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Digital transformation meets regulation 4.0 in 2030: How incumbents can succeed (2/3)

Where should incumbents play?

In this series “Digital transformation meets regulation 4.0 in 2030: How incumbents can succeed”, we present how incumbents could play and win to hedge the value of their digital transformation against regulatory change.

How should incumbents approach their digital transformation? In this publication we explore where incumbents should play to hedge against regulatory risk by assessing their optimal digital transformation target and their geographic footprint.

Introduction

As regulators continue to develop their response to disruptive innovation, the regulatory risk – what type of regulatory change will occur in response to innovation – for incumbents is increasing. In our previous publication "Coping with disruptive innovation. Towards regulation 4.0" we explored how regulators may respond to innovation by presenting two forward-looking regulatory scenarios. In light of this, how should incumbents approach their digital transformation? In this publication, we explore where incumbents should play to hedge against regulatory risk by assessing their optimal digital transformation target and their geographic footprint.

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Despite this rising regulatory risk, incumbents cannot afford a "wait and see" approach delaying their decisions to invest in digital transformation. Indeed, three interrelated trends in particular underlie the necessity of digital transformation: profitability, customer centricity and competition. In terms of profitability, on average, from 2005 to 2016, the return-on-equity (ROE) for European and US retail banks has decreased by 9% and the cost-to-income ratio has increased by 6.8%, despite renewed effort on cost containment. Digital transformation can help increase ROE through various levers, including through cutting costs sustainably. Indeed, Temenos and Deloitte estimate that banks running modern core banking systems have enjoyed on average a 28% higher ROE and a 6.5% lower cost-to-income ratio than banks running legacy applications.

There is a continuing focus on customer centricity – an approach to banking where customers are considered primary stakeholders and which results in increased trust-based relationships. The aim here is to establish long-term banking relationships by leveraging customers' data to provide more personalised products and services. Incumbents still have much to do. Examples of providing seamless 24/7 interactions across multiple channels continue to rise, such as video on demand service for mortgage advice, which is not based on appointments and reduces waiting time to talk to a specialist.

Finally, in terms of competition incumbent retail banks are increasingly at risk of losing their market share to non-traditional players. In particular, the spectre of BigTechs is looming. Incumbents' services around payments and lending, in particular, will continue to face a higher risk of market share loss as these services offer more opportunity to create differentiated customer experiences. BigTechs have a competitive advantage over incumbents insofar as they have no technological legacy issues, have significant volumes of customer data, large cash reserves for investing in new ventures, and, critically, are better positioned to attract the already scarce talent. It is also clear that the interplay between customer centricity and competition puts pressure on incumbents' cross-subsidisation business model, which will further indent their market share.

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We have segmented the disruptive innovation underpinning digital transformation into four maturity clusters:

Cluster 1	high maturity: online banking, mobile banking, wearables and biometric security
Cluster 2	medium maturity: cloud, blockchain, chatbots, open banking and cryptocurrencies
Cluster 3	low maturity: quantum computing, virtual reality, artificial intelligence, initial coin offerings and sonic payments
Cluster 4	next frontiers of future disruptive innovations

The value of undertaking digital transformation based on “cluster 1” and “cluster 2” typically scales linearly. The value of adopting digital transformation based on “cluster 3” and, in particular, “cluster 4” will be determined by a more complex set of factors.

In our previous publication “Coping with disruptive innovation. Towards regulation 4.0”, we explored the interplay of three factors (and the two regulatory scenarios that could result, whilst keeping in mind that are many other scenarios that could also be considered):

- risk management;
- regulatory design and architecture; and
- regulatory convergence.

Alongside these factors, the “disruptive innovation maturity level” (degree of adoption and penetration of disruptive innovation by market players) should be considered. This results in us identifying four forward-looking scenarios for digital transformation (Figure 1):

Each scenario then identifies where incumbents should play to hedge against regulatory risk by assessing their digital transformation target and geographic footprint.

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Implication (continued)

Figure 1: Forward-looking digital transformation scenarios

Scenario 1: With the flow Where to play? Augment existing digital transformation perimeter across the international footprint	**Scenario 2: Clear waters** Where to play? Augment existing digital transformation perimeter across the international footprint
Scenario 4: Turbulent waters Where to play? Retrench existing digital transformation perimeter across the international and domestic footprint	**Scenario 3: Against the flow** Where to play? Optimise existing digital transformation perimeter across the domestic footprint

Where next for digital transformation?

In "Scenario 1: With the flow", stagnant economic growth results in sluggish profitability, which puts pressure on incumbents' budget for innovation (organic and inorganic) and on new entrants' capacity to attract funding for innovation. Customers are becoming increasingly vigilant towards data privacy risks. In an attempt to counter this stagnant economic growth, regulation acts as a facilitator for innovation. New entrants emerge slowly.

In this scenario, incumbents focus their efforts on augmenting their existing digital transformation perimeter across the international footprint. This can be achieved through:

1. investing in the existing value chain to generate scale;
2. retaining the existing customer base by alleviating their key pain points as part of the customer experience journey; and
3. acquiring a small set of new entrants based on their capacity to achieve 1. and 2.

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In "Scenario 2: Clear waters", strong economic growth results in solid profitability, which allows incumbents to invest in innovation (organic and inorganic) and new entrants to attract funding for innovation. Customers are becoming ever more demanding in terms of their experience. Given that market players (incumbents and new entrants) are effectively managing the risks related to disruptive innovation, regulation acts as a facilitator for innovation. New entrants emerge quickly and competition from both incumbents and new entrants accelerates.

In this scenario, incumbents focus their efforts on advancing new digital transformation frontiers across their international footprint. This can be achieved through:

1. developing in-house disruptive products and services to generate new market penetration;
2. expanding the customer base by offering a highly anticipative customer experience (giving customers what they need before they know to ask for it); and
3. buying a large set of new market entrants based on their capacity to achieve 1. and 2.

In "Scenario 3: Against the flow", uneven economic growth results in unbalanced profitability, which channels incumbents and new entrants to pursue innovation, and subsequently operate, on a more geographically constrained basis. Customer demand is becoming ever more heterogeneous. As national and/or regional protectionism are on the rise, regulation acts as a deterrent because it is divergent (gaps and/or inconsistencies within the regulatory framework). New entrants emerge slowly but compete aggressively with incumbents.

In this scenario, incumbents focus their efforts on optimising their existing digital transformation perimeter across the domestic footprint. This can be achieved through:

1. developing an agile operating model to generate speed;
2. optimising the customer base through micro-segmentation; and
3. buying a small set of new entrants based on their capacity to achieve 1. and 2.

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Implication (continued)

In "Scenario 4: Turbulent waters", high profile cyber-attacks and data privacy wrongdoings undermine confidence in the financial services sector. Customers are ever more protective in terms of their data usage and privacy and exercise their civic muscle to ensure market players are held accountable. Consequently, regulation acts as a deterrent, whereby it de-risks market participants by limiting both the depth and breadth of the applications of disruptive innovation. The number of both new entrants and incumbents shrinks.

In this scenario, incumbents retrench their existing digital transformation perimeter across both the international and domestic footprint. This can be achieved through:

1. minimising the interconnectedness with third parties within existing value chain;
2. divesting from products and services which are high impact in terms of customer mistrust if things go wrong; and
3. pausing on acquisitions.

Incumbents should start now using this or similar scenario analysis as a tool – for developing a long-term corporate strategy – to help them determine:

- which of their existing fundamental assumptions about the future of digital transformation must be re-examined;
- which actions they should stop if future events indicate that digital transformation is headed towards "Scenario 3: Counter the flow" or "Scenario 4: Turbulent waters"; and
- which actions they should take if future events indicate that digital transformation is headed towards "Scenario 1: With the flow" or "Scenario 2: Clear waters".

Since scenario analysis is an art rather than a science, incumbents should adopt a "learning by doing" approach and probe earlier scenarios that with the benefit of hindsight turned out to be wrong, so as to identify what went wrong. The next publication "How can incumbents win?" in this series will explore how incumbents should play to win.

Authors

Simon Brennan
EMEA Centre for Regulatory Strategy, Director
simbrennan@deloitte.co.uk
linkedin.com/simon-brennan/

Simon is a Director in Deloitte's EMEA Centre for Regulatory Strategy, specialising in prudential regulation for banks. Simon joined Deloitte after 11 years at the Bank of England, where he worked in a number of areas covering macro and micro prudential policy, and financial institution risk assessment.

Dr. Alexandra Dobra-Kiel
EMEA Centre for Regulatory Strategy, Manager
adobrakiel@deloitte.co.uk
linkedin.com/Alexandra Dobra-Kiel/

Dr. Alexandra Dobra-Kiel is a Manager in Deloitte's EMEA Centre for Regulatory Strategy, specialising in corporate strategy for banks. Prior to Deloitte, Alexandra worked in consulting, where she focused on strategy, innovation and thought leadership. Alexandra's research has been published in top-tier US and European journals, gained prestigious honours and scholarships and lectured at Warwick Business School.