



THE VIRTUES OF INCREMENTAL DIGITIZATION

WHY INCUMBENT BANKS WILL ULTIMATELY BE
THE BANKS OF THE FUTURE

Barrie Wilkinson

Banks have a cost problem. The costs of a typical bank represent anywhere from between 60 percent and 80 percent of its income. Add credit losses and fines to the mix, and little remains from income to return to shareholders.

That's one reason why the conventional wisdom among digital gurus is that it is only a matter of time before technology players with low-cost models disrupt the banking industry. Cursed by their incrementalist approach to innovation and cost cutting, incumbent banks are bound to fall behind.

We are skeptical of this pessimistic viewpoint. Incrementalism, we believe, can be a virtue, provided it is relentless. This is the lesson from many enterprises, including tech businesses. And incumbent banks enjoy important advantages over tech challengers. The bank of the future is likely to evolve from the bank of today.

THE LOW-COST BANK OF THE FUTURE

Banks already provide a good digital experience. Most people in developed economies have access to online and mobile banking. And, once you are set up, it's easy to transfer money, make payments, and gain access to new banking products.

The problem is not banks' digital offerings. It's that their operations continue to be labor-intensive. More than half the cost-base of a typical European bank is employee compensation.

Suspend reality for a moment and imagine that a new "Tech Bank" came onto the scene with technology that allowed it to operate with no employees. If all other costs and revenues were unchanged, the economics of banking would be transformed. The cost-to-income ratio would fall to about 30 percent, and return on equity would climb from the 3 percent to 5 percent range, to between 15 and 25 percent. The golden years

Relentless incrementalism is the right strategy for incumbent banks

of high banking returns would be back. But this time, the returns would be driven by efficiency rather than leverage. (See Exhibit 1.)

INCREMENTAL AUTOMATION

Further automation is unavoidable. If a process can be automated without a loss of performance, it is only a matter of time before a competitor or third party will make it happen. Cost pressures will force banks to follow suit or outsource the processes concerned.

But two misconceptions must be avoided. The first is that the end point will be full automation. Recent case studies suggest that the optimal approach to most processes brings humans and machines together to maximize performance and efficiency. Trying to automate beyond the current capabilities of "machine intelligence" can increase the need for human corrections and overrides to the point where costs actually rise.

Nevertheless, the optimal division of labor between humans and machines will keep shifting in the direction of machines, and bankers need to be on the lookout for new opportunities. Indeed, one is in the area of detecting and correcting errors in automated processes. This is now done

by humans, accounting for considerable employee time and cost. But it is amenable to a high degree of automation. Systems will always generate problems and, hence, extra work. But this extra work need not be done entirely by humans.

The second misconception is that extending automation requires a major project to overhaul the bank’s systems. Ambitious technology efforts at banks have a track record of failure. But the problem lies not so much with banks as with the revolutionary ambition. Incrementalism is a better strategy.

Dr. Dave Brailsford, the sports scientist who revolutionized British cycling, applied the concept of accumulating marginal gains. According to Dr. Brailsford, every mundane detail of a system needs to be analyzed for potential improvement. Each improvement might lead to only a tiny improvement in performance but, if there are enough of them, they add up to a substantial gain. And there are thousands of processes involved in banking, all of them improvable.

Even the best technology players, such as Uber and Amazon, have suffered from major systems and data problems on their path to greatness. They have succeeded by relentlessly optimizing every component of their workflow to the point where the whole platform delivers superior efficiency. From day one, these firms have displayed a commitment to the process of cumulative marginal gains.

CHALLENGER VERSUS INCUMBENT

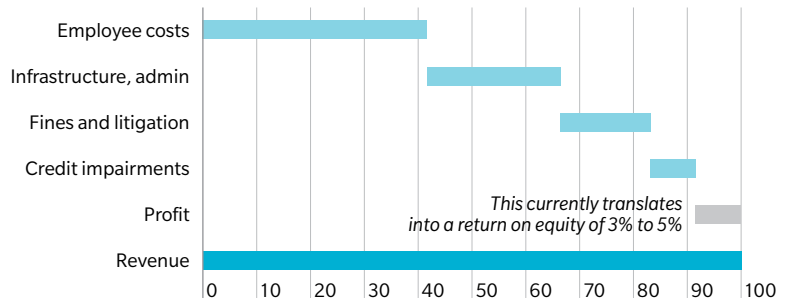
Some providers will eventually find a way of delivering a level of performance and efficiency that meets the needs of both customers and shareholders. The question is whether they will be mainly the familiar banking names or technology-driven challengers.

Technology players have some advantages. They lack the cumbersome legacy systems that cost incumbent banks so much to maintain and modify. They have a culture more conducive to technological innovation. And they lack the swathes of non-tech staff who, at banks, have a strong incentive to resist changes aimed at reducing headcount.

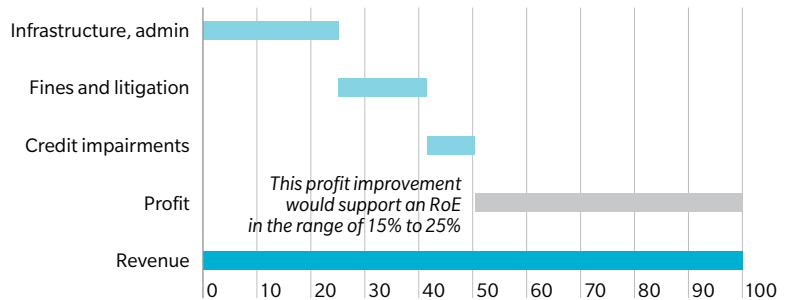
But these challenger advantages should not be overestimated. A few fintech players have succeeded in parts of the value chain, such as payments and currency transfers. But it is becoming clear that the core activities of deposit gathering and lending will continue to be dominated by licensed banks with access to central banking facilities and deposit insurance.

EXHIBIT 1: THE ANATOMY OF A BANK BEFORE AND AFTER DIGITIZATION

REVENUES, COSTS, AND PROFITS OF A TYPICAL EUROPEAN BANK



REVENUES, COSTS, AND PROFITS OF “TECH BANK” WITHOUT EMPLOYEES

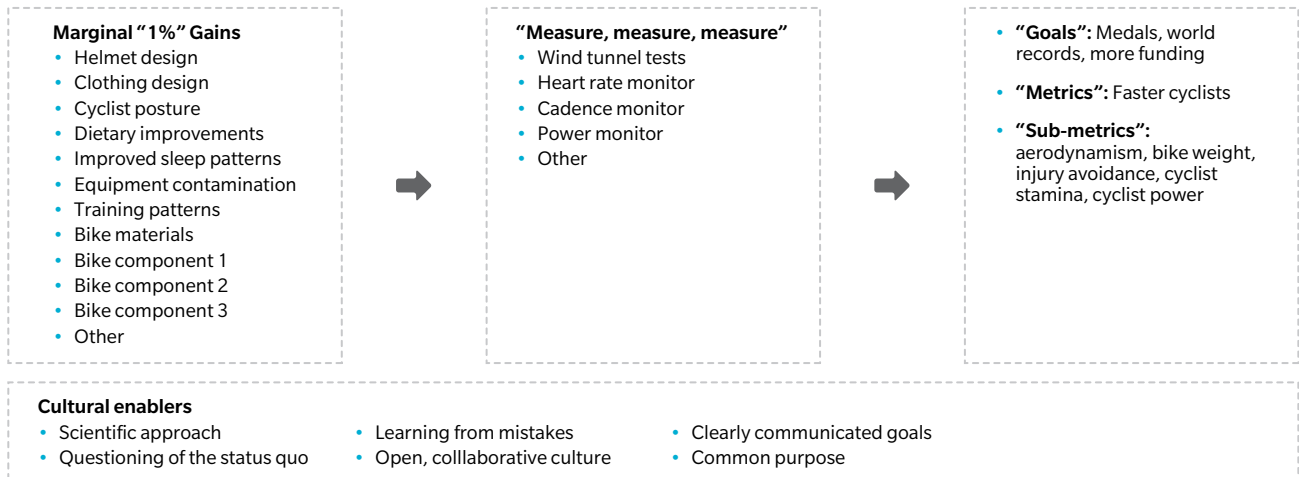
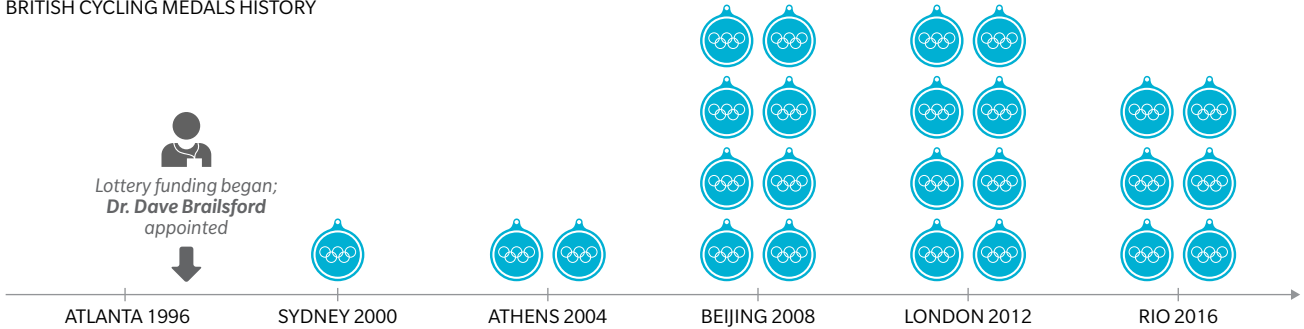


Source: Oliver Wyman Analysis

EXHIBIT 2: LESSONS FROM BRITISH CYCLING

TRANSFORMATION IS BEST ACHIEVED BY AN ACCUMULATION OF MARGINAL GAINS

BRITISH CYCLING MEDALS HISTORY



Newly licensed “challenger” banks are also struggling to achieve scale, partly because they lack brand recognition but also because they are discovering that banking is a difficult business. Challengers will find that regulations and customer demands pull them toward the cost structure of incumbent banks.

Technology will cut the cost of banking operations. But the transformation won’t come all at once and won’t cause a mass extinction of the incumbent banks. On the contrary, a relentless drive towards automation provides banks with their best prospect of achieving healthy and sustainable returns.

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