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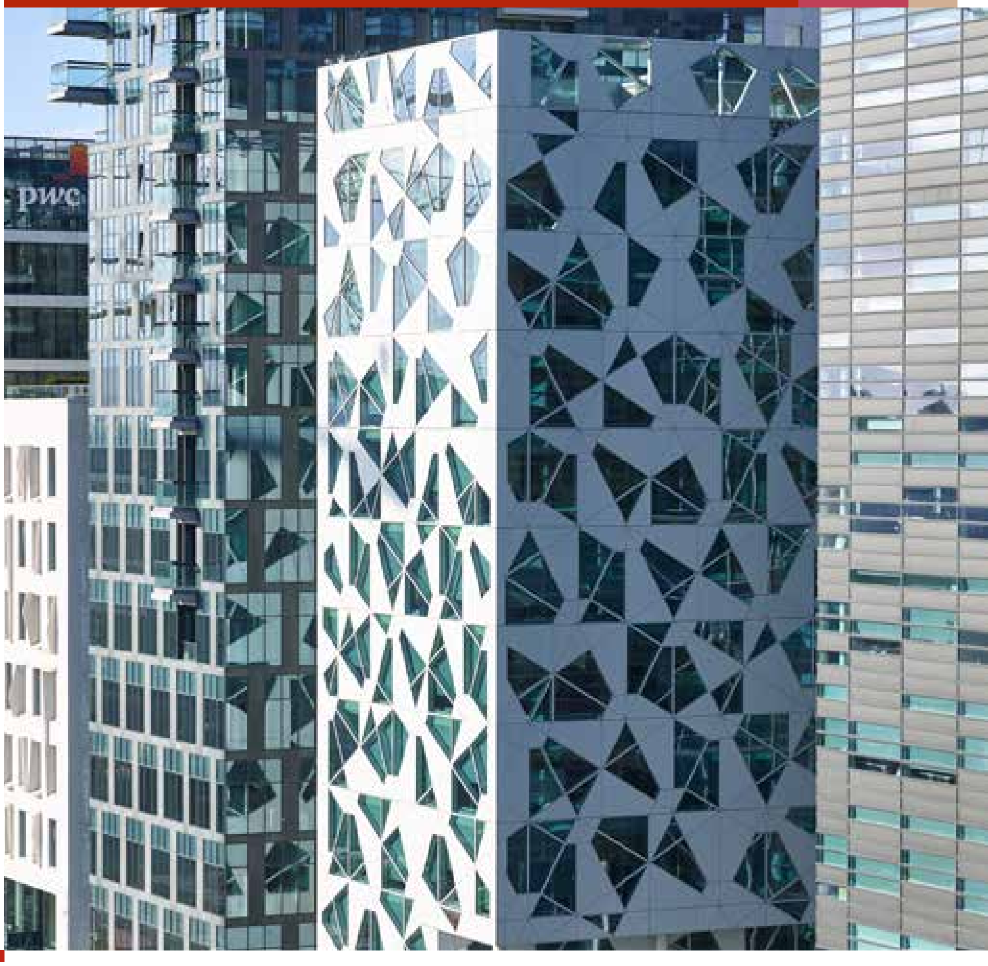
Bank to the future: Finding the right path to digital transformation

How can you deliver the experience your customers want? Learn about three options for digital banking transformation.



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The heart of the matter

Digital banking can give a boost to your bank's bottom line. When transactions are done on a mobile app instead of in a branch, they can be dramatically cheaper. You can also generate more revenue from customers who manage their money with a smartphone, tablet, or PC. But not all banks are prepared for a full digital transformation. We've identified three options for banks looking to start the transition. Read on to determine the approach that's best for you.

How do your customers connect with you? The answer may be more troubling than you'd expect—and this could have real implications for your strategy. Nearly half of the consumers in PwC's 2017 US Digital Banking Consumer Survey reported they skipped the physical branch altogether this past year.[1] If you're a banking executive, you'll need new ways to attract this growing segment of "omni-digital" customers. Increasingly tech savvy, these customers gravitate toward lower fees, convenience, and ease-of-use.

OK, so you want to become even more digital. To compete, you should drastically alter your cost structure and improve your offerings. Moving away from traditional hardware-based IT and embracing cloud-based technologies can help. But how do you figure out which digital transformation is "just right" for your organization?

Broadly speaking, there are three options for banks looking to start a digital transformation. The simplest is to digitize the front end only. The second approach is to "wrap and digitize," fixing the front end while gradually replacing legacy infrastructure and integrating the middle and back office. Finally, you can opt to "go digital native," creating a fully digital bank from the ground up.

By expanding their digital footprint, banks can reduce costs and boost financial performance while meeting consumer demand for a more streamlined and personalized customer experience. The closer you get to digital native, the more substantial the cost reductions and the greater the corresponding increase in ROE.

That doesn't mean going digital native is the right answer for every bank. Whatever you choose, the solution needs to be in line with your long-term strategy. After all, each bank has a different set of core capabilities, and not all banks are prepared for a full digital transformation. The right answer for one bank might be the wrong answer for another.

[1] PwC, "(Don't) take it to the bank: What customers want in the digital age," May 2017, accessed August 22, 2017, www.pwc.com/fsi.

An in-depth discussion

Customers are changing the way they buy financial services. That means that firms can't afford to sit on the sidelines when it comes to their digital capabilities. But a bank shouldn't think of a digital transformation as only a way to stay ahead of the competition. A bank should make sure its transformation fits its strategy, because transformation is really all about strategy. What makes sense for your bank? Where are you succeeding with customers? What can help you keep going down that road?

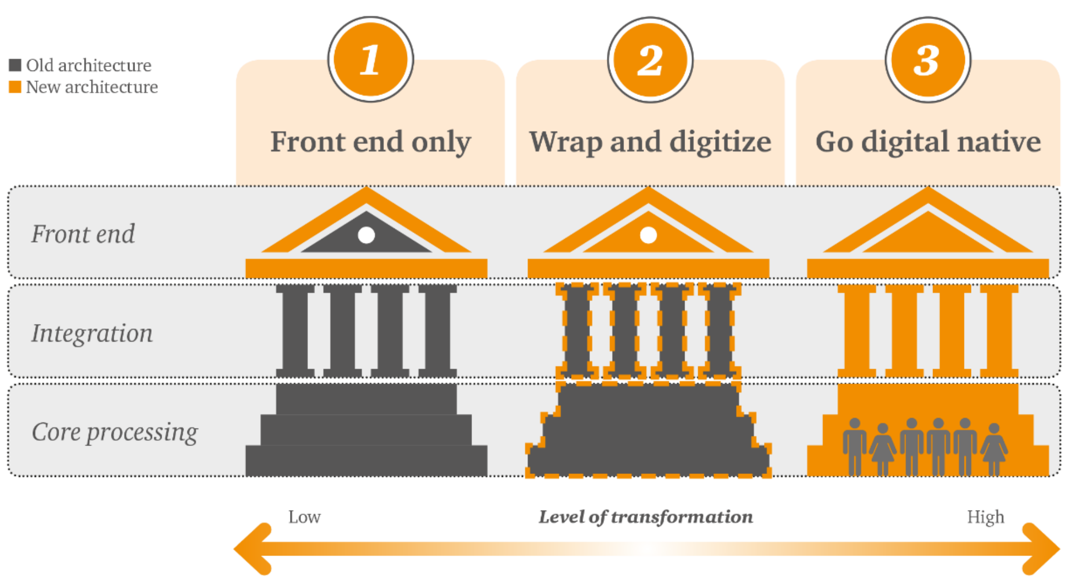
While it's important to keep up with competitors, your digital transformation should be tailored to your bank's particular needs. Each institution has its own footprint, legacy infrastructure, customer demographics, and so on. Let's explore the three most common approaches to digital transformation in more detail (see Figure 1). Each option creates a different customer experience, has a varying effect on profitability, and comes with its own set of challenges. From there, we'll discuss how you should weave in digital transformation as part of your overall strategy and what you can do to get started now.

Front end only

The simplest approach is to modify the front end only, focusing on the primary ways a customer interacts with a bank (website, app, etc.). Largely a cosmetic fix, the bank designs an appealing mobile app and web interface but keeps the organization's workflows, culture, and back-end infrastructure intact. We understand the appeal of this approach. For an organization that needs a quick win, it's certainly the fastest route. In fact, this approach may be a quick interim step for banks that have real client-facing issues. It's a solid stop on the road of transformation, but for most banks, it won't be the destination.

After the initial fix, customers may see their bank becoming more digital. Behind the scenes, though, the bank remains limited in what it can deliver. Customers might be able to apply for a credit card using a mobile app, but without integration of back-end systems and no fundamental change to the operating model, the experience will be not be significantly different than what customers

Figure 1: Banks are responding in three different ways—which one(s) are you adopting?



had before. In other words, the front end promises what the back end can't deliver.

Fixing the front end might help reduce customer churn. Unfortunately, the gains may not last if the back-end can't meet or exceed customer expectations—and quickly, too. In fact, costs could increase if you have to add employees to maintain the new digital front end or assign an additional IT team to design and build solutions to fulfill customer requests.

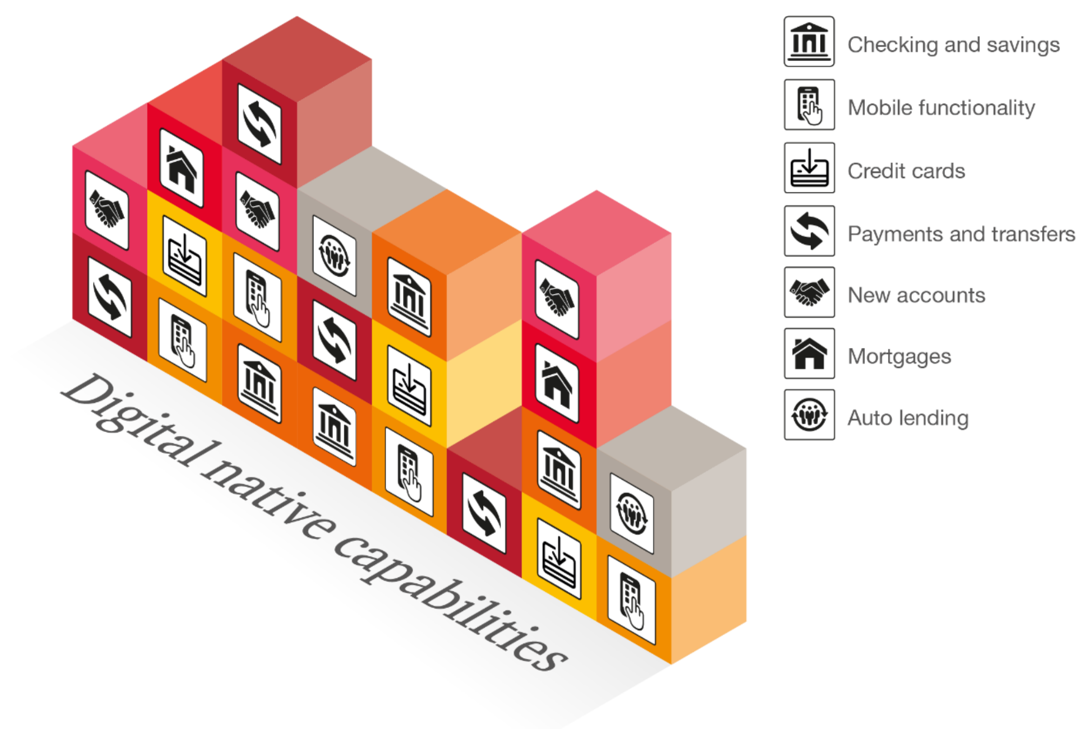
In the long run, digitizing the front end without making additional investments could cost more than sticking with the status quo. Still, it's a starting point for banks facing budget or organizational constraints that make a more extensive transformation difficult.

Wrap and digitize

With the wrap and digitize approach, you fix the front end *and* go one step further, gradually replacing legacy infrastructure with digital technology, integrating the middle and back offices along the way.

One bank, for example, used application program interfaces (APIs) to integrate data across product groups and functions. This integration layer gave employees a 360-degree view of the customer and set the stage for modular, "plug and play" capabilities. It also meant that product line or system upgrades could be quickly connected to the larger network (see Figure 2). With data integrated across the organization, the bank became more agile, and its customers noticed. Instead of multiple sites for banking, cards, and lending, customers now have access to all of their accounts with a single sign-on. Customers can also start an application on their mobile device and transition seamlessly to a desktop. Transactions are faster, too. And now that employees can quickly turn data into real insights, customer interactions are more tailored to them. This bank has truly committed to transforming itself.

Figure 2: Wrap and digitize allows a bank to upgrade individual components and build on them as the bank continues to develop.



Wrap and digitize improves customer experience more than the front-end-only approach because of improved infrastructure and organization. A bank undergoing this type of transition will look different in the following ways:

- Many banks form business transformation groups internally or bring in external partners.
- Employees might be transitioned to higher-value roles in new centers of excellence, as this conversion eliminates the need for certain manual tasks.

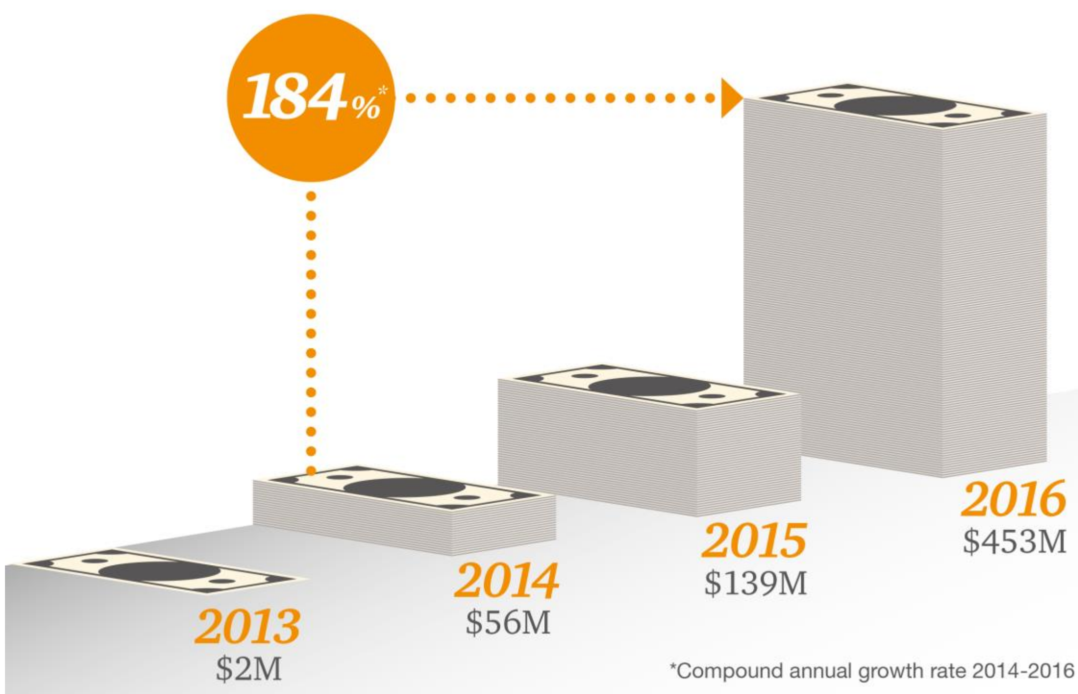
The biggest drawback that banks find in this approach is that it's a long process. Because wrap and digitize focuses on individual improvements, it can take some time before the full scope of the bank's processes has been overhauled. Still, this is a great option for banks that need to take a more gradual approach. They can test out an individual IT improvement and show benefits quickly once they go live. Frequently, this can be a cost-effective approach. It can be a much easier sell to leadership, too, avoiding some of the political conflict that a full blown transformation can often introduce.

Go digital native

Some banks choose to go all in. They create a digital native bank that uses a fully digital customer interface *and* back end. This strategy can deliver significant cost savings as well as the ability for the bank to adapt quickly when change comes.

These banks generally start as minimally viable banks (MVBs) offering just a handful of products. A basic retail bank, for example, might focus on deposits, payments, or lending. This approach to digital transformation is poised for explosive growth with the rise of challenger banks, startups that directly challenge the products and services of traditional financial institutions. These are up sharply since 2013 (see Figure 3).

Figure 3: Funding of challenger banks.



Reducing costs is one reason to go digital native. Branch transactions cost roughly $4 each, while online and mobile transactions cost $0.09 and $0.19, respectively.[2]

But the main reason banks decide to go digital native is that it makes them much, much more agile. It lets them adapt to rapidly changing customer tastes, and it lets them test and iterate rather than commit and hope. The digital core and open architecture also allow flexible approaches for partnering with third parties to offer a range of products and services. It's now possible to set up a fully functional, digital native bank using third-party architecture in the cloud. Using modern infrastructure, you can quickly tailor product and service offerings, such as new account types or advisory services, as well as change pricing when necessary. We describe the advantages of a cloud-based operating model in more detail in our recent paper, "*Get your head in the cloud*."[3]

Under this model, your customers are likely to have a drastically different banking experience, and one that most will find more appealing:

- They will have seamless experiences that are designed based on their needs instead of having a bank try to sell them products.
- Banking processes such as opening accounts and signing up for offerings will be much less time consuming and more convenient based on individual preferences. Your customers will be able to use the channel of their choice to conduct their business.
- You'll be able to tailor products to your customers' needs on the fly. This is almost impossible to do with legacy systems.

If this is so attractive, why don't we see more of it? Usually it comes down to perceptions of expense. Many financial institutions think it's costly and time consuming to launch a fully digital bank, though this doesn't have to be the case. Using cloud technology, it's now possible to launch a digital native bank in months and at far less expense than ever before. And the options aren't mutually exclusive: you can combine this with the wrap and digitize approach, with customers gradually transitioned away from the legacy system toward the digital bank.

Digital banks won't bypass the regulatory environment in the United States. US regulators expect new entrants to meet the same reporting and consumer protection standards as incumbents. But the agile design of digital banks could help them stay ahead of a changing regulatory landscape, adapting as necessary.

Launching a digital native bank requires a new way of thinking. It's a radically different operating model that calls for smaller, less siloed middle-office and back-end teams. It also emphasizes buying or partnering with vendors rather than building technology solutions.

How should you choose?

Many banks have started down the path to digital transformation, but these efforts are often *ad hoc* and fail to yield the expected improvement in profitability. To increase the odds of success, we recommend that you refine long-term strategy and define the endpoint before you get started.

[2] *Ibid.*
[3] PwC, "Get your head in the cloud," August 2016, http://www.pwc.com/us/en/financial-services/publications/assets/cloud-innovation-digital.pdf.

Refine the long-term strategy…

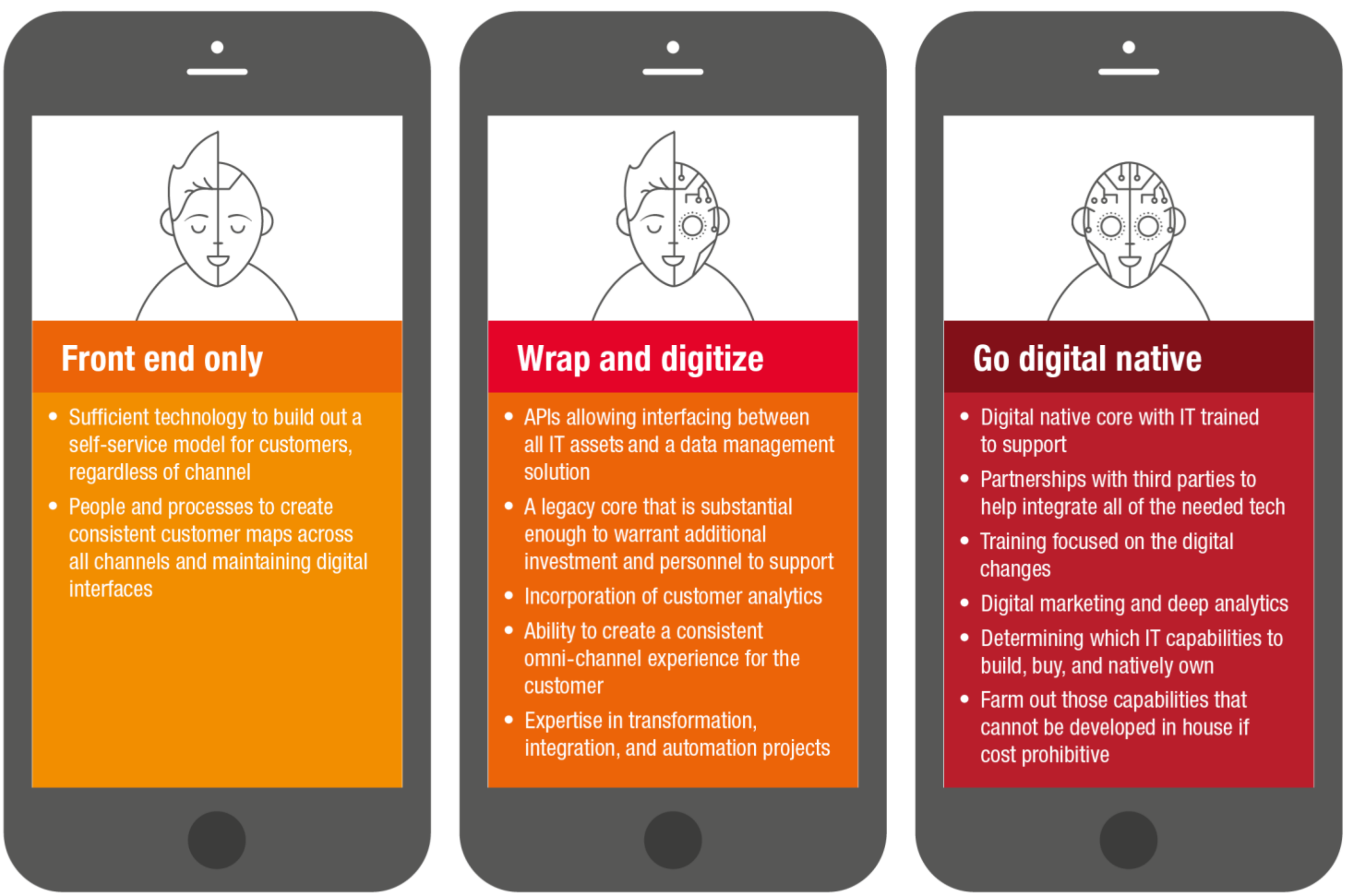
It's important to review your long-term organizational strategy. Only then can you decide which digital transformation strategy is just right for your bank. A good first step is to consider questions like:

- What do we want to be known for?
- Which consumer segments are we targeting?
- What are our core capabilities and how can a digital strategy strengthen them?

Some bank executives have said that they want to digitize "everything," but that's not necessarily the best option. After all, each bank has a different set of core capabilities, and you might not be prepared yet for a full digital transformation.

Once you've examined the options, we recommend that you consider the tradeoffs and potential conflicts associated with each option, keeping in mind factors like organizational strategy and culture, existing technology, cost pressure, and risk appetite (see Figure 4). It's also important to address human capital strategy, including what the workforce would look like in a transformed organization.

Figure 4: Factors to consider when choosing a digital strategy.



...and then get started

You don't need to have a bulletproof, exhaustive plan before you get started. If you want to deploy an MVB, you can choose one product to test on one customer segment in a single channel. The idea is to test and refine the concept based on market response. If successful, you may find that:

- Others will see evidence that digital technology can lead to streamlined processing and improved customer experience.
- Other leaders will look to your example as a way to improve results for their own divisions.
- Customers can be transitioned to the digital bank gradually while the digital bank team continues to refine the model through learning what works and what doesn't.

Even if the experiment isn't successful, you'll learn valuable lessons that you can apply to your second attempt.

Regardless of the path you take, it's important to get started. It's a good idea to focus on initiatives that directly influence customer experience and that have the potential to quickly deliver cost savings. Avoid quick fixes in areas where you've experienced long-standing customer complaints. Those areas most likely need solutions that can be hard to identify and implement. Small steps can generate buy-in and unlock savings that can help to free up budget for bigger changes down the road.

What this means for your business

These days, if you're a bank executive who wants to make big strides against your competition, you need to expand your firm's digital footprint. During the past year, the proportion of consumers who did all their banking digitally and chose not to step into a bank branch surged to 46%, up from 27% in 2012.[4]

Digital banking can give a swift kick to your bank's bottom line. When done on a mobile app instead of inside a branch, the cost of a typical transaction shrinks dramatically. You can also generate more revenue from customers who manage their money with a smartphone, tablet, or PC. These omni-digital consumers using self-service channels tend to buy more financial service products beyond savings, borrowing, or investments than their counterparts visiting a bank branch, according to our survey. The upshot: omni-digital consumers are less expensive to serve and generate higher customer lifetime value.

Banks that don't move in this direction may quickly find themselves on the wrong side of a relentless demographic shift. Increasingly, the most attractive customer segments by age and net worth expect a seamless experience from their financial institutions. Unfortunately, legacy technology limits many firms in giving customers what they want. Banks likely need to commit to a sweeping change if they are to remain competitive. But this shouldn't require a complete redesign of how the bank operates.

Not all banks are prepared for a full digital transformation, and every bank has different core capabilities. We've identified three options for banks aiming to start the transition. The simplest is to digitize the front end only. The second approach is to wrap and digitize, fixing the front end while gradually replacing legacy infrastructure and integrating the middle and back office. Finally, you can opt for the most comprehensive option and go digital native, creating a fully digital bank from the ground up.

Whichever option you choose, pause from time to time to make sure that your plan remains aligned to your long-term strategy and that you're using the right options based on your core capabilities and available technology. If not, make the appropriate adjustments and keep going. The important thing is that you get started.

[4] PwC, "(Don't) take it to the bank: What customers want in the digital age," May 2017, accessed August 22, 2017, www.pwc.com/fsi.

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