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Digital banking in the Gulf

Keeping pace with consumers in a fast-moving marketplace

Banking November 2016

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Digital banking in the Gulf

As consumers in the Gulf go digital, they are creating opportunities for innovative financial services providers to disrupt the market.

McKinsey's latest study[1] of urban retail banking customers in the UAE and KSA shows how their preferences and behaviours are changing. Incumbents and new entrants alike should plan for the implications.

The digital revolution that has turned global industries upside down has reached the realm of banking. Millions of people now embrace fully integrated mobile banking experiences, using smartphones, tablets and wearables to do everything from buy ecommerce products and services to open new accounts and make payments. New McKinsey research on urban consumers in UAE and KSA (primarily focusing on internet users - UAE currently has 92 percent internet penetration while KSA has 65 percent[2]) shows that at least 80 percent of these consumers now prefer to do at least some of their banking on computers, smartphones and tablets, and visit branches and call service hotlines only to meet specific and more complex needs.

Both Gulf markets also exhibit significant e-commerce penetration, with 80 to 90 percent of respondents having purchased products online. However there is still enormous room for growth in terms of financial products sales (only 20 to 25 percent of respondents purchased a financial product online in the past 12 months).

Despite some structural obstacles, the shift is likely to intensify, and incumbents and entrants alike should prepare for the new normal. Incumbents who can keep pace with consumers' changing preferences – and the new entrants poised to serve those customers in new ways and at a lower cost – are likely to gain lasting competitive advantages. Laggards will fail to deliver engaging digital experiences, will lose market share and become irrelevant within 3 to 5 years. We expect a difference in return-on-equity of about 5 to 10 percentage points between winners and laggards.

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1 To understand the dynamics of the personal-financial sector in the Middle East, McKinsey surveyed 1750 urban consumers (key decision-makers on banking-related matters in their households) through online questionnaires in the UAE and KSA in October 2016

2 Internet user defined as people who can access the Internet at home, via any device type or connection. Internet Live Stats by International Telecommunication Union, World Bank, and United Nations Population Division

For incumbent banks, the stakes are particularly high. About 80 percent of the consumers we surveyed said they were willing to consider shifting at least a portion of their holdings to a bank that offers a compelling digital-only proposition.

This result squares with our findings in developed Asian markets[3], where 83 percent of consumers are willing to shift. Many types of accounts are in play: respondents said they could shift 35 to 55 percent of credit card balances, 30 to 45 percent of savings and term deposits, and 35 to 50 percent of personal loan balances. In the most digitally penetrated geographies and customer segments, such as the United Kingdom and Western Europe, 40 percent or more new deposits could come from digital sales by 2020[4].

However, bank branches will not disappear from the GCC any time soon. Despite the allure of digital offers, our survey showed that physical channels – branches and ATMs – will continue to play major roles in banking across the region. Banks will have to balance regulatory demands and consumers' needs for a physical presence against the cost, reach and convenience advantages of digital services.

Physical channels – branches and ATMs – will continue to play major roles in banking across the GCC.

Our research also shows that consumers want digital to enable frequently used and value added features such as loyalty programs and discounts through mobile. Banks should increasingly focus on creating strong ecosystems of partnerships.

3 Australia, Hong Kong, Japan, Singapore, South Korea, and Taiwan – "Digital Banking in Asia: what do consumers really want?", March 2015, mckinsey.com
4 "Strategic choices for banks in the digital age", January 2015, mckinsey.com

Embracing digital banking

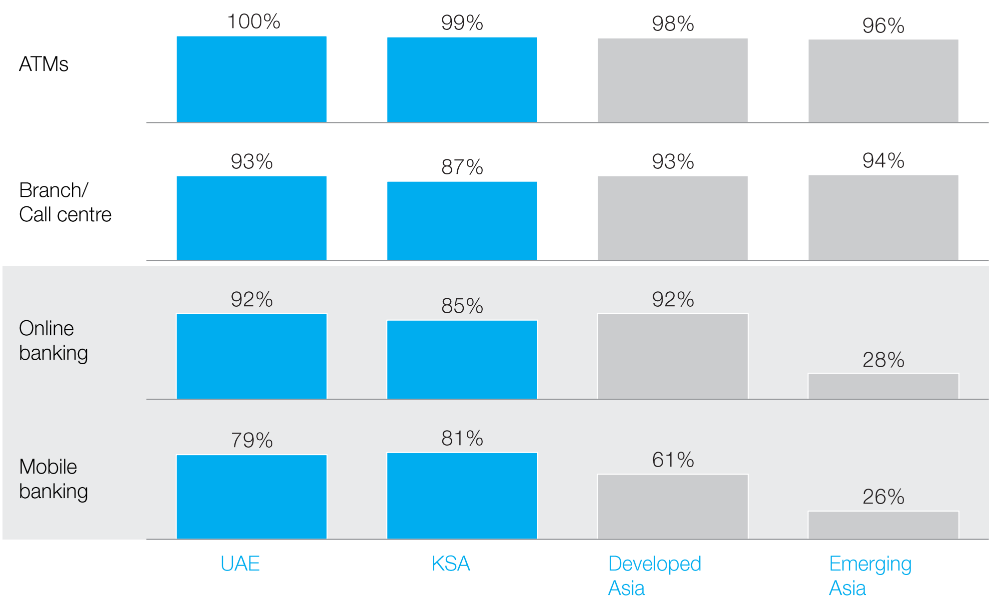
Three powerful trends are underscoring banks' urgent need to embrace digital: (1) strong customer adoption; (2) increasingly multichannel consumer decision journeys; and (3) customers' openness to purely digital propositions.

1. Strong adoption

Consumers in the UAE and KSA are already heavy users of digital banking channels: 80 to 90 percent of respondents said they use digital banking channels, in line with benchmarks in developed Asia (Exhibit 1).

Exhibit 1: **Significant penetration of digital channels in the UAE and KSA**

Penetration of banking channels



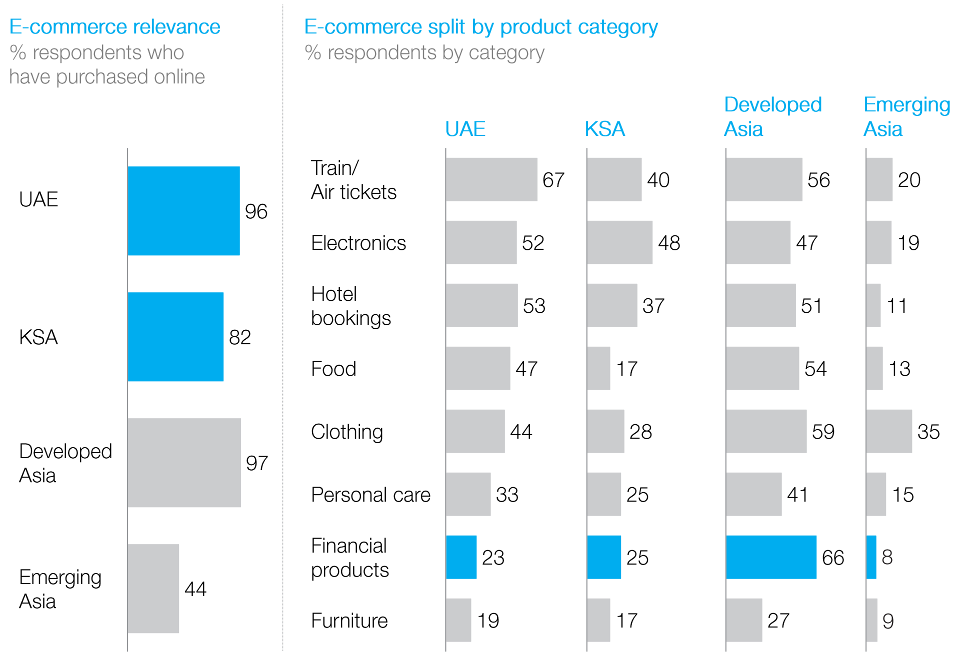
Both Gulf markets also exhibit significant e-commerce penetration, with 80 to 90 percent of respondents having already purchased products online – particularly for travel and electronics. But consumers' moves to digital banking have just begun: only 20 to 25 percent say they have acquired a financial product digitally[5] (Exhibit 2) – which is driven by lack of availability of meaningful digital products and security concerns, see section: "What do customers want from digital banking?". This suggests enormous room for growth in the next few years.

Enormous room for growth: only 20 to 25 percent have acquired financial products digitally.

In particular, banks should leverage current e-commerce penetration to drive growth of digital banking sales through partnerships.

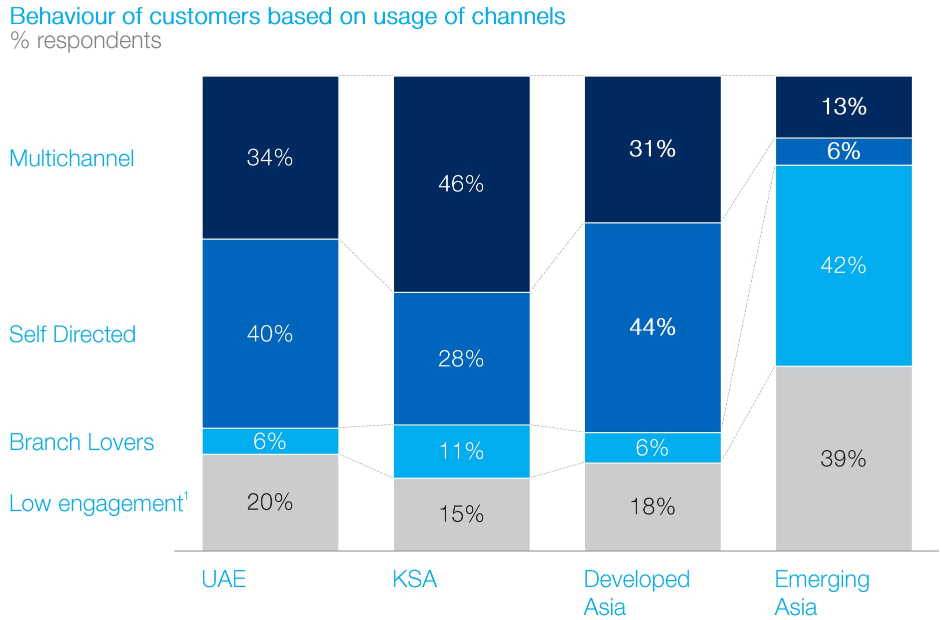
[5] Saving and term deposits, credit cards, personal loans, mortgages, insurance, and investment products.

Exhibit 2: **UAE & KSA have significant e-commerce penetration but lag in digital sales of financial products**



The study also showed that over 70 percent of UAE and KSA consumers are multichannel or self-directed (Exhibit 3). Banks cannot afford to dissatisfy multichannel customers, since they tend to have larger account balances driven by higher salaries and education.

Exhibit 3: **Three out of four GCC consumers use digital channels frequently**



1 Customers that seldom interact with their banks across all channels

2. Multichannel consumer decision journeys

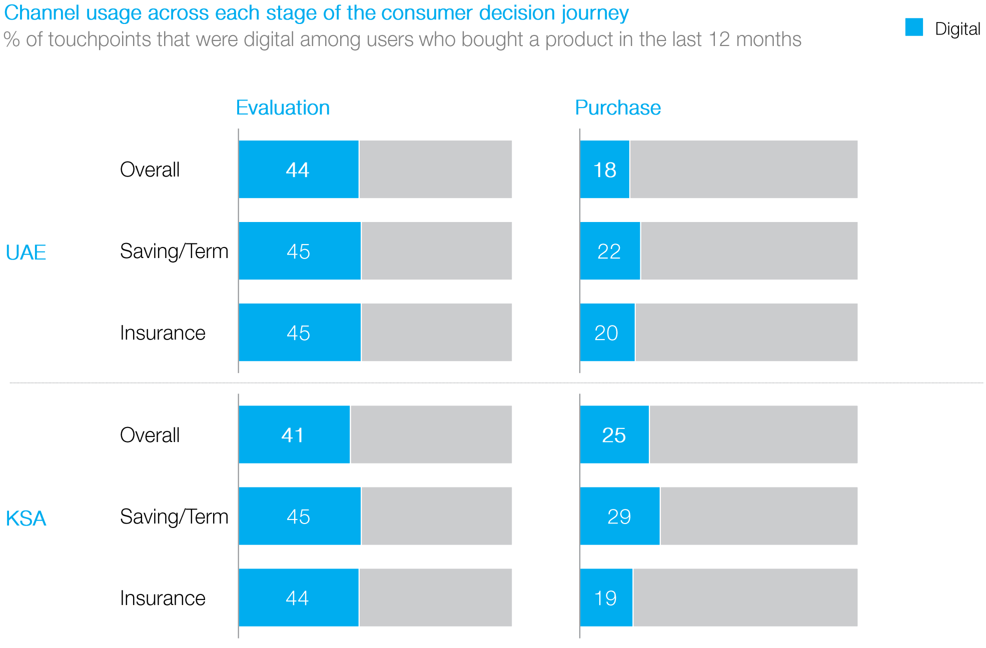
A second trend propelling the growth of digital banking in the region is that more consumers are using multiple channels to research banking options. Consumers often investigate products and offers digitally, even though they continue to complete the transactions in branches.

While the share of banking sales made in digital channels is small today, digital access to banking-related information already exerts significant influence on customers in the Emirates and the Kingdom.

About 45 percent of our respondents said they researched banking products and services digitally before making final purchase decisions (Exhibit 4). More important, 30 to 35 percent of those who conducted research through digital channels said the information they found changed their minds about their purchases.

Exhibit 4: **Digital touchpoints influence consumer decisions even when purchases are made offline**

Channel usage across each stage of the consumer decision journey
% of touchpoints that were digital among users who bought a product in the last 12 months



3. Openness to compelling digital-only offers

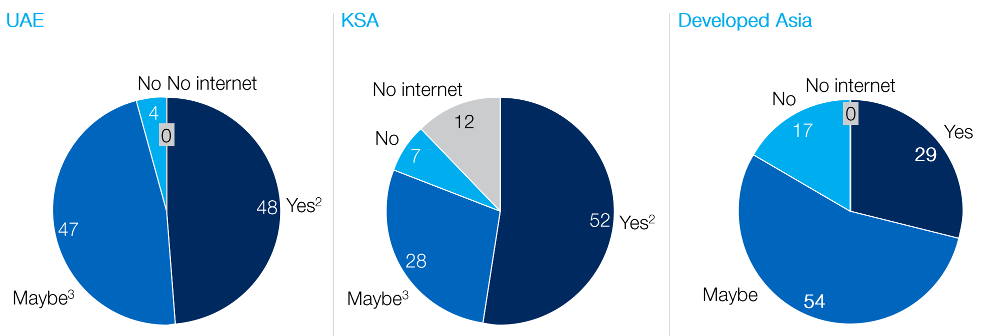
A final trend underlying the growth potential of digital banking in UAE and KSA is that more consumers are prepared to consider compelling digital-only offers for financial products and services. In both countries we surveyed, about 50 percent of respondents said they would open an account with a purely digital bank – an additional 30 to 50 percent said they might consider it (Exhibit 5).

> About 50 percent of respondents said they would open an account with a purely digital bank.

Among the customers who would open an account with such a player, more than 80 percent said they were willing to shift at least some of their holdings to a bank that offers a compelling digital proposition (Exhibit 6). Many types of accounts are in play, with respondents indicating that they would shift 35 to 55 percent of credit card balances, 30 to 45 percent of savings and term deposits, and 35 to 50 percent of personal loan balances.

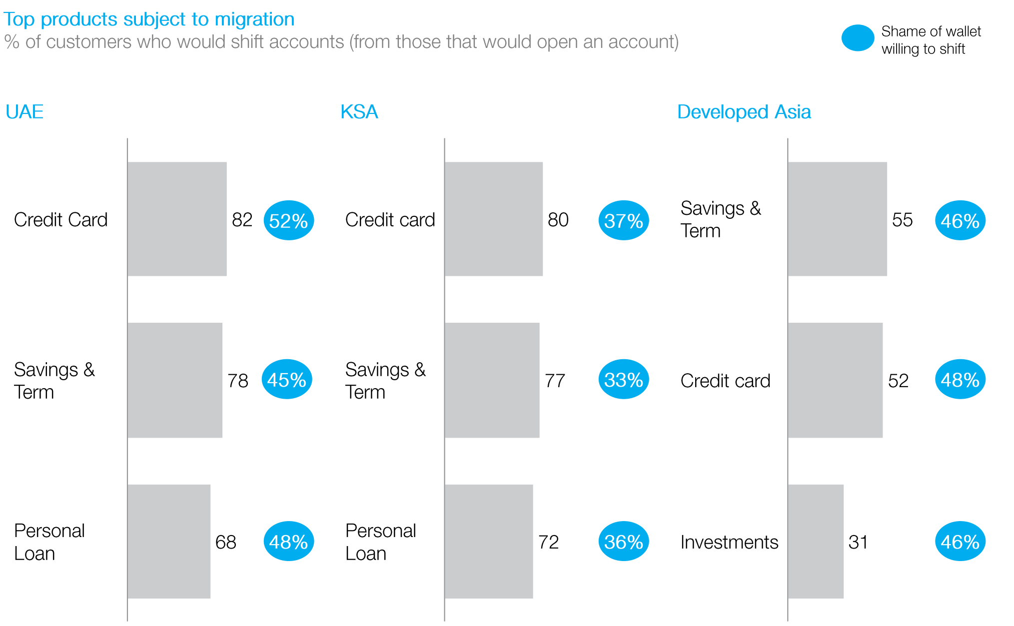
Exhibit 5: About half of customers would consider opening an account with a digital bank

Question: Would you be willing to open a new account with a new digital attacker bank with no branches



1 Excludes customers who already use a bank like this
2 Includes those who answered "I would consider this bank while considering my primary bank", and "I would consider, as long as the pricing is competitive"
3 Includes those who answered "I would consider it only if it is part of a larger banking group" and "I would consider only if they had some branches"

Exhibit 6: **A compelling digital proposition could deliver significant market share**

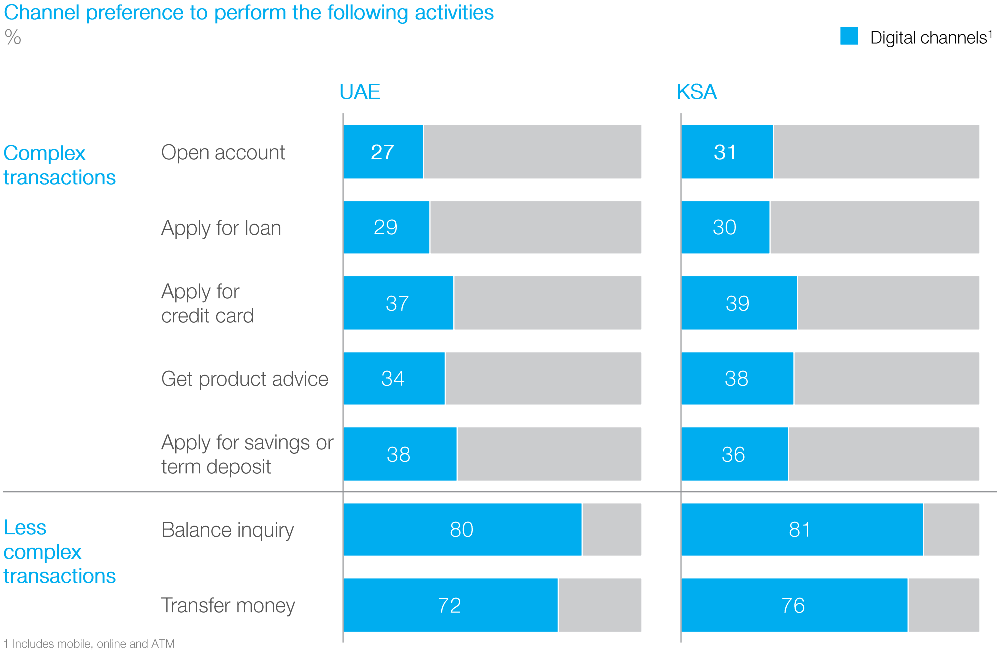


Branches are down but not out

UAE and KSA banking consumers now rely less on bank branches for routine transactions such as transfers and balance inquiries (Exhibit 7). As they continue to discover the convenience of self-service and digital channels, they will visit branches less frequently.

Exhibit 7: **Simpler transactions have migrated to digital channels, but branches remain relevant for more complex activities**

Channel preference to perform the following activities
%



1 Includes mobile, online and ATM

That said, branches will continue to play an important role, at least in the near term, for more complex transactions such as loan and credit card applications. In fact, 40 to 50 percent of customers still visit branches at least once a month. This means that they are increasingly multichannel, rather than turning solely to digital or branch services.

Three main factors explain the continued relevance of branch networks:

- **Sealing the deal:** Most polled customers said they continue to need personal advice about products even after conducting research digitally. One reason consumers need to visit branches is that their banks do not offer meaningful end-to-end digital propositions for more complex products. The most innovative banks will close this gap by developing such propositions and integrating better personal advice features, such as video-conference and virtual relationship management, into digital journeys.

- **Regulatory necessity:** Some national regulations mandate personal contact (or wet signatures) for specific transactions, especially for first-time customers. In addition, in both UAE and KSA (and more broadly in the GCC), stringent know-your-customer (KYC) and anti-money-laundering rules require that banks verify identities in person. Some countries are exploring ways to meet these regulatory requirements digitally. In Germany, for instance, banks can confirm identities using Skype and other video-conferencing tools. In Spain, the regulator has enforced a system-wide KYC – once a customer has opened an account with one bank (with full KYC process), he/she can subsequently open accounts with other banks by simply transferring 1 Euro from one account with the same name and information. Moreover, BBVA just launched a fully online account opening process where the customer takes a photo of the ID followed by a video-conference with one of the bank's representative.

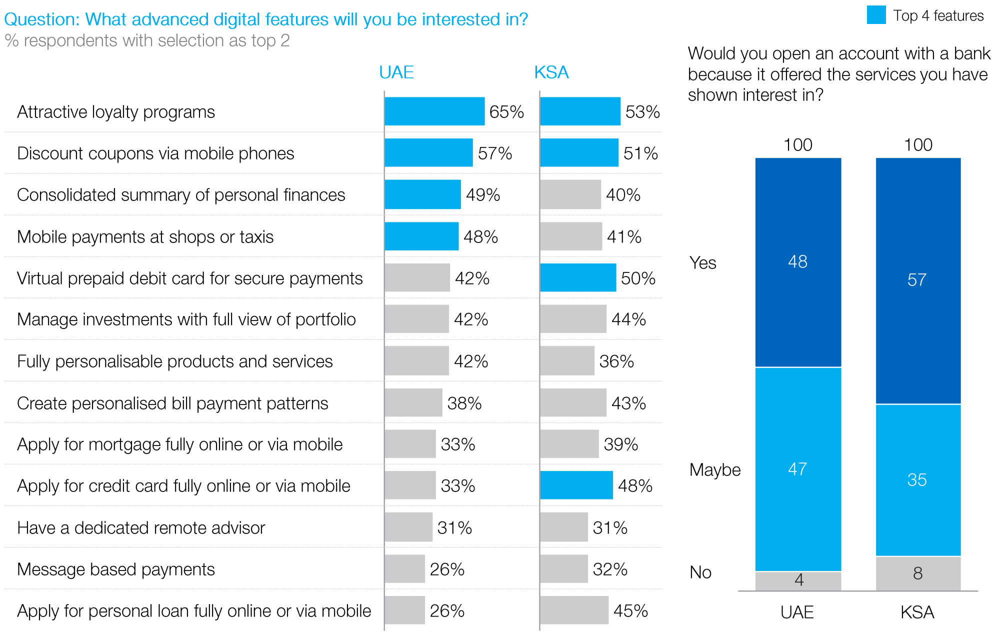
- **Security concerns:** Branches provide a sense of permanence and security that is difficult for digital banks to match. We expect branch relevance to shift to advisory and marketing roles.

What do customers want from digital banking?

Our research shows that consumers who use digital banking channels want frequent usage features such as loyalty programs and discounts through mobile. Respondents said they would be more likely to open accounts with banks that offered these features.

While banks typically focus on digitising high-cost processes such as loans, our research shows that customers tend to value everyday use features. In part, this may be due to the lack of seamless, easy-to-use, end-to-end loan-related solutions. If banks start offering quick, painless loan applications, for example, they might raise customers' interest and increase digital sales from today's low levels.

Exhibit 8: **Consumers prefer digital features they would use frequently**



1 Includes only respondents with Internet access

Our findings also show that simplicity and security are keys to digital success. Among the banking customers who have not purchased any digital banking products, 40 to 50 percent said the primary obstacle was that the products are so complicated that they need a person to explain them. Lack of availability or awareness of digital solutions was mentioned by about 30 percent of respondents. Finally, about a third of the customers, cited security concerns.

In order to encourage customers to increase their use of digital channels banks should make seamless, easy-to-use end-to-end digital solutions available that provide assisted experience, while improving customers' perception of security.

Responding to the change

The strong uptake of digital banking in the Middle East presents significant threats and opportunities for the entire financial-services industry.

Large incumbent banks should transform their existing businesses. In fact, we believe they should have already begun the transformation journey. The winners will harness new technology to re-invent their customers' experience, simplify and streamline their internal processes, and re-purpose their branch networks for sales and advisory rather than servicing. Incumbent banks have an opportunity to capitalise on their existing customer base but should not be complacent, as agile and efficient new entrants and Fintechs have quickly acquired market share in other parts of the world and are starting to move to the region.

Attackers banks can use digital banking as an innovative way to capture market share by building low-cost business models (without extensive and expensive branch networks and with product and processes specifically designed for digital channels). Our research indicates that these players can achieve cost bases that are significantly lower than incumbents by focusing on a limited set of high-value products and micro-segments, and lower cost-income ratios by about 10 to 20 percentage points compared with traditional, branch-oriented retail banks.

However, attackers will need to find creative ways to offer customers a sense of security and meet regulatory requirements. Many entrants globally are marketing heavily to strengthen customers' sense of security. Marketing budgets for digital banks are typically about 15 percent of total expenses, compared with less than 5 percent for incumbents.

Other companies and start-ups outside the financial sector and Fintechs can begin offering traditional banking products and services. These companies tend to be far more innovative than incumbent financial institutions and are not held back by legacy IT systems or entrenched corporate cultures. Their biggest challenges will likely be regulatory. McKinsey's proprietary Panorama research on Fintech[6] notes the recent explosion in the number of start-ups – currently tracking more than 2,000 companies globally. Globally, nearly $19.1 billion of venture capital and growth equity has been deployed to Fintechs in 2015 alone, and we expect a 50 percent increase in 2016.

[6] "Cutting through the Fintechs Noise: Markers of Success, Imperatives for Banks", December 2015, mckinsey.com

Irrespective of their starting position, banks should focus on a set of digital initiatives to deliver on the digital opportunity. These include:

Elevate digital to the C-level: To succeed, digital cannot be a hobby or a project. Top executives should consider digital transformation as a strategic initiative and provide a clear vision and adequate sponsorship and funding.

Acquire and nurture digital talent and organise for creativity, flexibility and speed: Competition for digital talent, intense around the world, is particularly challenging in the Middle East. Developing a clear talent acquisition strategy and the right operating model to nurture and retain this talent is essential. The move to digital should go beyond technology to encompass the bank's culture, design, brand and marketing. While an actual 'garage like' environment is not necessary, a physical space that provides a nurturing environment for creative thinking and close collaboration is.

Digitise processes end-to-end: Technological change is giving companies of all kinds new opportunities to make dramatic improvements in process efficiency and customer experience. After the last dot-com boom, banks 'electronified' core processes. Now they must digitise them. The difference is crucial – an electronic loan processing and fulfilment process at a bank largely implies the sharing and processing of PDF files of paper documents. Digitising a mortgage application would involve creating and manipulating data fields in an automated manner. This will require integrating multiple legacy systems and potentially re-platforming to enable truly digitised processes. Simplification, digitisation and streamlining opportunities exist across large swaths of banking operations. The sooner banks tackle these opportunities, the more prepared they will be to compete with attackers that have a structurally lower cost base. For example, a European bank that redesigned its mortgage process cut processing costs in half and now completes offers in as little as 15 minutes, down from two to five days.

Transform the branch network: Branches will continue to play an important role, although a different one (and in some cases less relevant than today). Banks need to shift the branch's emphasis from servicing to advisory and sales. This will imply smaller branches with fewer employees at more accessible locations and, with in-branch technology for self and assisted servicing.

Use data and advanced analytics to drive revenue: Banks should be tapping their enormous stores of in-house data, including customer demographics, transaction and product usage and credit behaviour, to drive revenues through cross-selling, superior risk assessment and so on.

Deliver outstanding customer experiences[7]: Banking customers expect digital experiences on par with those they get from players such as Uber, Apple or Airbnb. Banks should go beyond copying their existing processes into digital forms. They need to adopt design thinking processes to understand their customers' needs and reimagine outstanding customer experiences, beyond the direct scope of financial products. The winners among digital banks will leverage this opportunity to create strong ecosystems of partnerships to deliver on customers' expectations for everyday usage features.

Build digital marketing capabilities that equal e-commerce players: Today, banks are in a fight for the customer, not only with other banks but also non-banks. The moats that have historically protected banks will not even begin to compensate for the wide gap in marketing skills between e-commerce players and banks. Big data and the advanced analytics capabilities described above are merely the foundation of digital marketing. Mastering digital media, content marketing, digital customer lifecycle management and marketing operations will be critical to banks' success. Building these capabilities, recruiting, and retaining digital marketing talent will also require considerable time and investment.

Set up a two-speed IT architecture: Traditional organisations weighed down by legacy back-end systems struggle to make improvements fast enough to keep pace with rising consumer expectations. To compete in the digital environment, banks will need two-speed architecture that accommodates a rapid customer-centric front-end running alongside a slower speed, transaction-focused legacy back-end.

Financial-services customers in the UAE and KSA are increasingly digital and, as our latest survey findings show, open to new digital propositions. The appetite for digital is likely to keep growing, so incumbents and new entrants need to move quickly to stake their claims in the new landscape.

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[7] Prashant Agarwal, Mahin Samadani, and Hugo Sarrazin, "What every executive needs to know about design", mckinsey.com, November 2015

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Acknowledgements

The authors would like to thank Abdulkader Lamaa (VP McKinsey Digital Labs), Sonia Barquin (consultant in McKinsey's Kuala Lumpur office), and Vinayak HV (Partner in McKinsey's Singapore office) for their contributions in helping to produce this report.

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Banking Practice
November 2016
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