DIGITAL BANKING

The time is ripe, don’t spoil the opportunity

Bradley Kellum
Cosimo Schiavone
Tim de Vries
After mixed success in the late 1990s and early 2000s, digital banking has finally arrived. Buoyed by changes in customer behavior and maturing technology, digital banks are now leveraging a superior client experience and structural cost advantage to rapidly gain customers and deposits. Disruption does not always equal success, however. Without a compelling customer value proposition, sound monetization model and sharp execution, digital banks are more likely to destroy value than make profits at scale.

In this paper, we explore why the conditions are now right for digital banking, review current market plays and share key lessons for successfully building a digital bank.

**WHY NOW IS THE RIGHT TIME FOR DIGITAL BANKING**

Many firms have long held interest in digital banking; however, the first wave of digital banks that entered the market in the late 1990s and early 2000s mostly disappeared within a decade, either merging with more established players or shutting down altogether.

**Exhibit 1: Outcomes for the first wave digital banks**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>TeleBank</td>
<td>Launched in 1996, acquired by E*Trade in 2000</td>
</tr>
<tr>
<td>Eloan</td>
<td>Founded in 1997, acquired by Banco Popular in 2005</td>
</tr>
<tr>
<td>NextBank</td>
<td>Launched in 1999, closed by regulators in 2002</td>
</tr>
<tr>
<td>ING Direct</td>
<td>Launched in 2000, sold to Capital One in 2012</td>
</tr>
</tbody>
</table>

A winning business strategy requires three critical components: (1) customers, (2) a compelling value proposition and (3) a strong monetization model. Early entrants struggled with all of them (except possibly ING Direct, though it ended up being acquired by Capital One). While many factors contributed to the demise of the early internet banks, arguably a combination of limited customer adoption and nascent technology impacted their success most greatly.

The world has changed significantly in the past nearly two decades:

- Digital-only banks now represent ~7 percent of US consumer liquid deposits
- Digital lenders account for ~40 percent of all unsecured personal loans
- Non-bank (including digital) lenders originate over 35 percent of mortgages (and Quicken Loans became the largest originator in 2020)

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1 Federal Reserve Bank of St. Louis; Inside Mortgage Finance; Nilson Report; Call reports (via SNL); Oliver Wyman analysis.
Banking is ripe for further disruption — from favorable changes in consumer preferences and market dynamics — to a supportive regulatory environment, and advances in banking technology and enabling infrastructure.

**Customer preferences**

Customers have embraced digital models across industries, the best of which have created premium new experiences rather than simply re-creating traditional ones digitally. At the same time, incumbent banks lag with respect to customer engagement (reflected in Net Promoter Score — see Exhibit 2) making them vulnerable to new competitors.

**Exhibit 2: Average Net Promoter Score for select industries**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Average Net Promoter Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Digital/Direct</td>
<td>34.9</td>
</tr>
<tr>
<td>Multi-channel</td>
<td>30.8</td>
</tr>
</tbody>
</table>

Source: Forrester Net Promoter Benchmarks (2020) of 250 organizations across 14 industries

The current COVID-19 pandemic has further accelerated customer trust in and adoption of digital. In a recent survey over 50 percent of consumers said they had increased their usage of digital channels during COVID-19. 90 percent of consumers said they would continue to do so after the pandemic.²

**Market Dynamics**

The low rate environment has reduced the value of deposits (see Exhibit 3), creating pressure on incumbent economics (given heavy reliance on interest income), and challenging traditional bank business models.

**Exhibit 3: Average retail deposit margin of three leading banks over time**

Deposit margin = Value of deposit funding to the bank minus rate paid to customers

<table>
<thead>
<tr>
<th>Year</th>
<th>Deposit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>3%</td>
</tr>
<tr>
<td>2020 Q2</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Source: Oliver Wyman research on bank public disclosures for three leading banks that report deposit metrics over time

Regulatory environment
The regulatory stance toward new bank charters has also markedly changed over the past decade. While just nine bank charters were approved in the five-year period between 2011-2016, banking regulators have approved more than 45 new bank charters over the past four years. Note: it is possible that the recent change of the US administration will impact the regulatory environment in the future, but no change in this trend is yet definitive.

Technology and infrastructure
Ubiquitous high-speed internet, the proliferation of powerful smartphones with extensive app “supermarkets”, the availability of external-facing APIs and the adoption of open banking principles have lowered switching costs and reduced friction for many customer journeys (for example, account opening, money movement). At the same time, vendors of low cost, modern core platforms which began gaining traction in Europe several years ago have now turned their attention to the US market (see Exhibit 4).

Exhibit 4: New installations of US challenger core platforms

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>1</td>
</tr>
<tr>
<td>2015</td>
<td>0</td>
</tr>
<tr>
<td>2016</td>
<td>1</td>
</tr>
<tr>
<td>2017</td>
<td>2</td>
</tr>
<tr>
<td>2018</td>
<td>2</td>
</tr>
<tr>
<td>2019</td>
<td>6</td>
</tr>
<tr>
<td>2020</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: Oliver Wyman analysis

A rich ecosystem of partners now exists to enable challengers to build digital banking platforms rapidly and cost effectively by leveraging best-of-breed technology while focusing proprietary development on differentiating capabilities (for example, UX/UI).

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3 Federal Deposit Insurance Corporation (FDIC) https://www.fdic.gov
These changes have resulted in erosion of economics for incumbents. For example, the 280 bps all-in cost of deposits advantage of incumbents vs. digital players in 2007 has eroded to only 20 bps in 2020 (see Exhibit 5).

Exhibit 5: All-in cost of deposits (Interest Expense - Fees + Operating Expense) by bank model
Basis points (BPS) of deposit balance

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Digital leader</td>
<td>280</td>
<td>20</td>
</tr>
<tr>
<td>Incumbent leader</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Oliver Wyman analysis based on public financials of leading US banks

Secular trends strongly support digital banking

<table>
<thead>
<tr>
<th>Historical headwinds</th>
<th>Current tailwinds</th>
</tr>
</thead>
</table>
| **Customer preferences** | • Customer dependence upon cash and checks; and therefore, value of the convenience of the physical location/infrastructure  
• Adoption of mobile banking (as primary method of accessing bank) <6% in 2013 | • Increased customer expectations for convenience and speed driven by experiences with large retail digital platforms  
• Increased consumer trust and adoption of electronic payments and a digital experience  
• Adoption of mobile banking (as primary method of accessing bank) at 34% in 2019; COVID-19 has further accelerated digital adoption |
| **Market dynamics** | • Relatively higher base interest rates and significant demand for deposit liquidity pushed up the cost of ‘rate-driven’ deposits | • Historically low base interest rates and massive inflow of deposits during COVID has reduced rate paid on digital savings deposits 90% vs. the mid-2000s and 60% vs. the pre-COVID period |
| **Regulatory environment** | • Challenging regulatory environment — only nine bank charter approvals between 2011-2016 | • Supportive regulatory environment — more than 45 bank charters approved in the last four years (note: may shift back with the change in US administration, but still uncertain) |
| **Technology & infrastructure** | • Installed software and web browser limited UX  
• Expensive, legacy banking platforms with limited mobile capabilities  
• High operating costs, even for digital-only banks | • APIs and open-banking principles  
• Flexible and modularized core banking platforms combined with cloud computing efficiency and scalability  
• Proliferation of key FinTech enablers for security, onboarding, etc.  
• Ubiquity of apps, powerful mobile phones, high speed mobile internet |

Source: Federal Deposit Insurance Corporation (FDIC) https://www.fdic.gov; Oliver Wyman research
NEW DIGITAL CHALLENGERS HAVE EMERGED

Digital challengers are rapidly gaining prominence in the US market, with new entrants such as Chime (8MM accounts), MoneyLion (5MM app users) and Varo (1MM users) attracting a large number of customers; and players such as Marcus by Goldman Sachs gathering large volume of deposits ($97BN).4

With operating costs per account less than one-third of traditional banks — and no historical profits to cannibalize, challengers are weaponizing cost advantage to disrupt incumbents through higher deposit rates and lower or no-account fees (see Exhibit 6).

Exhibit 6: Challengers are offering better product terms enabled by lower operating cost

![Exhibit 6: Challengers are offering better product terms enabled by lower operating cost](chart.png)

Source: Oliver Wyman analysis

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4 Public disclosures Q3 2020.

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We observe four digital banking plays in the marketplace competing respectively on price, rate, experience, and brand. Players include FinTechs (for example, Chime, Monzo, Revolut), incumbents (for example, Citizens Access a division of Citizens Bank, PurePoint by MUFG Union Bank, etc.) as well as non-FS firms (for example, Google, Apple, etc.) (see Exhibit 7).

**Exhibit 7: Digital banking plays in the marketplace**

<table>
<thead>
<tr>
<th>DIGITAL BANKS</th>
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- **Compete on price**  
  - Eliminate transaction account fees

- **Compete on rate**  
  - Attract savings accounts with high interest rates

- **Compete on experience**  
  - Build a deep customer experience for specific customer segment

- **Compete on brand**  
  - Jump to an adjacent product space with fresh perspective

Across all of these options, we are seeing customers responding favorably. Compared to traditional banks, digital challengers have more satisfied customers (see Exhibit 8).

**Exhibit 8: Net Promoter Score**

<table>
<thead>
<tr>
<th>Leading challenger bank</th>
<th>70+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average for traditional banks (multi-channel)</td>
<td>19</td>
</tr>
</tbody>
</table>

Source: Forrester Net Promoter Benchmarks (2020) of 250 organizations across 14 industries; Oliver Wyman research and analysis

**Will new challengers succeed?**

Despite high marks from customers, it is too early to tell whether the new disruptors will succeed in creating significant enterprise value. Measured against the three critical components for a winning business strategy — (1) customers, (2) a compelling value proposition and (3) a strong monetization model — we see good progress on the first two, but the economics of current digital banks remain challenging.
Players competing on rates (for example, with high-yield savings accounts) need to capture more of the client relationship (and lending wallet) to improve overall business profitability, while those with an interchange-dominant revenue model have yet to demonstrate an effective asset generating capability.

Deepening client relationship is not easy — many incumbents have struggled for many years: challengers need to develop a business plan which is credible and realistic on how they will generate the fee income or net interest margin that will lead to economic success. For challengers that already have an asset business (e.g., a consumer lending franchise that they would like to be able to hold themselves instead of securitizing) this is relatively easier, although they will need to ensure appropriate diversification and risk management capabilities. For those that don't have an asset side yet, it is becoming clear that it is very difficult to generate fee income at scale, and therefore most likely will need to have a very clear asset strategy to generate strong economics. There is no one-size-fits-all approach: the asset strategy will need to be tailored to the challenger’s unique preferences and capabilities, as well as fit into its broader value proposition and the needs of its target audience. Exhibit 9 below shows a sample framework for evaluating the attractiveness of different assets looking at overall economics and market competition.

Exhibit 9: Asset selection — illustrative assessment framework

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Economics</th>
<th>Level of Competition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Card</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Personal</td>
<td>High</td>
<td>Medium</td>
</tr>
<tr>
<td>Home Equity Lines of Credit/ Home Equity (HELOC/HE)</td>
<td>Medium</td>
<td>Low/Medium</td>
</tr>
<tr>
<td>Mortgages (on balance sheet)</td>
<td>Low/Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Indirect Auto</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Student Loan Refinance</td>
<td>Low</td>
<td>Medium</td>
</tr>
</tbody>
</table>

Note: High, Medium, Low refer to relative levels between the asset classes
Source: Oliver Wyman analysis
KEY LESSONS FOR SUCCESSFULLY BUILDING A DIGITAL BANK

Building a successful digital bank is a complex affair. The journey starts with defining clear objectives for the digital bank/banking offerings (for example, access additional deposit funding; access a new customer group; increase stickiness of existing relationships); and then developing a clear strategy and compelling business case. Some of the most important questions to answer early on include:

• What is the level of ambition and target state (for example, full-service bank, monoline specialist)?
• What key customer needs will the bank address?
• What does the firm’s brand stand for within the core customer segments? Is a new brand required?
• What is the initial ‘beachhead’ that will provide sufficient economics to power further business growth?
• What is a compelling and differentiated value proposition (that may include products, services, experiences, and advice) and what are the associated economics?
• What is the right approach for market entry (for example, strategic partnerships, build/buy bank license)?

Bank sponsors must understand and demonstrate the purpose for the bank and benefits to the community, as well as how they will operate the bank in a safe and sound manner that protects the sanctity of the bank charter. Following development of the strategy and business case, firms should design and detail the bank operating model to specify exactly how the institution will function.

This includes a wide range of activities and considerations such as:

• Developing a marketing plan.
• Identifying the management team and overall staffing plan.
• Designing key business processes.
• Selecting technology systems and contracting with providers.
• Defining a sound approach for capital, liquidity and balance management.
• Creating an overall risk framework (that includes the second and third lines of defense); identifying key financial and operational risks given the bank’s mix of customers, products and services and establishing mitigating controls.
• Developing a sufficiently detailed and well supported financial model and stress scenarios to demonstrate appropriate levels of capital and liquidity under a variety of market and firm conditions.

This work can be organized across six key workstreams as illustrated in Exhibit 10.
Having a structured process on all of these areas is critical to get this right from the beginning. Oliver Wyman has helped multiple organizations (for example, greenfield digital banks, large domestic banks, wealth managers, insurers, foreign financial services firms) create and bring new banking offerings to market quickly — and we have created a playbook for each of the above workstreams. By way of example, we take a “Customer First” approach to help clients create compelling value propositions that focuses on: identifying specific client segments, targeting/ addressing big unmet needs (see Exhibit 11), and creating client value.
Exhibit 11: Customer financial needs with examples of solutions areas

- **Grow**
  - High-yield deposits products
  - No/low fee brokerage accounts and robo-advisory

- **Safeguard**
  - Insurance aggregators
  - Lower cost and/or better insurance solutions

- **Borrow**
  - Low-rate student loans
  - Low-rate mortgages

- **Earn**
  - Incremental earnings opportunities
  - Early access to wages
  - No fee, no overdraft transactional account
  - Budgeting tools to monitor spend

- **Transfer**
  - Low FX fees for international money transfer
  - Instant and easy transfer of money

**Legend**:
- Traditional FS needs
- Non-Traditional FS needs

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Starting with an initial ‘beachhead’, leading firms create a ‘flywheel’ of products and services with engaging customer experiences to increase customer stickiness and strengthen business economics. Exhibit 12 illustrates a representative ‘flywheel’ that builds upon an initial ‘beachhead’ of a high-yield savings product.

Exhibit 12: Illustrative ‘beachhead’ and ‘flywheel’

<table>
<thead>
<tr>
<th>Phase &amp; Timing</th>
<th>Products</th>
<th>Experience</th>
<th>Channels</th>
</tr>
</thead>
</table>
| **Phase 1 — Establish the beachhead**  
Years 1-2 | • Limited set of products, (e.g., high yield savings with top of market rates) | • Core digital bank features (e.g., streamlined account opening, P2P payments, PFM tools) | • Bank owned  
• Deposit aggregators |
| **Phase 2 — Broaden and deepen relationships**  
Years 2-3 | • Additional core products to deepen existing relationships and attract new customers  
• Product bundle discounts  
• Gradual transition to market average rate for HYSA | • Enhanced features and overall customer experience (e.g., customization, rewards) | • Add strategic partners |
| **Phase 3 — Expand the audience**  
Years 3+ | • Product expansion and potentially broadening of the customer base (outside of the target audience)  
• Other solutions areas (e.g., investments, insurance) | | • White-label to other partners |
FIVE KEY SUCCESS FACTORS FOR BUILDING A DIGITAL BANK

In closing, we offer five key success factors for building a digital bank:

1. Develop a clear strategy and business case

Pursuing a simple ‘me too’ approach or focusing on deposit gathering without a cogent asset strategy is not a road to success. Pick your spots and focus energy and resources to win in the marketplace and deliver strong business economics.

2. Design a differentiated, client needs-driven value proposition

Create and don't extract client value by addressing clients’ needs through a combination of client experiences, tailored products and services and value-based pricing. Design journeys that satisfy and delight; and develop supporting processes with the customer in mind. Develop an authentic brand that creates a connection with clients, communicates what you do, and creates trust and inspires loyalty; deliver the brand through actions and client experiences to differentiate in a crowded marketplace.

3. Understand available implementation options (build, buy or partner) and adopt a disciplined stage-gate approach to de-risk execution

Not every firm needs to own a bank; a number of successful Fintechs have executed effective strategies through carefully structured relationships with bank providers and best-of-breed technology partners. There is no one right option, the best choice for each firm will depend on a range of factors including its starting point, level of ambition, strategic and cultural fit, availability of resources (human capital, capital and investment dollars) and risk appetite. Focus proprietary development on differentiating capabilities to accelerate time to market and achieve required operational efficiencies. Rapidly prototype concepts to test and refine propositions and build conviction before migrating from design to execution.

4. If you decide you want a digital bank, bring in the expertise needed to run it

Many FinTechs have struggled to gain approval for a banking license due to a lack of understanding of the complexity of the process, a lack of credible, senior banking talent, and an incompatibility between a ‘fail fast, fix it’ culture and the ‘don’t break it’ banking regulator mindset or lack of deep banking expertise. To succeed, ensure that you are prepared for a robust and structured process and that you have the employees and advisors necessary to both prepare the application and run the bank.

5. Always put the customer first

Make sure not to lose the “customer first” aspect over time, particularly as you scale — and design the operating model accordingly. Some large organizations got into major troubles for failing to do so.

The time is ripe for digital banking, don’t spoil the opportunity. Players that execute well have the potential to enjoy superior economics and structural cost advantages over many incumbents, while firms that delay or fail to develop a sound monetization model may ultimately share the same fate as the first wave disruptors.
HOW WE CAN HELP

We can help organizations bring differentiated digitally enabled financial services propositions to market quickly through our integrated approach to strategy and business model design; client experience and value proposition development; brand design & marketing; governance, financial and risk management; technology and operating model set-up (including vendor selection, architecture blueprinting); bank chartering and regulatory guidance; and build/launch support including building bespoke components.
Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information, please contact the marketing department by phone at one of the following locations:

<table>
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<th>Region</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Americas</td>
<td>+1 212 541 8100</td>
</tr>
<tr>
<td>EMEA</td>
<td>+44 20 7333 8333</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>+65 6510 9700</td>
</tr>
</tbody>
</table>

AUTHORS

Bradley Kellum
Partner
bradley.kellum@oliverwyman.com

Cosimo Schiavone
Principal
cosimo.schiavone@oliverwyman.com

Tim de Vries
Principal
tim.devries@oliverwyman.com