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DIGITAL BANKING

WHY EMBRACING A MEANINGFUL DIGITAL TRANSFORMATION IS THE ONLY OPTION

NBK·CAPITAL

HIGHLIGHTS

- The fast pace of technological innovation is radically changing the financial services industry and commercial banking is no exception. However, upgrades to parts of the IT infrastructure and to the customer interface through online banking and mobile apps is not enough to qualify as digital transformation.
- The global banking industry has gone through a lot of flux since the financial crisis. Banks have since largely recovered, and their revenue pools have been expanding, which may be contributing to some banks feeling immune from the disrupting forces of the digital revolution.
- The needs of today's retail banking clients are completely different from those of earlier generations. Such needs are driven by predominately young customers that are becoming increasingly reliant on smartphones to run their lives. They value a digital offering that would satisfy their needs with the least amount of friction and that would complement other digital solutions they use.
- Automation in banking has been about optimizing the use of resources, both financial and human. It can no longer be looked at only as a means of cost saving, however. True digitization of the banking industry has become an enabler for delivering future growth and a prerequisite for survival.
- Emerging competition both from tech giants and smaller Fintechs, in addition to evolving regulatory frameworks, is becoming a serious threat to those who do not embrace a meaningful digital transformation.

DIGITAL BANKING

The fast pace of technological innovation is radically changing the financial services industry and commercial banking is no exception. It is true that banks have traditionally been on the forefront of innovation as far as their IT infrastructure is concerned, but the nature of the current disruption is challenging the conventional commercial banking model and competition is coming from traditionally unlikely places.

Smart digital platforms are everywhere and a big part of our everyday chores, including ride hailing, food delivery, flight booking, and online shopping, to name a few, could now be managed through a simple mobile app. The same applies to the financial services industry with the emergence of online investment brokers and consumer banking apps. Commercial banks were among the first to offer some of their services through digital channels starting with web-based interfaces and then mobile apps.

Mobile banking apps have become the norm today and most banks that have incorporated mobile apps and web-based interfaces into their product and service offering have been fairly successful in shifting sizable customer traffic away from branches and into cyberspace. This has allowed banks to reduce costs and shift resources into more productive areas. Moreover, it led to repurposing and redesigning branches to cater to more complex banking needs such as wealth management and planning as opposed to the traditional services of retail banking.

Even though mobile apps have long been used to digitize the frontend customer experience of banking clients, the banking industry is still, in many ways, far from true digitization. Digitization efforts at commercial banks have been primarily motivated by a drive to cut cost and become more efficient. It rarely touched on the core traditional model that defines commercial banking and how the consumer is viewed.

A true digital transformation in the banking industry is much more than an upgrade to the customer interface. Such a transformation ideally requires a significant overhaul of the traditional culture of banking and embracing new agile ways of conducting business and viewing the customer.

THE CURRENT STATE OF BANKING

The global banking industry has gone through a lot of flux since the financial crisis. Low levels of interest rates, a higher regulatory burden and capital requirements, and increased competition both from within and from outside the sector have contributed to declining profitability. But banks seem to have largely recovered and their revenue pools have been expanding. According to estimates by Boston Consulting Group (BCG), global banks revenue pools will expand by around US 1.2 trillion by 2022 to reach a total of around USD 5.4 trillion up from USD 4.2 in 2017 and USD 3.3 in 2012. Those estimates show that the largest growth will be coming from Asia-Pacific which will contribute 37% of global revenues, adding almost half of the total revenue growth over the coming 4 years. Bank revenues in this region will also be among the fastest growing globally with a compounded annual growth rate of around 7.5% over the forecast period.

Chart 1. Global Banking Revenue Pools (USD trillions)

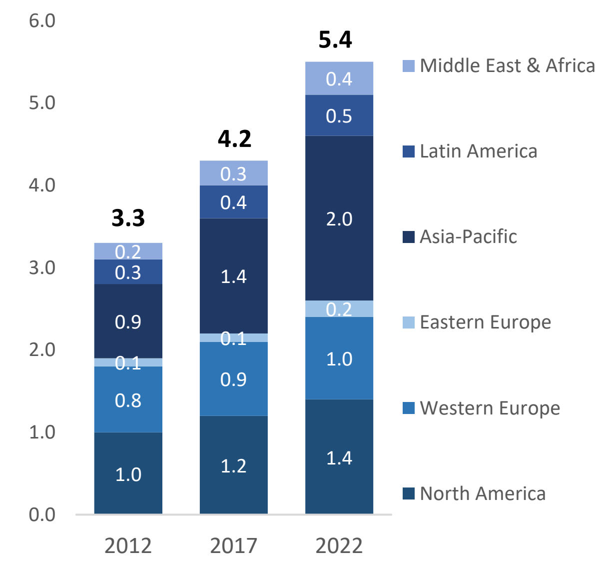
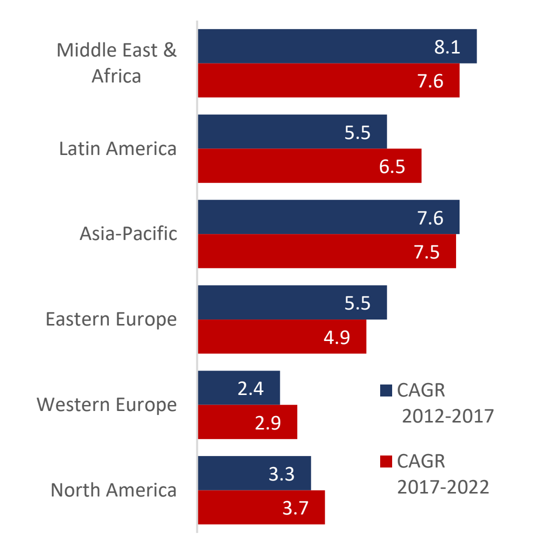


Chart 2. Revenue CAGR% (2012-2017, 2017-2022)

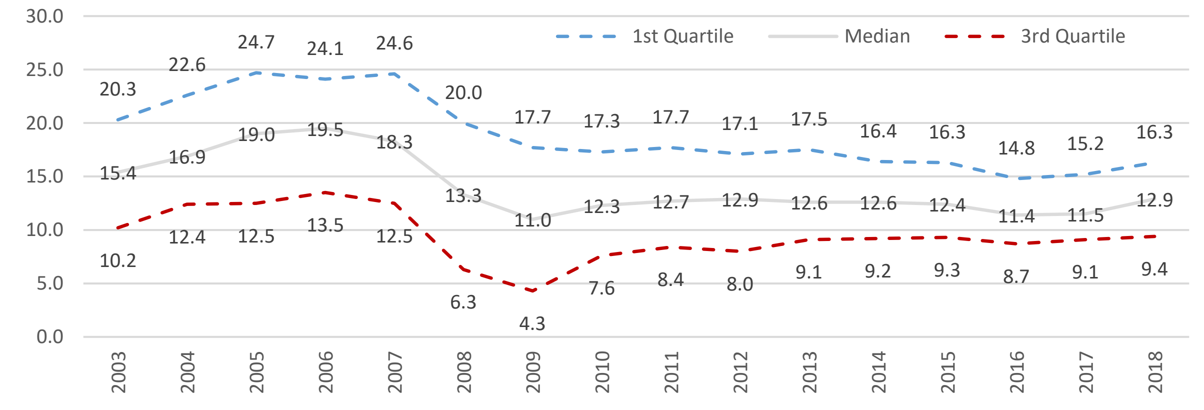


Note: 2012-2017: Historical, 2017-2022- Forecast

Source: Boston Consulting Group, NBK Capital

Profitability figures also tell a similar story. Banking profitability took a significant hit during and after the financial crisis but have since stabilized and are starting to trend upwards, albeit at much lower levels.

Chart 3. Historical Global Banks' ROEs



Source: Boston Consulting Group, NBK Capital

One implication of the preceding analysis is that banks, in general, may feel some immunity from the disrupting forces of the digital revolution. They have weathered the financial crisis, revenue pools are expanding, profitability is improving, and customers are not actually leaving traditional banks to join other forms of non-bank digital service providers.

Banks have historically been well insulated from outside competition. They enjoy high barriers to entry in the form of high capital requirements and an operating ecosystem that is highly regulated and complex. The disruptive forces of digital transformation, however, are slowly seeping into the most profitable segments of the banking industry and banks that are not proactive and lead in their transformation are at a much higher risk of losing market share over the coming few years.

Digital disruption has the potential to challenge traditional banking models in many ways. Customers' attitudes towards traditional commercial banking are changing and the competition is starting to appear from unlikely sources, including digital giants and payment solution providers.

CLIENT ATTITUDES AND NEEDS ARE SHIFTING

Clients' preferences and attitudes towards banking services are being shaped by their experience with smart digital platform and the convenience they offer. Today's digital consumers look for service quality and a superior customer experience. Likewise, banking clients are starting to place special emphasis on convenience, service quality, and overall customer experience when choosing a financial institution or a certain financial product. They are no longer comparing banks; they are comparing the overall customer experience offered by various service providers.

The needs of today's retail banking clients are completely different from those of earlier generations. Such needs are driven by young customers that are becoming increasingly reliant on smartphones to run their lives. They value a digital offering that would satisfy their needs with the least amount of friction and that would complement other solutions they use. What they are looking for from a bank is a digital offering that would allow such things as fast account opening, access to loyalty programs and discounts, sensible savings plans, and a reliable payment solution that would complement their e-commerce needs. A bank's safety and reputation are still important, but all things being equal, they are becoming a less important determining factor than they used to be.

Bank loyalty has been traditionally driven by several factors including family history, personal relationships, proximity of branches and convenience of visits, in addition to other factors that are chiefly motivated by the need to have face-to-face interactions at the bank. With the advent of digital channels, most day-to-day banking needs could now be fulfilled remotely while branch visits are becoming few and far apart. This is contributing to a decline in bank loyalty on a large scale as the typical "young" customers of today tends to be much less "loyal" to the bank that their families have been banking with for decades.

Therefore, gaining, or even preserving, market share requires being sensitive to the needs of an emerging client base that is young and whose requirements from a retail bank are very different from those of the previous generations. This logic especially applies in the GCC region where mobile penetration is one of the highest globally and the demographic profile is predominately young.

The GCC market, and Kuwait in particular, is dominated by the youth. According to the World Bank's population estimates and projections, more than 90% of the resident population in Kuwait is below the age of 55 while more than 50% is below the age of 35 and this is expected to continue for the next ten years. (see table 1 below)

Table 1. Kuwait Population Age profile

	2017	2018	2019	2024	2029
% of Population below age 55	91.1%	90.7%	90.2%	86.3%	82.0%
% of Population below age 45	76.0%	75.0%	74.1%	70.3%	67.1%
% of Population below age 35	53.2%	53.0%	52.9%	51.7%	50.6%

Source: World Bank - Population estimates and projections.

According to a survey published in an EY report as part of a study on digital banking in the GCC, 78% of survey respondents in the GCC said they would be ready to switch banks if they were offered a better digital experience. This number goes up to 89% for respondents from Kuwait. Another interesting set of results is that related to the innovations customers are looking for. The top innovations identified in the EY GCC survey are very interesting in that they have nothing in common with a "traditional" retail bank offering 10 years ago. They include easy electronic payment methods (90%), customized alerts and notifications (89%), paperless account opening (86%), simplified and local loyalty programs (88%), cloud-based document management (83%), financial planning, monitoring and spending assistance (82%).

Digital literacy in the GCC and particularly in Kuwait is very high and e-commerce penetration, the use of smartphones, social media, and instant messaging are very significant. A large majority of GCC residents have purchased products online. According to a McKinsey survey this number ranges from 80% to 90% in Saudi Arabia and the United Arab Emirates. These purchases range from apparel and electronics to travel and leisure. E-commerce seems to be at par with developed Asia, but it is still lagging in terms of digital acquisition of financial products. In the same study, McKinsey shows that while 66% of respondents in Developed Asia have acquired financial products digitally, only 25% and 23% have done so in Saudi Arabia and the UAE. This shows that, while there is wide acceptance of e-commerce in general, taking the next step into digital banking hasn't fully happened yet. Clients are still unsatisfied with the digital channels offered by their banks and their usage rate is still very low. In many cases customers would still need to go to a branch to conduct transactions or conclude a transaction that was started online.

This could be the result of security concerns and/or a lack of a meaningful and comprehensive digital offering in the market. Security concerns were a significant issue for e-commerce in its early stages of development but have since been largely overcome, and the same will ultimately happen with financial products offered digitally. This shows that there is plenty of appetite for a digital bank offering in the region and a significant growth potential for those who can get it right. Banking clients are increasingly valuing the convenience of doing things on the go more than the convenience of having a branch next to their residence. It has become crucial, therefore, for banks to point the value offering in the right direction and think openly and strategically about the future of commercial banking in order to mitigate the negative consequences of the digital disruption on market share and profitability.

NO LONGER A COST SAVING EXERCISE

Tech innovation and automation in a banking environment has been about cost saving and optimizing the use of resources, both financial and human. Online banking, for example, was viewed first and foremost as a means of reducing customer traffic into branches and consequently reducing the need of ever expanding the branch network to service the existing client base and grow market share. It has allowed banks to repurpose branches that now cater to a different set of services including financial planning and investment advisory, while cutting down the cost of human capital. In the meantime, most traditional day-to-day retail banking transactions were moved to online banking interfaces and mobile apps.

Process automation and digitization, however, can no longer be looked at only as a means of cost saving. With the digital disruption that is sweeping across industries, digitization of the banking industry has become an enabler for delivering future growth and therefore a necessity for survival.

Digital transformation requires banks to redefine themselves and change the way they operate. A truly digital bank needs to be connected across the organization and customer journeys need to be digitized end-to-end including initial KYC and account opening and subsequent periodic updates. KYC and account opening are major pain points that could take weeks instead of being automated tasks that would take minutes. Product designs processes should be simplified as well as document management processes and workflows, in addition to many aspects of the credit decision process that could be automated.

Personalization of retail banking services is crucial to the success of a digital banking offering the same way it is the core strength of digital giants. A company like Netflix customizes the client’s interface and tailors its programming to specifically suit an individual’s needs. This is done through direct surveys upon account opening and subsequently through analyzing browsing, searching, and viewing behavior. Personalization requires having a unified view of the client across the bank through collaboration among its business units. This would avoid bombarding the customer with competing products or pushing the same product to clients that have different preferences and needs. This calls for a significant shift from mass marketing to mass customization. Clients need products that would complement each other and that are tailored to their specific needs and circumstances. This, however, is easier said than done. To be able to be successful in mass customization, banks need to invest in and develop their capabilities in handling big data, analytics and the use of Artificial Intelligence

(AI). Leveraging big data and enhancing analytical capabilities would allow banks to predict the needs of a customer and act accordingly even before the customer is aware of that need.

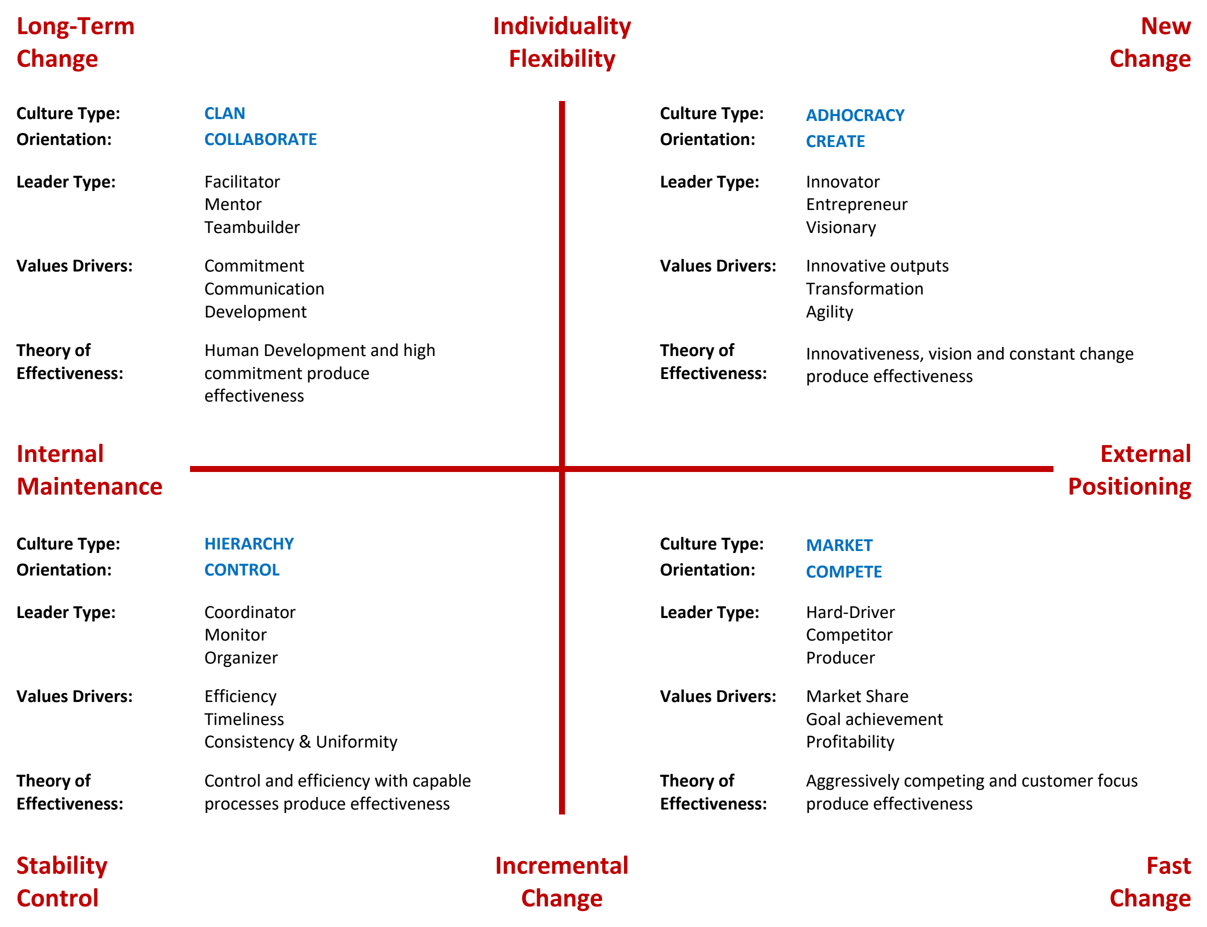
The success of a digital enterprise also depends on agility, flexibility, innovation, and creativity. Deployment of digital services needs to be fast. In a banking context, it requires a reinvention of the retail banking business model rather than seeing it as an incremental change that sits on top of existing models. This is why the drive of digital transformation is proving to be challenging for many. More specifically, challenges are related to legacy IT systems and application complexity that result from duplicated functions and heterogeneous and outdated technologies which end up slowing the deployment of digital solutions. Organizational silos and culture also contribute to hindering deployment progress, in addition to limited digital skills and the difficulties in hiring and retaining digitally skilled manpower.

To that last point, cultural differences between the organization and the management style of a commercial bank and that of a Fintech startup for example are very significant. This fact would pose challenges on two levels.

First, because of these cultural differences, it is proving difficult for banks to attract and retain digitally skilled manpower. Highly qualified tech talent is in short supply and it generally favors an ecosystem that is flexible, supportive to creativity and speed in execution. Such an ecosystem needs to be able to support flexible working hours and an informal culture and atmosphere, in addition to being able to outsource functions and processes as a business-as-usual procedure not an exception.

Second, it would make it extremely challenging for banks to collaborate or partner with outside entities especially when the corporate culture of such entities is the complete opposite to that of commercial banks. By default, a bank’s culture is hierarchical, control oriented, and guided by a drive to limit and control risk. Its value drivers are efficiency, timeliness, consistency and uniformity. Typically, there is no one decision maker and decisions are taken by committees representing various internal stakeholders, including business leaders, risk management, compliance, and IT. Tech companies, on the other hand, champion a collaborative and creative oriented culture. They focus on nurturing an entrepreneurial environment that would encourage innovation, creativity, and operational agility. These cultural differences could be better visualized by examining the competing values framework (CVF) developed by Cameron and Quinn and illustrated in chart 4.

Chart 4. The Competing Values Framework



Source: An introduction to the Competing Values Framework, Kim Cameron

The competing values framework developed by Cameron and Quinn identifies two dimensions in organizational structure and culture. Each dimension groups organizations based on the importance of flexibility, discretion, and dynamism in their structure as opposed to stability, order, and control. The other dimension uses the level of internal orientation and focus on integration, collaboration, and unity as opposed to external orientation and focus on differentiation, competition and rivalry. These dimensions form four quadrants each representing a unique set of organizational and individual factors. These factors represent opposite and competing assumptions and form quadrant that are contradictory on the diagonal. Banks would typically fall into the lower left quadrant while Fintechs would be on the opposite top right quadrant.

COMPETITION IS COMING

Competition to the traditional commercial banking model is starting to emerge from unlikely places. While part of the reason of the intensifying competition stems from regulatory forces aimed at increasing consumer welfare and transparency in the system, a significant force that is driving this trend is the role technology is playing in democratizing the financial services industry.

New laws and regulations around the world are driving a tougher competitive environment. The UK's open banking initiative and the EU's payment Services Directive 2 (PSD2) are two prime examples. They are facilitating access to customer data, encouraging and strengthening disintermediation and direct dealing, and creating opportunities for smaller third-party non-bank players.

The PSD2 is aimed at breaking down the banks' monopoly on clients' data. It will allow, for example, online merchants to get direct access to clients' bank data, with their permission, and make the payment directly on their behalf without passing through a credit card service provider or another service like PayPal. Open banking, on the other hand, is essentially a practice that uses application programming interfaces (APIs) to allow third party access to a consumer's banking data and transactions. Such access would be secure and permissioned by the data owner i.e. the consumer. It allows financial services customers to securely share their banking data with other parties including financial institutions and Fintechs, who would then be able to consolidate the client's financial data into one platform allowing the client a host of benefits. Clients could, for instance, share their financial data with other service providers when applying for new services or buying new products such as loans, more easily transfer funds between financial institutions, and compare multiple product offering. Open banking would also make it easier for clients to switch financial service providers, including banks, as the "pain of switching" would no longer be a factor in their decision-making process when they decide to transfer part or all of their business to a different financial institution. Open banking might seem to be a great threat to banks as it would significantly reduce the captivity of clients to banks and make it much easier for them to leave one bank for another. However, if adopted and applied on a wide scale, it would increase competition among banks, whether established or small, and theoretically result in lower costs, better technology, and overall better customer experience.

Open banking could become the incentive that pushes banks to stop considering themselves as sole providers of financial services and convert into financial services platforms. Much like digital platforms, financial services platforms would carry both their own and third-party products and services as long they satisfy the needs of their client base. This will enhance customer relationships and consequently customer retention by helping clients manage their finances as opposed to simply facilitating transactions.

Another very serious source of competition that is emerging for banks are the so-called digital giants like Apple, Facebook, Amazon, and Alibaba. One of the most important success factors for these companies is their ability to leverage the huge quantum of customer data they have to customize their product offering. As of January 2019, Apple had around 1.4 billion active devices, of which 900 million are iPhones. Amazon Prime had over 105 million members in the United States alone as of June 2019, while Alibaba had around 674 million active customers. Companies like Facebook, Amazon, and Google each have a lot more customer data than any single commercial bank. This data ranges from shopping habits and trends, to social influences and lifestyle preferences, to simple demographic and personal information. The amount and quality of data in their possession would allow them to potentially compete with the largest banks on a global scale. They have developed ecosystems that serve multiple customer needs from a single platform and scaling their networks further to offer financial services seems to be a very natural "next step" to close the circle.

The digital capabilities of these companies including AI and data analytics gives them a significant advantage over commercial banks. They would know their customers better than banks know theirs and maybe even better than their customers know themselves. This would give them the ability to better assess the credit riskiness of their clients and greatly reduce the default risk of their portfolios should they decide to venture into the lending business for instance.

Digital giants and emerging tech companies represent what could prove to be the greatest threat to the traditional commercial banking model in recent history. Back in 2013, the chief content officer of Netflix Ted Sarandos said that for Netflix "the goal is to become HBO faster than HBO can become us". Today it is about banks versus and digital giants and Fintech. The digital giants might be busy today fighting with regulators on privacy issues and the use of consumer data and don't really need to open another front with banking regulators, but these issues will ultimately be resolved and the road to new complementary ventures would be wide open. Banks need to digitize and evolve their operating models and philosophy before it is too late. Today it is much easier for apple to offer financial services than it is for a long-established commercial bank, with decades of layering IT systems on top of each other, to become fully digital. If banks didn't digitize fast enough, their most profitable business segments will slowly be lost to a new kind of competition.

FINAL THOUGHTS

The transition from a traditional banking model to a digital model is proving to be a very challenging for banks especially that the two models are based on two opposite cultures and management styles. In its current state, the financial services industry is mostly using exploitation as it tries to improve existing processes in an effort to improve efficiency and increase profitability. The business model of Fintechs and digital start-ups, on the other hand, is based on exploration. They explore opportunities in uncharted waters and are free from legacy systems, mindsets, and traditional ways of doing things. It is true that in the short term the vast majority of start-ups would fail, but those who survive will be in a very strong competitive position. Banks have it in the opposite direction. Exploitation would help banks survive and remain profitable in the short term, but if they don’t adapt and prepare for the long term, they will slowly start to lose market share and ultimately become irrelevant.

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