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A digital crack in banking's business model

Low-cost attackers are targeting customers in lucrative parts of the sector.

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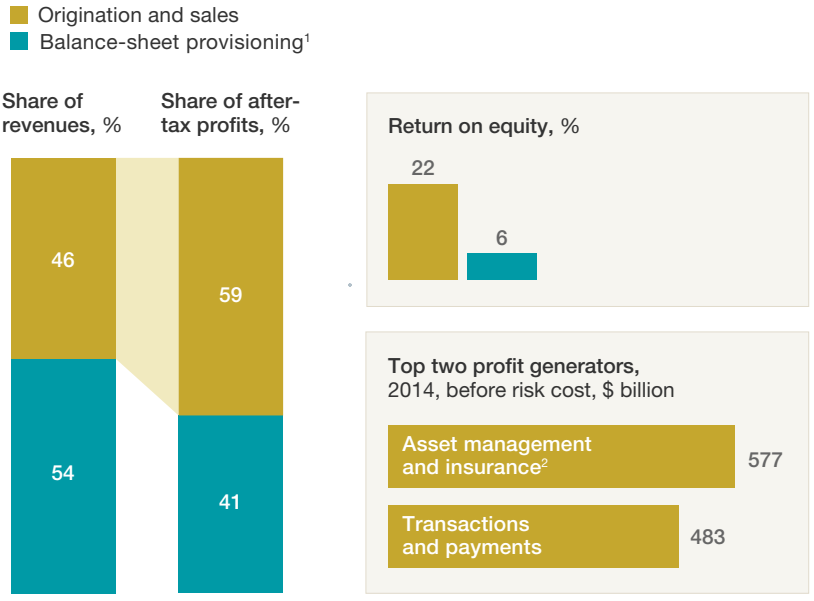
The rise of digital innovators in financial services presents a significant threat to the traditional business models of retail banks. Historically, they have generated value by combining different businesses, such as financing, investing, and transactions, which serve their customers' broad financial needs over the long haul. Banks offer basic services, such as low-cost checking, and so-called sticky customer relationships allow them to earn attractive margins in other areas, including investment management, credit-card fees, or foreign-exchange transactions.

To better understand how attackers could affect the economics of banks, we disaggregated the origination and sales component from the balance-sheet and fulfilment component of all banking products. Our research (exhibit) shows that 59 percent of the banks' earnings flow from pure fee products, such as advice or payments, as well as the origination, sales, and distribution component of balance-sheet products, like loans or deposits. In these areas, returns on equity (ROE) average an attractive 22 percent. That's much higher than the 6 percent ROE of the balance-sheet provision and fulfillment component of products (for example, loans), which have high operating costs and high capital requirements.

Digital start-ups (fintechs)—as well as big nonbank technology companies in e-retailing, media, and other sectors—could exploit this mismatch in banking's business model. Technological advances and shifts in consumer

Exhibit

Digital attackers disintermediate profitable customer-facing businesses and avoid capital-intensive areas.



[1]Revenues generated by carrying loans and other assets already sold and sitting on the books.
[2]Asset management includes investment and pension products. Only insurance sold by banks is included.

Source: Analysis and data provided by Panorama (a McKinsey Solution)

behavior offer attackers a chance to weaken the heavy gravitational pull that banks exert on their customers. Many of the challengers hope to disintermediate these relationships, slicing off the higher-ROE segments of banking's value chain in origination and sales, leaving banks with the basics of asset and liability management. It's important that most fintech players (whether start-ups or China's e-messaging and Internet-services provider Tencent) don't want to be banks and are not asking customers to transfer all their financial business at once. They are instead offering targeted (and more convenient) services. The new digital platforms often allow customers to open accounts effortlessly, for example. In many cases, once they have an account, they can switch among providers with a single click.

Platforms such as NerdWallet (in the United States) or India's BankBazaar.com aggregate the offerings of multiple banks in loans, credit cards, deposits, insurance, and more and receive payment from the banks for generating new business. Wealthfront targets fee-averse millennials who favor automated software over human advisers. Lending Home targets motivated investment-property buyers looking for cost-effective mortgages with accelerated time

horizons. Moneysupermarket.com started with a single product springboard—consumer mortgages—and now not only offers a range of financial products but serves as a platform for purchases of telecom and travel services, and even energy.

Across the emerging fintech landscape, the customers most susceptible to cherry-picking are millennials, small businesses, and the underbanked—three segments particularly sensitive to costs and to the enhanced consumer experience that digital delivery and distribution afford. For instance, Alipay, the Chinese payments service (a unit of e-commerce giant Alibaba), makes online finance simpler and more intuitive by turning savings strategies into a game and comparing users' returns with those of others. It also makes peer-to-peer transfers fun by adding voice messages and emoticons.

From an incumbent's perspective, emerging fintechs in corporate and investment banking (including asset and cash management) appear to be less disruptive than retail innovators are. A recent McKinsey analysis showed that most of the former, notably those established in the last couple of years, are enablers, serving banks directly and often seeking to improve processes for one or more elements of banking's value chain.

Many successful attackers in corporate and investment banking, as well as some in retail banking, are embracing "coopetition," finding ways to become partners in the ecosystems of traditional banks. These fintechs, sidestepping banking basics, rely on established institutions and their balance sheets to fulfill loans or provide the payments backbone to fulfill credit-card or foreign-exchange transactions. With highly automated, scalable, software-based services and no physical-distribution expenses (such as branch networks), these attackers gain a significant cost advantage and therefore often offer more attractive terms than banks' websites do. They use advanced data analytics to experiment with new credit-scoring approaches and exploit social media to capture shifts in customer behavior.

Attackers must still overcome the advantages of traditional banks and attract their customers. (See the sidebar for the story of how one financial incumbent, Goldman Sachs, is using digitization to strengthen its core businesses.) Most fintechs, moreover, remain under the regulatory radar today but will attract attention as they reach meaningful scale. That said, the rewards for digital success are huge. Capturing even a tiny fraction of banking's more than $1 trillion profit pool could generate massive returns for the owners and investors of these start-ups. Little wonder there are more than 12,000 of them on the prowl today. Q

WHY GOLDMAN IS BANKING ON THE CLOUD

Facing digital attackers and a host of market challenges, financial incumbents are turning to digitization to battle-harden their core. Digital tools and cloud platforms can give them a powerful leg up, further automating processes, providing economies of scale in IT, and increasing agility. In this edited excerpt of a conversation with McKinsey's James Kaplan, Don Duet, global head of the Goldman Sachs Technology Division, discusses how the organization has used a cloud infrastructure to hone its strategic edge.

Open-source software and cloud architectures have created more opportunity to innovate at a higher pace and lower cost. We're rethinking how we do things and the way we articulate our services for customers—and for ourselves. It's a process of continual transformation: moving more and more core parts of our business to models where things are done electronically, at higher scale, and delivered in a more seamless fashion. Think about how much digital literacy there is today compared with even 10 or 15 years ago. Our customers and our employees want to be empowered through technology.

A few years back, we did a meaningful reorganization in the Technology Division. We were vertically oriented, with teams that focused on different parts of the business. But we wanted to be more like an agile start-up that can go from nothing to running products in months, with very little capital investment. To do that, we created a platform team, moving many people in our division into different roles. This team uniformly supports and delivers core cloud-based services, applications, and data-related services across all business units and groups within the organization. More of our developers now sit on teams aligned with the business. They find that going from concept to product is much simpler.

This uniform structure of our private-cloud infrastructure has allowed us to reduce complexity, which is enormously important for managing risk. We can respond to failures more quickly. We've also moved from an environment in which it could take months to launch or update an application to where it now takes days, sometimes even minutes. Better capacity planning translates into faster turnarounds and much more responsiveness, without creating pools and islands of computing that ultimately increase risk and reduce efficiency.

For more on Goldman's cloud strategy read, "Banking on the cloud," on McKinsey.com.

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For more on digital banking, see *The fight for the customer: McKinsey Global Banking Annual Report 2015* and "Cutting through the noise around financial technology," both on McKinsey.com.