VIEW POINT

DIGITAL-ONLY BANKS – THE NEXT IN BANKING

Abstract

Digital-only Banks have heralded a new chapter in banking on the back of digital technologies and a unique value proposition. In the backdrop of enabling regulation, these banks have taken bold steps towards growth and expansion while sharpening focus on distinctive customer experience and optimized product offerings. While challenges remain, how these banks navigate their next will be key to their sustenance, scale, and success.

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Introduction

The business of banking is undergoing significant changes today. Products built with latest technologies are seeing significant traction with customers. With adoption of these new age offerings, customer's behaviors and expectations are changing – and with it the Banking business and operating models.

Digital-only banks, unlike the previous generation brick and mortar and direct banks, are exploiting mobility and digital technologies to deliver hyper-distinctive customer-centric experiences. Customer onboarding, communication and servicing are being handled entirely through digital touchpoints. The rising penetration of internet and smartphones is helping augment this end-to-end digital model further.

In a relatively short span of time, these banks have been able to carve out a niche market for themselves. Various online-only banks have grown by providing fee-free banking services, hence appealing to a mass customer base. Higher interest rates on the back of a lower cost model, 24x7 accessibility, financial planning functionalities and personalization have brought about acceptability and penetration. Supportive regulation and unified API integration have further enhanced the growth of the neo and challenger bank market.

Despite all the potential advantages for the Digital-only banks and the end customer, this space remains a tough space to operate in. A pandemic induced decline in discretionary spending and propensity to shift deposits to the larger and perceived safer traditional banks8, has only made the battle for the customer wallet harder. However, the rush to enter the segment and chase the accompanying value proposition, remains unabated.

Understanding the gold rush

Digital only Banks are digital end-to-end. Unlike their traditional counterparts, these banks are not constrained by siloed systems, tightly coupled value chains, hierarchal organizational structures, and complex regulations. Their architecture enables access to customer ecosystems, yielding significant benefits in terms of data.

The digital business models and slimmed-down operations help lower the costs of serving customers. Once established, these banks can generate better returns at a lower per customer cost than incumbent players.

The all-digital lean back-office model receives a further boost from the front-end channel – not a Branch or ATM kiosk but the omnipresent smartphone. It is not a channel, but the channel. The exponential growth in smartphone penetration coupled with leveraging of digital technologies make the Digital only Banking model a win-win proposition.

What is in it for the customer?

Superior interest rates on the back of a lower cost base have been an attraction for a vast majority of the customer base, augmented by a seamless and paperless onboarding process. From N26[1] letting customers sign up for an account by verifying their identity with a supported ID via a video call to Tide[1] in the UK and Azlo[1] in the US providing a fast and fully digital account signup and onboarding on mobile, Digital-only Banks have heralded a completely swift and seamless customer experience.

The banks have enhanced this seamless customer experience proposition by making Money Management an intrinsic part of the offering. Instead of keeping it as a separate service, Digital only Banks help customers generate a consolidated view of their financials facilitating prudential savings management. Australia's UBank[1] has pioneered this, offering customers personalized financial insights, contextual alerts, and sophisticated tools to manage their money. Simple[1] in the US helps customers manage their cash flow with tracking and budgeting tools.

At a macro level, digital banks aim to capture, analyze, and use demographic and transactional data residing with the bank, coupled with the customer's external digital footprints, to improve customer experience and optimize product offerings. Digital banks like Tinkoff[1] in Russia have set up analytics infrastructures and built large data teams to make insights-driven decisions and develop customer-centric products. Simplicity lies at the core of most digital banks' customer propositions.

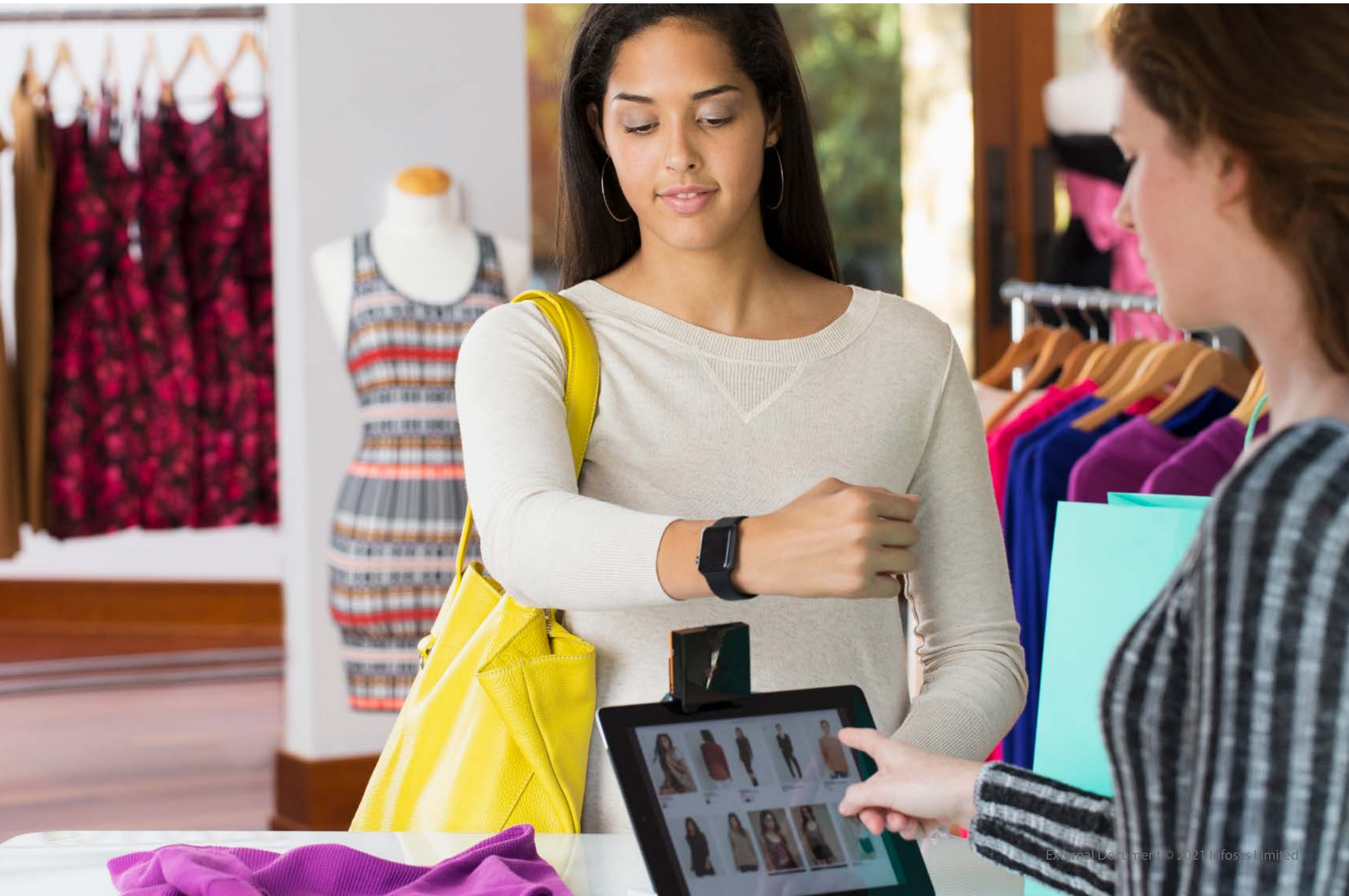
Digital only Banks also serve another segment – those underserved or overlooked by the traditional banking system. Segments like small businesses, often do not get their needs sufficiently fulfilled by the existing banking system thus creating space for Digital-only Banks to step in. The convenience of opening accounts, seamless payments and remittance solutions, easy to deploy APIs and alternative credit scoring methods are features that are attractive to small businesses, underbanked customers and freelance workers. One of the reasons for Revolut's[1] success is its offering of foreign exchange at interbank exchange rates. Another example is of UK-based Monese[1] which helps immigrants and freelancers by making it easy to open and manage a current account through an app.

The growth trajectory

European regulations make it easier for digital banks to enter multiple European countries. Hello1 bank operates in five European countries. N26[1], which launched in Germany and Austria at the start of 2015, now operates in 24 countries. Australian Prudential Regulation Authority[1] introduced a new licensing framework.

With the backdrop of enabling regulation, Digital-only Banks have taken bold steps towards growth and expansion stepping up product launches, partnerships, and collaboration.

Revolut Mar-2020	Revolut[2] entered a partnership with Metropolitan Commercial Bank under which Revolut launched its financial super app, an innovative digital banking platform used by 10 million people globally, to customers in the US.
Dec 2020	Revolut[2] shifted gears from a mobile-only to an online model. This allows its 13 million customers around the world to access their accounts from a desktop PC or laptop.
Jan 2021	Revolut[1] applied for a UK Banking licence, followed by filing a draft application for a US Banking licence.
N26 June 2020	N26[2] expanded the scope of its partnership with TransferWise, a global remittance leader. The partnership aims to offer a wide spectrum of options for foreign currency transfers.
Nov 2020	N26[2] has introduced a subscription-based model which helps individuals and businesses manage their financial corpus in a better manner integrating new financial management features. Subscription solutions, N26 Smart and N26 Business provide these features in the form of roundups and dedicated call support.
Atom Nov 2020	Atom[2] formed an alliance with Codat, an API platform connecting small enterprises to banks and financial service companies. Under this, Codat delivers their API, which allows Atom to connect with customer's accounting systems obviating the requirement for manual intervention.



Challenges

Despite all the positives, Digital only Banks continue to have their own share of challenges. Covid-19, which has accelerated digitization and increased affinity for touchless banking, surprisingly did not boost the prospects of Digital only Banks. The crisis instead made customers lean towards traditional banks, for the perceived greater trust and security the 'too big to fail' banks offer. Add to this low interest rates[6] fueled by surplus liquidity, and the consequent lack of rate competitiveness led to a further decline in adoption and penetration rates in this segment.

The challenges that these new age banks face today do not stop here. The larger and pervasive challenge for this space remains to be achieving profitable scale. Scale requires efficient customer acquisition and onboarding – relying on viral marketing, and customers embracing digital sales and onboarding.

Being digital only, the need for customer checking account and transaction security is paramount. This entails large cybersecurity outlays, which are often not available. Digital-only Banks incur a higher cost for some operations such as fraud management, and there is an urgent need to reduce cost of operations for such processes.

Also, building a digital brand is a long gestation exercise, and requires continuous investments in marketing. Online-only banks rely on funding in their initial growth stages and cannot sustain large marketing campaigns. These banks are dependent on use of social technologies and networking effects to drive growth.

Last but not the least, is customer mindset. Winning the customer entails not just account opening but maintaining a healthy balance and active usage of the account too. A longer and more arduous journey involves the digital only account moving up as the primary account[7] and banking relationship of the customer, from its typically 'secondary to primary bank' status.

Being a successful Digital-only Bank

Digital Only Banks present a vast plethora of opportunities and can bring different opportunities to different players. Regional banks can spawn a Digital-only Bank to spread beyond their existing geo, while national and well-established banks can use the opportunity to launch new products, differentiated from their traditional identity. Hitherto lower banked segments like gig workers and immigrants too can be tapped. Standing out with a sustainable business model entails the following:

- **The licensing homework**: Banking remains a tightly regulated industry. To succeed, prospect banks need to be prepared for rigorous licensing scrutiny and demonstrate that their business case can deliver on the ground. Well chalked out alliances with partner banks are an essential component to provide deposit accounts, cards, and lending products.
- **Early revenue generation**: Successful digital banks maintain a sharp focus on revenue enhancing products, including loans, money transfer services and third-party offerings. Revenue, margins, and a growing customer base are at the heart of building a successful venture.
- **Cost efficiency**: An existing and active customer base does away with the need to spend on customer acquisition. Availability and access to data enables improved targeting and marketing campaign optimization. Online-only models leveraging digital technologies such as AI and RPA substantially decrease cost-to-serve. We Bank and XW Bank[4] reported healthy efficiency ratios (2019 cost-to-income ratios of 25 percent and 23 percent respectively), amongst global Digital-only Bank peers.
- **Ecosystem play**: Digital-only Banks can build traction when they can offer a complete suite of financial offerings under one umbrella. Alliances with adjacent players and ecosystems play a vital role here. Starling[1] uses APIs to offer services from partners like Tail for cash back or Moneybox for micro saving, as well as enabling direct product offers in its marketplace, such as travel insurance from KASKO. Participating in eco systems also gives, in parallel, access to a broad set of ecosystem customers, further growing the customer base.
- **Monetize key assets**: Additional revenues can be generated by allowing use of white-labelled pre-packaged products and services to other organizations. Moven[5], a popular FinTech, offers expense-tracking solutions that can be plugged into mobile apps of other Banks. It is working with TD Canada and Westpac New Zealand successfully piloting a B2B2C model to offer these solutions in its non-target market.
- **Truly augmenting Customer experience**: A sleek customer interface alone does not form a Digital-only Bank's value proposition. Since Digital-only banks have no brick-and-mortar presence, their online customer experience needs to be truly exceptional to compete with traditional banks. Their mobile and web applications must provide for a complete range of transactions and customer support activities with no need felt of a manual or branch intervention.
- **Assisted Channel support**: While Online-only Banks are built on a DIY model, the provision of support services through social media, online chat and e-mail can help provide customer support where pure automated customer service may not deliver. Adding advice and guidance services to money management functionalities can be an additional revenue stream.

Conclusion

With growing competition among traditional players, FinTechs, and non-banking participants, it remains to be seen whether there is enough room for Digital-only Banks to grow and thrive sustainably. How these banks pivot from managing key obstacles in terms of data compliance, cyber security, and product portfolio expansion to re-imagining the next in banking will be crucial for their success.

About the author

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Akshay has over 14 years of experience in the Banking & Financial Services domain, with significant experience in Consumer Banking and Digital Payments. He has worked in multiple roles across Pre-Sales and Process & Domain consulting.

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Glossary of Terms

API	Application Programming Interface
AI	Artificial Intelligence
DIY	Do it Yourself
RPA	Robotic Process Automation

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