AN IDEA IN BRIEF

ROBO-ADVISOR: THE NEXT BIG THING IN BUNDLED CHECKING?

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AN IDEA IN BRIEF

The world of financial services is changing fast. Digital and data driven disruption is opening the doors to vast numbers of new possibilities, and both new entrants and incumbents alike are walking through. With the ‘Ideas in Brief’ series, Oliver Wyman highlights a range of new product innovations that could impact the landscape for banking and investing in the not too distant future. The papers are brief and meant to spark ideas and conversation – not to ‘prove’ a concept beyond a reasonable doubt. We hope you enjoy and are eager to discuss further with those interested.
EXECUTIVE SUMMARY

Automated portfolio management – also called robo-advice – could be a key part of the next stage in the evolution of banks’ core value proposition in checking. It is firmly established in wealth management, where many large wealth managers have launched robo offerings and others have announced their intention to do so. Bringing a robo-advisor to checking adds a natural, low-inertia, low-cost investment option for customers, and elegantly completes the liquidity-savings-investments trifecta. It naturally fits into a digital banking offering, which has strong appeal for millennials. Finally, as customers accumulate assets and their needs become more complex, banks should be able to realize the ‘option value’ of this product by ‘graduating’ customers into full-service advice offerings.

Banks should seriously consider redesigning their checking value proposition to include and emphasize this investment offering. This adaptation would help a client easily move an appropriate amount of her funds from low return (but safe) deposits into higher return (but riskier) investments that would be managed automatically. Subsequently, banks can consider establishing a service model that thoughtfully graduates customers to full-service advice offerings as their needs progress over time.

Sceptics will argue that migrating deposit balances to investment balances is a significant risk – and they would be right. But we believe that with a product that is appropriately designed and targeted, the true cannibalization would be minimal while the appeal to a segment of clients would be significant. The key implementation challenge would be to determine whether existing bankers can sell this ‘checking bundle’ without requiring to be licensed for providing financial advice – something we don’t have full clarity on at the time of writing.

An agile product development approach can enable banks to develop and pilot this offering quickly and refine it on the go. They can cut down the time to launch to just a few months and be in market with a very compelling offering.
THE ROBO-ADVISOR OFFERING

Robo-advisors provide financial advice and/or portfolio management with minimal human intervention. They are based on mathematical rules or algorithms, which automatically allocate and manage clients’ assets. Robo-advisors offer a unique “self-directed plus” experience – a client can manage her investments without doing significant research or trading. The algorithm makes asset allocation decisions based on her investing objectives and risk appetite. Her portfolio is automatically rebalanced and most algorithms also harvest it for tax losses.

The two most well-known independent robo-advisors are Wealthfront and Betterment, which have collectively gathered $12 billion in assets. Following their success, most large US wealth managers have either launched their own robo offering, or announced plans to do so. Charles Schwab, Fidelity, Bank of America Merrill Lynch and Vanguard have launched robo-advisors while Wells Fargo, Morgan Stanley and others have announced plans to do so. Most of these firms see robo-advice as another offering on the wealth management continuum, appealing either to the investor who values access to capital markets but does not have the skills or the time to invest on his or her own, or the investor who does not have the willingness or the ability to engage a financial advisor. Given the extremely low marginal costs to service these customers, a robo-advisor is also seen as a great way to acquire new clients. Collectively, robo-advisors are estimated to have more than $75 billion in assets – which may be less than 0.2% of investable assets in the US but is larger than many regional banks’ wealth management businesses.

The typical customer is a young, affluent investor – less than 35 years of age with less than $1 MM in investable assets. Older and wealthier investors currently prefer other service providers, though they are becoming more open to trying this out. See Exhibit 1 for a broad demographic comparison between Betterment customers and the overall US population.

Exhibit 1: Wealth distribution by age and investable assets

<table>
<thead>
<tr>
<th>AGE</th>
<th>Betterment</th>
<th>US population</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 50 years old</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>&lt; 50 years old</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>&gt; $1 MM in investable assets</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>&lt; $1 MM in investable assets</td>
<td>80%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: Betterment data is from various news reports. US population data is from the 2013 US Survey of Consumer Finances.

1 SEC ADV Part 2 filings
2 Robo-advisor websites, SEC ADV Part 2 filings, Statista Digital Market Outlook
BUNDLING WITH CHECKING

Banks have struggled to effectively serve their customers with investment products – the average bank has an investing relationship with only 10-12% of its affluent primary checking customers. This is driven by both demand and supply-side factors. Customers are perfectly content to get investing services from other, non-bank providers (like online brokerages) and it is expensive for banks to build out either an online brokerage offering or a full-service advice offering, so most of them have never even tried to win their customers’ investment business.

The advent of robo-advisors and agile development approaches change that dynamic. They make the ‘product’ relatively cheap and easy to create (or license from a third party) – with the promise of downstream updates and enhancements – and easier to integrate with a core checking offering (such as real-time payments functionality). One can imagine a bundled checking package which combines typical checking attributes with a robo-advisor – as part of a redesigned checking product suite. This also makes the core checking product more digital and increases its appeal to millennials.

The simplest use case on how this could work is as follows. A customer selects a checking package which includes a robo-advisor. She is prompted to fill out a simple questionnaire on her investing objectives and risk appetite. She allocates funds to be managed by the robo-advisor, and can set up automatic deposits from her checking account. Beyond this, a bank can add other functionality over time, such as aggregating other financial relationships, budgeting and spend management, and broader balance sheet advice.

So far, most robo-advisors have either attracted mass market customers or those more-affluent customers who want to give it a try with a small share of their assets. The average account balance at Betterment is $29,000, which translates to annual revenue of $72 – or 25% of revenues associated with the average DDA. Additionally, the gross margin on this revenue is extremely high, ROE is higher and there is tremendous option value in cultivating these relationships early on. As these customers’ affluence increases and their needs become more complex, the bank can make a very natural play to serve those needs.

It can be argued that a key risk of this approach is that deposits balances migrate to these accounts, which would reduce NIM and the bank’s funding capacity (and balance sheet). However, asset flows between banking and investing products are largely driven by macroeconomic factors such as interest rates and market volatility. A customer who decides to move money from his or her deposits account to a robo-advice offering would likely have done so anyway at another provider. As such, if a bank chooses to integrate a robo-advisor into a checking product suite, it will, by and large, provide convenience to its clients and steal wealth share from other providers. Is there still a risk here? Certainly. However we believe the risk of a stagnating value proposition is far greater and that the risk that does exist will be offset by careful design, targeting and piloting. Also, any cannibalization that does occur will be balanced against increased quality household growth and the ability to target these clients for additional deposits liquidity when needed (through promotional pricing or other means).

3 Oliver Wyman Survey of Consumer Finances. Includes households with more than $100K in investable assets
4 Assuming investment pricing of 0.25%. Average revenue per DDA based on Oliver Wyman Consumer Profit Pools
What, then, is the value to the consumer? Faster payments between the bank and the brokerage account is one simple benefit. But the biggest value is the ability of consumers to manage all their finances from one place, in a way that’s simple and intuitive. Consolidation plays have been tried before but they have not worked in the past since consumers have been willing to find the best provider for each product, but no one has also been able to create value from integration, which this offering does.

**CALL TO ACTION**

We believe that there are three key action items for banks to take advantage of this development. One is to redesign their checking value proposition to incorporate this offering as an option. This need not take long: an agile approach that combines research and iterative design can result in banks developing a working prototype in a matter of weeks and then testing it in-market with either employees or a subset of customers. Feedback can then be incorporated into the next iteration, enabling a full-scale launch in a matter of months.

The second action item is to establish a graduated service model for clients who adopt this bundled product, to ensure that the bank can proactively identify and serve their emerging wealth management needs. This includes developing triggers or client touch-points for ‘graduation’, and ensuring seamless engagement across different service models. Consumer banking and wealth management businesses typically operate in strong silos; this will provide a good reason to work across them. Wealth management businesses often complain about lack of referrals – in this case, they have it from day one of the customer’s relationship with the bank.

Lastly, banks need to figure out the right sales and distribution model. A purely digital play is an obvious option. They should explore whether they can sell it in branches with their existing sales force, since the cost to have new licensed experts will likely be prohibitive. There could be creative in-between models, e.g. customers can open the account in a branch on a self-service kiosk.

The next big thing in checking is here. It is up to banks to own it.
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