products and services. But the agile efforts at banks are mostly fragmented and experimental: consequently, they have not led to the desired productivity, customer satisfaction, or efficiency gains.

Similarly, few traditional banks have turned data, analytics, and AI into priorities, and even fewer have integrated these capabilities into their core processes. Also, it is the rare bank that has come up with distinctive value propositions to attract top engineers, data scientists, and user experience designers.

The still-preliminary nature of these initiatives leaves many attractive parts of banks' businesses fragmented and vulnerable, including retail and small business deposits, payments, and wealth management. These are areas in which digital giants' brands, customer bases and data, and technological sophistication give them significant advantages. (See Exhibit 3.)

The Elements of a Holistic Digital Transformation

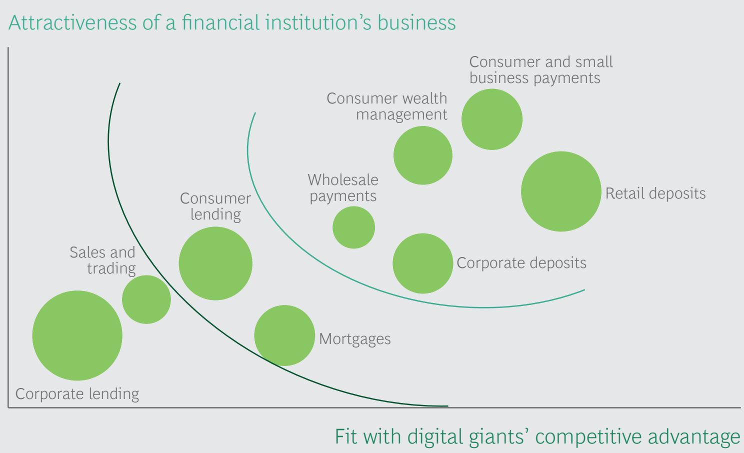
Instead of isolated efforts, traditional banks need a holistic digital transformation. Such a transformation is a good strategy—both offensive and defensive—no matter what happens between now and 2025. Even if forays by digital giants don't materialize by 2025, or if they affect only certain product lines, a bank that has undergone a holistic transformation and remade itself for a digital age will be well positioned to increase its market share, revenues, and profitability—as well as to deliver superior returns to shareholders. Meanwhile, if disruption from digital giants does materialize in the form of a frontal assault, a bank that has undergone digital transformation will be less vulnerable.

The impetus for this transformation must come from the top. The CEO needs to establish a few big goals to guide the company's digital investments and activities—and use the bully pulpit to put an end to incremental thinking. The stretch goal might be to increase digital sales or lower the cost-income ratio within five years to a percentage that seems inconceivable today. It might be to fully digitize the bank's 100 most common back-office transactions so that by 2025, there is no such thing as executing them manually. The goal could be to use digital innovations to push customer satisfaction to levels the bank has never achieved before. Each of these objectives would require large-scale changes and would yield measurable results.

EXHIBIT 3 | Disruptive Threats to Various Banking Businesses

The attractiveness of a financial institution's business reflects the following:

- Size of the revenue pool
- Return on equity
- Capital intensity
- Regulatory considerations



The fit with digital giants' advantage reflects the following:

- Customer access
- Power of the brand
- Scale and network effect
- Data advantage
- Growing customer trust

Source: BCG analysis.
Note: Bubble sizes reflect the relative revenue pools of each business.

A holistic digital transformation will require coordinated efforts across multiple, interlinked elements.

Drive to scale. Scale—sheer size—which allows for operating at lower unit costs, has always been a source of competitive advantage for banks. Today, however, scale is more important than ever before: it gives banks a much greater ability to invest in marketing and technology, and, perhaps most critically, scale today means larger customer bases and more data. These are huge sources of advantage. In explaining their plan to merge earlier this year, two regional US banks, BB&T and SunTrust Banks, acknowledged the importance of scale in a digital-first world. "We will be able to leverage our scale to create capacity for incremental investments and technology," BB&T chief executive Kelly King told analysts when the deal was announced. "We've talked about 'disrupt to thrive,' and this is it."

Of course, there are ways other than M&A for banks to achieve scale, including by becoming more focused in their portfolios—a strategy that might involve divesting low-return businesses—and by pursuing partnerships.

This is the Holy Grail—the use of data and analytics to make banking easier and more personalized.

Digitize end-to-end customer journeys. Banking products and services are notoriously friction filled and tedious, entangling customers in the machinery of the banks' legal and risk policies, P&L structures, and legacy IT systems. Yes, most banks have started to map customer journeys end-to-end, precisely to eliminate these pain points. This theoretically straightforward exercise almost invariably runs smack into the reality of bank operating models, processes, and product silos.

Take, for example, the experience of many wholesale-banking customers. In many cases, the know-your-customer and account-opening processes of the onboarding phase take days or even weeks instead of being largely automated tasks that take minutes. For hundreds of relatively simple servicing interactions, customers still need to call their bankers because the institution hasn't provided self-service procedures. For credit transactions, it's not unusual for a banker to have to complete long credit memos while the customer is required to search for evidence of company ownership, income, and assets and liabilities, and to wait for credit check results—all information that is in the bank's own databases or the public domain. Weeks into the process, the banker may be forced to ask the customer for additional "missing" information or, worse, to decline the credit with an inadequate explanation.

Transformation of the wholesale-banking customer journey—the redesign of transactions to reduce the time they require and irritation they cause—will require banks to have a handle on their existing and public client information, embrace radical process and policy simplification, move to simple product designs, and automate aspects of their credit decisions, document management processes, and workflows. (The same requirements apply to banks transforming the journeys of retail customers.) Banks will be forced to do a better job of internal coordination and to set targets that apply across functions, including distribution, technology, credit, risk, legal, compliance, operations, and digital.

Leverage big data, analytics, and AI. This is the Holy Grail—the use of data and analytics to make banking easier and more personalized for customers and more profitable for banks. When combined with big data, AI can, much earlier than traditional methods, help banks identify customers who might leave for another bank—in many cases, they can do this before the customer even realizes that he or she is dissatisfied. The combination of big data and AI helps banks improve their service at the individual-customer level, whether by recommending a more economical way of handling a transaction—perhaps through self-service—or offering to automate a recurring task, such as a monthly transfer to a parent or child.

These examples of data and analytics that allow banks to anticipate the needs of their customers are part of a paradigm shift: retail banks, in particular, instead of merely responding to their customers' needs, are starting to "think" and deliver "nudges" to help customers achieve their goals. These more frequent interactions, if they reflect guidance that a customer considers valuable, have the benefit of increasing that customer's trust in the bank.

Pursue partnerships to increase capabilities and scale. For the things they cannot do well on their own, banks must develop a partnership strategy. Many banks have already entered into partnerships with fintechs, generally by making minority investments. However, the strategic rationale for these investments isn't always clear. A partnership that lacks a clear purpose, the potential for capability enhancement, and a genuine prospect of helping one of a bank's core businesses is not a partnership worth entering in the first place.

One possibility is to partner with one or another of the digital giants directly. This may seem like a risky move, and it would take some pretty special circumstances for such a partnership to make sense, but digital giants have intensely loyal customer bases, great technology, and massive distribution potential. For a bank with a unique attribute or capability that a digital giant might covet, there could be a negotiation of peers—and a successful partnership.

There is no reason why agile methodologies at banks must be limited to technology work.

Adopt new ways of working. Most banks haven't fundamentally changed the way they approach their work in decades. This is certainly true in software development, and sequential "waterfall" methods, misalignment of business and technology organizations, and emphasis on product features over customer benefits often produce disappointing results. Banks need to rethink this aspect of their work. In particular, they would do well to move to agile approaches.

Pioneered by technology companies as a software development method—Spotify, Google, and Netflix do pretty much all their work through agile teams—agile ways of working are now increasingly common at traditional companies. Several global banks, in fact, treat agile as the default operating mode in their product development, digital, data and analytics, and IT departments. For that matter, there is no reason why agile methodologies must be limited to technology work. Agile can also increase the effectiveness of nontechnology departments, including marketing, human resources, and finance.

ING Group, based in the Netherlands, provides an example of a bank that conducted an agile transformation early on. ING has frankly said that it is following the example of digital giants, changing its people practices, rethinking its funding model, streamlining its decision-making processes, and introducing new technology. The impact of ING's transformation is evident in the bank's results, which include dozens—instead of just a handful—of new product and service releases annually, a significant increase in IT efficiency and capacity and in employee engagement.

Attract and retain digital talent. Even the largest banks with the most ample resources have struggled to recruit and retain the talent they need to compete in a digital age. There simply aren't enough software engineers to fill the jobs that are available in all industries globally, and generally, banks are not the first places where highly trained tech workers look for jobs. Moreover, the sort of digital transformation we're talking about requires highly trained people with specialized expertise: data scientists who can coax value from information, enterprise architects who can help with new decisions involving platforms, and engineers who can solve business problems through technology and smooth delivery processes.

To provide the digital experience customers expect, banks will have to aggressively adopt the technology paradigms of digitally native companies.

Some IT workers currently working in banks may be able to develop these skills through dedicated training and coaching. But this is also an area in which it will make sense to partner with, or even acquire, high-caliber fintechs or boutique engineering firms. The challenge is to find a structure for these partnerships that will create a compelling value proposition so that the new contributors are motivated not just to stay but also to do their best work.

Simplify technology and data infrastructure. Having the right technology and data infrastructure is a prerequisite to digital transformation. To provide the digital experience customers expect, banks will have to aggressively adopt the technology paradigms of digitally native companies. This can happen only if banks drop the vertically integrated legacy technology stacks they're using today and opt for horizontally layered, platform-based technologies.

As part of this change, banks should adopt virtual private clouds, move toward a service orientation (by using containers, microservices, and other frameworks), decouple business logic from data (including through service tiers), and merge operational and analytical data storage (through DaaS, or Data as a Service). All of these moves can help banks position themselves to deliver products and capabilities much faster than they do today. These moves will also lead to a change in the CIO's fundamental role: from serving the line of business to providing a platform.

Ensure cybersecurity resilience. This is a condition not only for succeeding in a digital age but also for having a chance of surviving it. All of the good things that banks are trying to do with the help of digital technology—create step changes in convenience, turn their customers into advocates, and operate more efficiently—can be undone by security breaches. A best practice for banks' chief risk officers (CROs) is to form strategic partnerships with promising fintechs, "risktechs," and cloud service providers that provide needed talent and speed important innovation. Indeed, some bank CROs—looking at the strides that cloud service providers have made in cybersecurity—already believe that their best bet for avoiding breaches will be to use such outside service providers for their most critical data and processing.

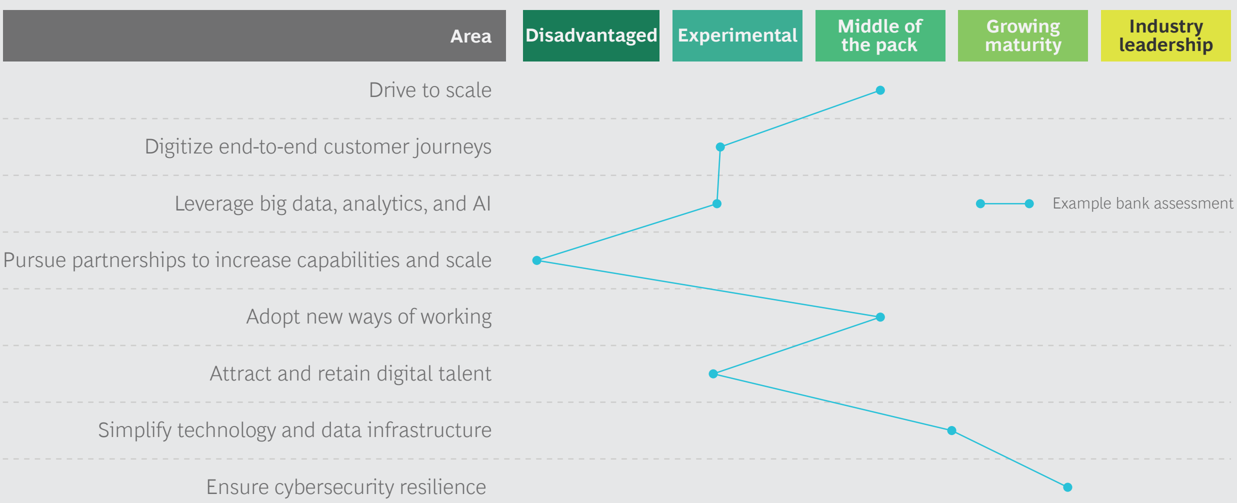
Now Is the Time

Many bank CEOs, in a discussion of digital initiatives that are starting to reshape the industry, initially respond, "I know. We already have projects going in those areas." It's when they more closely assess their situation that they realize the limited scope and value of what they're doing. A lot of the AI initiatives at banks, for example, are experiments that haven't yet had direct impact on the customer experience. Many of the agile teams are only in banks' IT groups; they aren't in the functions responsible for customer-facing services. Incrementalism is standard, and this becomes clear when companies benchmark themselves along the eight digital transformation elements. (See Exhibit 4.)

We understand why many banks have settled into incremental approaches to digitization. A decade after the financial crisis ran its course, many banks believe that their fundamental value proposition is intact. Bank leaders know that digital technology and changing customer behaviors will take the industry in new directions. However, many of them no longer think that disintermediation is likely in the near term. They expect an inflection point that will signal it's time to move quicker.

The inflection point is, however, already here, and the relatively calm waters in which banks find themselves a decade after the 2008 storm are deceptive. It's easy to ignore a new wave of disruption forming at a distance but impossible to navigate through it once it is upon you. Banks that are not preparing now will pay a price later on.

EXHIBIT 4 | Ready for the Future? A Diagnostic to Help You Self-Assess



Source: BCG analysis.

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