Banking business models of the future

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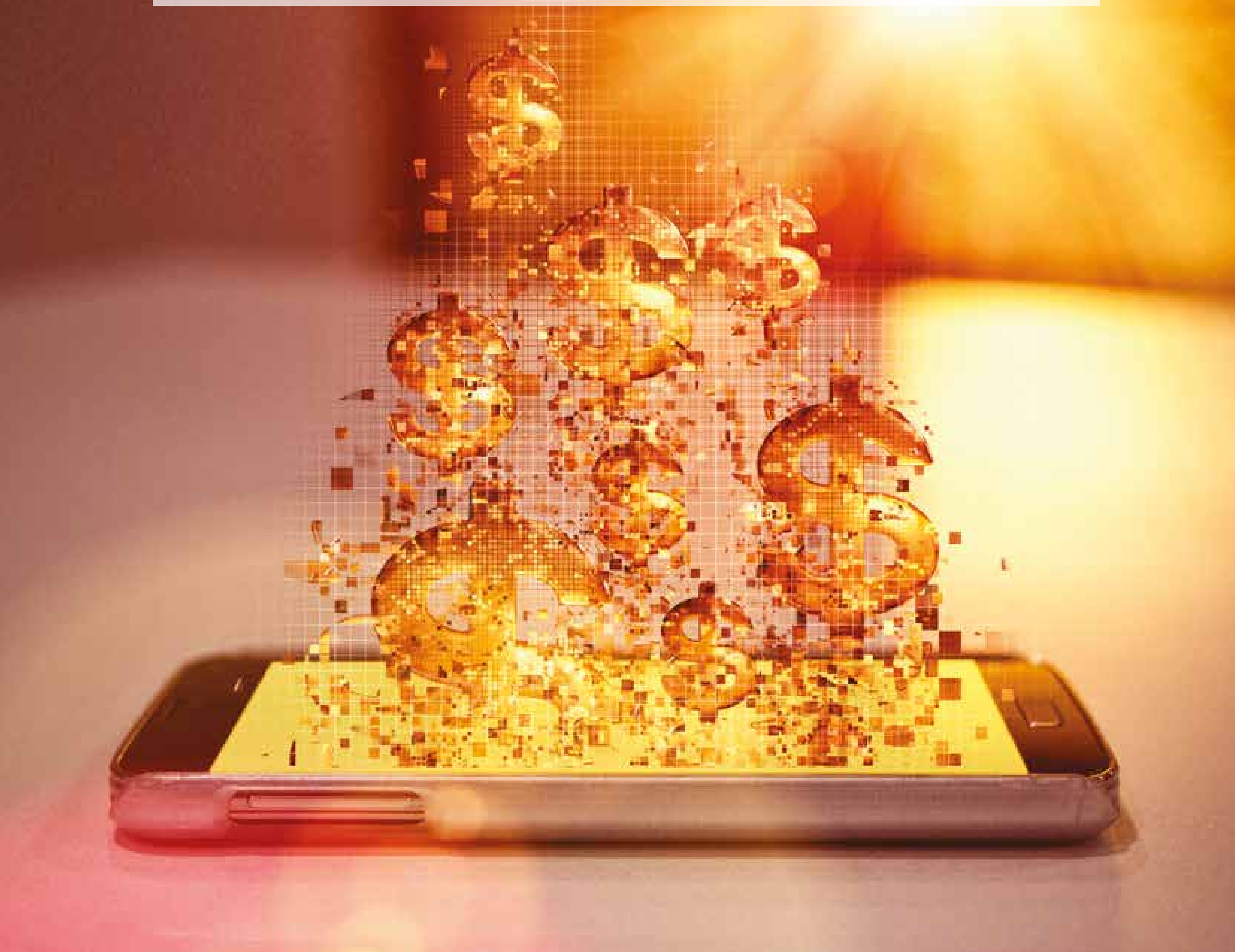


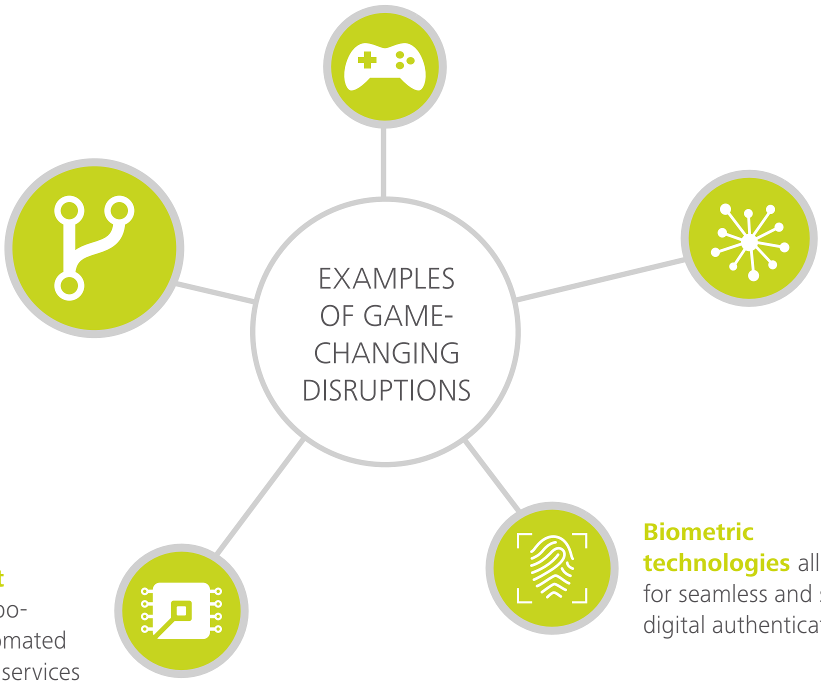
Banking is undergoing a significant change and all current business models are under scrutiny. Digitization is the most significant of several universal trends and disruptive new entrants may fundamentally change the competitive environment. We have identified three potential scenarios for the banking of the future and believe that now more than ever, banks need to choose a strategic business model and adapt it in accordance with the prevailing scenario. In light of these choices, banks must take action today to be prepared for tomorrow.

Digital disruptions challenging the traditional role of banks

New technologies are radically changing the traditional banking business model. From the way banks interact with customers to the way banks manage their middle and back office operations, technological innovations are challenging traditional processes across the entire value chain.

Today, there are several examples of game-changing disruptions that suggest how banking may develop in the future:

Gamification offers a more enjoyable and meaningful customer experience



Process automation offers large-scale cost reduction in combination with increased flexibility and accuracy of back office tasks

Blockchain technology could radically simplify the payments and transactions world

Digital investment solutions such as robo-advisors enable automated investment advisory services

Biometric technologies allow for seamless and secure digital authentication

With customers increasingly adapting to digital disruptions and with more and more new types of competitor and solutions arising in this space, “digital” has officially arrived in the banking sector to shine a spotlight on all major banking functions, described below.

Payments
Decentralized currencies, e.g., leveraging Blockchain technology and mobile money solutions provide compelling alternatives to traditional value transferring systems by streamlining intermediation processes. Driven by competitive pressure from these innovations, the future of value transfer will be more global, more transparent, faster and cheaper. Contrarily, the seamless integration of payment transactions into the purchase process (for example Amazon 1-click or Uber) reduces touchpoints between payment providers and customers, making it harder for payment providers to differentiate themselves from the competition.

Deposits and lending
Alternative lending platforms leveraging peer-to-peer models are transforming credit evaluation and sourcing of capital, as well as, narrowing the spread between deposits and lending. Platforms such as Lending Club, Zopa and Lenddo use alternative adjudication methods and lean, automated processes to offer loans to a broader base of customers and a new class of investment opportunity to savers. Eventually, this reduces the dependency on banks as financial intermediaries. At the same time, increased demand for flexible and alternative banking solutions paves the way for the rise of virtual banks (e.g., Fidor Bank) and the creation of customer-facing enhancements leveraging standardized application interfaces, for example provided by specialized providers such as Yodlee.

Investment management
A number of disruptors, from automated wealth management services (e.g., Wealthfront) to social trading platforms, have emerged to provide low-cost, sophisticated alternatives to traditional wealth managers. These solutions cater to a broader customer base and empower customers to have more control over the management of their wealth. At the same time, new providers such as Eco Financial Technology simplify process outsourcing, leading to improved levels of efficiency and reducing the advantage of larger wealth managers in terms of economies of scale.

Market provisioning
The development of smarter, faster machines in the field of algorithmic trading (e.g., Palantir and SNTMNT), which are learning to process unstructured information such as news feeds, will have unpredictable implications on market provisioning in terms of volume, volatility and spread. New information platforms, such as ClauseMatch, are improving connectivity and information sharing among market constituents, making the markets more liquid, accessible and efficient.

Capital raising
In light of the growing interest in startups and digital democratization, alternative funding platforms such as Seedrs and others have emerged, widening access to sources of capital and providing funding to a greater number of companies and projects, while investors can play a more autonomous role in providing capital for investment opportunities. New platforms enable companies to customize the benefits for the investors (e.g., Crowdcube).

In light of all these disruptive innovations, it is clear that all five banking functions will be affected and change in the banking sector will be inevitable. But what are the implications?

Three likely scenarios for the future of banking

To summarize the impact of digital disruptions on each of the banking functions, the traditional one-stop banking model will be eroded even further: payments will become more independent from banks, reducing customer touch points and making partnerships with retailers more important; deposits and lending will become more widely spread across different platforms, reducing the demand for traditional deposit and investment products; investment management will become increasingly commoditized by process automation and outsourcing; raising capital will become more customized to companies and investors' need to raise capital; and market provisioning will become more automated, reducing the role of humans and improving transparency. Differentiation through product innovations or personal holistic advisory services that go beyond pure banking services will become more important than ever to ensure client retention.

Given the current trends and depending on the ongoing process of customers adopting new behaviors, the current and future regulatory environment, the assertiveness of new innovative competitors, agility and willingness to adapt to the changing environment, by particular banks, we believe that the following three scenarios for the future of banking could materialize:

	1 Bank's domination	2 Banking reinvented	3 Banking ecosystème
Payments	• Clients prefer payment solutions that seamlessly link to their bank accounts • Incumbent institutions provide leaner, faster payment options within the existing network	• One-click solutions favor a default card, driving consolidation of the payment market • Incumbent institutions launch products connected to alternative payment schemes	• Digital wallets remove the limitation of large numbers of cards • Incumbent institutions compete with an alternative network of financial providers
Deposits and lending	• Traditional institutions absorb alternative platforms and build upon their trust • Banks strengthen client relationships beyond needs-based transactions	• Traditional institutions and alternative platforms cater to different clients • New banks focus on account management and partner with alternative networks	• Alternative platforms successfully move upstream to replace traditional players • Traditional players become product providers as new entrants own client relationships
Investment management	• Wealth managers focus on High Net Worth clients and Online tools serve mass affluent clients • With the externalization of previous core capabilities, human factors become differentiators	• High-value services become commoditized and banks focus on tailor-made services • Centralizing compliance increases speed at which banks can react to regulatory change	• Retail and social trading platforms compete directly with traditional wealth managers • External service providers give smaller players access to sophisticated capabilities
Market provisioning	• Large players develop platforms to improve connectivity and efficiency between them	• New platforms make counterparty selection more objective, empowering smaller institutions with less developed networks	• Platforms extend connections to individual investors and can act as market for specific assets
Capital raising	• Peer-based funding platforms focus on investors with motives beyond financial return	• Peer-based funding platforms focus on higher risk seed-stage companies, while banks provide later stage venture capital financing	• Peer-based platforms develop into alternative channels for larger companies to raise capital

1 Banks’ domination

Regulators increase entry barriers for new digital-driven disruptors, which have had little regulation thus far, and clients remain inclined to maintain their primary relationship with established and trusted institutions, so banks succeed in protecting their business model. A pre-requisite of this scenario is that existing banks keep pace with the changing client expectations and invest in new offerings (through in-house development or acquisitions).

2 Banking reinvented

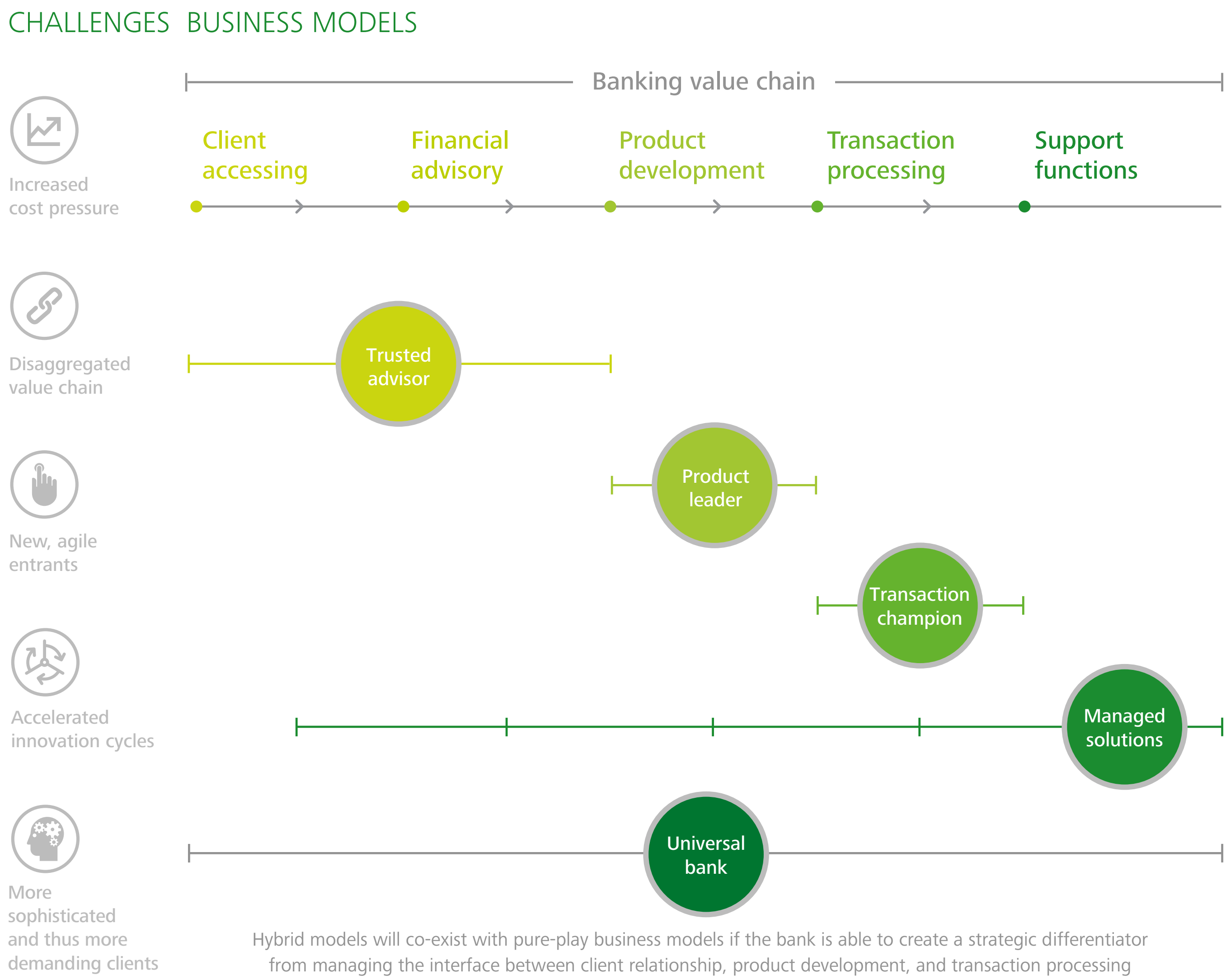
Customers gain trust in new banking players with attractive offerings, as process outsourcing makes it easier for new banking players to enter the market without significant infrastructure, and existing banks fail to adopt new technologies sufficiently quickly because they are held back by decades-old legacy systems. New banking players leveraging Finance 2.0 ideas thereby overtake established banks.

3 Banking ecosystem

Customers prefer to consume tailored services, existing banks underestimate the power of networks while the digital revolution largely ignores well-established rules and boundaries, and disruptive entrants gain significant market share in some market segments. Banks thereby lose the exclusive ownership of their client relationship for a wide set of services (“one-stop-shop”). Instead, successful banks transform themselves into platforms offering their capabilities to a wide ecosystem of specialized providers.

Once likely future scenarios have been identified and described, banks should test their strategic choices against them. First and foremost, business model choices need to be reviewed and refined.

Disaggregation of the value chain drives business model differentiation



Hybrid models will co-exist with pure-play business models if the bank is able to create a strategic differentiator from managing the interface between client relationship, product development, and transaction processing

In all scenarios, the standardization of IT interfaces and communication standards for banking services and other disruptive innovations foster the disaggregation of the value chain, which was traditionally dominated by banks operating an integrated business, i.e., managing large parts of the value chain in-house. Enabled by digitization, specialized firms emerge that focus on specific parts of the value chain and thereby challenge incumbent players. A review of the banking value chain suggests five possible business models which will enable each other in a particular kind of banking ecosystem.

Trusted advisor

Banks choosing "trusted advisor" as their business model will focus on exploiting economies of scope and gaining a high share of their client's wealth. The key value proposition of "trusted advisors" is building upon clients' trust and going beyond pure investment or transaction advisory services. We envisage an open-architecture product portfolio encompassing proprietary and third-party products as a pre-requisite for credibly offering advisory services truly focused on client needs. Furthermore, the "trusted advisor" bank distinguishes itself through offering tailored services based on a deep understanding of clients' needs beyond financial matters. Extending the offering into value-added services, such as concierge services, financial education or working seamlessly with real estate agents, corporate finance advisors, and philanthropy experts enables such banks to deepen the client relationship and increase client loyalty.

Product leader

"Product leaders" will differentiate themselves by developing innovative products for which they are able to command premium prices. Rapid time-to-market enabling banks to quickly gain market share is a key objective for "product leaders," enabling them to maintain their market position and exploit their first mover advantage. Central to the value proposition of "product leaders" are superior insights into technological and financial engineering developments and the capability to translate client needs into new products. While trust is a key asset for "trusted advisors," "product leaders" are valued by clients for the quality and performance of their products.

These five business models present a somewhat idealized picture and hybrid models may co-exist with pure-play business models if the bank is able to create a strategic differentiator for managing the interface between the client relationship, product development and transaction processing.

Transaction champion

As "transaction champions," banks will focus on exploiting economies of scale through partnering with other (bank and non-bank) providers. This business model builds upon a standardized offering at a low cost to end clients and third parties. The means of achieving the necessary economies of scale are white labelling, acting as a transaction consolidator and offering custody and depositary services. Integrating into an extensive network as a correspondent bank allows the "transaction champion" to offer connectivity that smaller banks may not be able to maintain on their own. In addition, a "transaction champion" might consider seeking to benefit from the disaggregation of the value chain by becoming the banking platform for unlicensed new entrants.

Managed solutions

Banks choosing a "managed solution provider" business model will focus on building economies of scale through providing specific banking solutions to other providers. In particular, their specialist offering allows banks and non-banks to break up their internal value chain and to source capabilities from the "managed solution provider." The focus is on becoming a solutions provider rather than a provider of single services. Solutions on offer may range from regulatory insights, to specialized investment advice, as well as, non-core processes, e.g., Know your customer (KYC), tax, and payments.

Universal bank

"Universal banks" must achieve scale in all their business lines to achieve low cost levels and overall efficiency. Banks choosing this business model will offer a comprehensive product offering across several industry sectors, i.e., retail, private, corporate and investment banking, as well as, asset management. Their key value proposition is the maintenance of seamless control over front-to-back processes (even if such processes are outsourced) and the smart reduction of the value chain depth to 50 percent. The aim is to provide "universal banks" with greater flexibility to tailor to client needs, particularly by offering sophisticated products and services leveraging capabilities across business divisions. Their diversified business mix will theoretically reduce the revenue volatility if the bank is able to manage the increased complexity efficiently.

What banks should do today

In order to prepare for the future, banks should assess their own capabilities compared against those of their peers and thoroughly assess their strengths and weaknesses. Next, a deep understanding of the recent developments and trends in the financial industry needs to be developed and shared across the organization. Current uncertainties dictate that we must consider varying scenarios for the future, against which each business area needs to be assessed. Irrespective of which scenario will materialize, banks should start preparing for the inevitable—imminent changes facing the industry. At board level, it is now time to conduct open and honest discussions about the likely scenarios and the most suitable business model in each. Once business model choices are made, strategic options can be derived based on SWOT analyses that account for uncertainty. The necessary changes to prepare for the future require the full attention and commitment from the top and need to be initiated now.

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To the point:

- Banking is undergoing fundamental change
- Digitization and disruptive new entrants are the key drivers of change
- Three scenarios are likely to emerge: 1) the continuation of traditional banks' domination, 2) disruption by leaner, more flexible and focused banks or 3) the emergence of an ecosystem of financial service providers
- The trends are accelerating the disaggregation of the value chain, forcing banks to choose one of five business models: 1) trusted advisor, 2) product leader, 3) transaction champion, 4) managed service provider or 5) universal bank
- Banks need to understand their own core capabilities and their strategic aspirations today to take actions for tomorrow

This article is adapted from the Deloitte Switzerland publication "Swiss Banking Business Models of the future."