FIG in Focus

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Analysing Banks of the Future

Welcome to FIG in Focus, a collection of Insight pieces focusing on Financial Institutions Group world from Adeva Partners.

This month we are focusing on the impact of digitalisation, whilst looking at how credit analysts should be analysing banks of the future.

In this article, we shall explore how much time we should spend reviewing whether the bank's business model is "fit for purpose" in the new digital future.

What we will cover:

- How to consider digitalisation during credit analysis
- What factors are working in a bank's favour
- DBS 'Bank of the Future' case study
- What other factors to consider

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Analysing Banks of the Future

Credit analysts focus much of their effort on spotting financial early warning signals, such as growth in bad loans, funding vulnerability or weak capitalisation.

Digital giants and fintech start-ups are luring away customers with dynamic products and attractive pricing. Many banks are struggling to compete as they have high cost-bases due to legacy branch networks, higher regulation and inefficient technology. Low interest rates and more competition means banks may have to pay more to attract stable deposits and charge less for lending and other services.

New Competition in 2020's

Fintech Companies

Non-bank Lenders

Insurance Companies

Big Tech Companies

Money Market Funds

Perhaps we should be incorporating the following thoughts into our credit analysis:

- How developed is the digital economy in the local marketplace? China has the most developed fintech competition with AliPay and Weixin Pay controlling 80% of the consumer market. The US banking system has been slow to innovate due to the dominance of the credit and debit cards but Apple Pay and Google Pay are growing fast.
- How dependent is the bank on fee revenues from payments, card services, FX etc.? European large banks generate c. 8% of revenues from payments but this varies widely. Despite its large credit card business, Citi is not too dependent on inter-change fees (1% of revenue) whereas Capital One is (11% of revenue).
- What is the bank doing to attract, retain and cross-sell to customers? e.g. partnerships with eCommerce and other digital operators; social media engagement; faster customer journeys.

There are several factors working in a bank's favour.

- Most digitalisation still occurs via the banking system infrastructure and so (at least for now) the tech firms partner with banks.
- When compared to other financial companies, banks have stable, long term client bases with huge amounts of data and good reputations for privacy. Used properly, the data would permit the banks to design new products and improve service.
- Fintechs are increasingly facing regulatory scrutiny leading to more balanced competition.

Most banks are investing heavily in their digital infrastructure. IT spend of 9% revenues is typical. Most have also benefited from a COVID induced increase in the use of virtual and digital services.

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Case Study: DBS - a Bank Leading the Way

DBS in Singapore has won awards for its innovation. It seeks to "become a tech company" with the growth and innovation mindset that involves. Within the past decade they have created an inclusive and efficient banking culture through their investment in digital, allowing DBS to 'step up' at a time of economic uncertainty and growing customer needs.

A few key metrics stand out for DBS:

- % Digital customers: 57% (defined as customers who conduct > 50% transactions digitally and / or by a product via a digital channel)
- Revenue from digital customers: 2 X revenue from traditional customers
- RoE digital segment: 24% vs 12% for traditional customers
- Digital cost / income ratio: 38% vs 67% for traditional customers

It would be good to see more banks reporting such metrics.

So, what has DBS done to become a digital disrupter?

DBS embraced digital technology into all areas of the business; they went through a full digital transformation. One of the main areas they led in is becoming data-led in their infrastructure and governance. They applied digital to the heart of their ecosystems, embracing API platforms. They had to ensure their business mindset was more like a 'tech company' than a bank; agile and focused on growth. Investment was made in ensuring transactions and processes were automated while engagement with customers and potential customers was via digital channels, like social media. Customer acquisition was targeted through digital channels. They were able to segment their audience via behaviours, making their marketing, data driven and therefore more effective and tactical.

Banks which succeed in building a true tech mindset combined with a traditionally loyal customer base have a bright future.

They can adapt to customer needs quicker, use data to drive decisions and are more efficient for transactions, making it more profitable to service customers. All this will be very appealing to generation Z customers and start-up businesses, making them appear to be one of the banks of the future.

Further reading: World's Best Banks 2020: DBS Honored As World's Best Bank | Global Finance Magazine (gfmag.com)

Analysing Banks of the Future

Is the bank's business model "fit for purpose"?

Business Model
- Strategy
- Key activities
- Financial drivers
- Risk drivers

It is also important to consider digitalisation when evaluating the bank's business model.

- Is the bank well positioned to manage the opportunities and threats in its environment?
- Consider diversity, stability and risk profile of the business model and key competitive advantages of the franchise. Does digitalisation help in these areas or hinder?

Citi's 'Bank of the Future – The ABCs of Digital Disruption' report has a useful framework in analysing a bank's propensity to adapt to digital.

A – Artificial Intelligence
B – Big Tech
C – Core Banking, Cloud & Challenges
D – Digital Assets

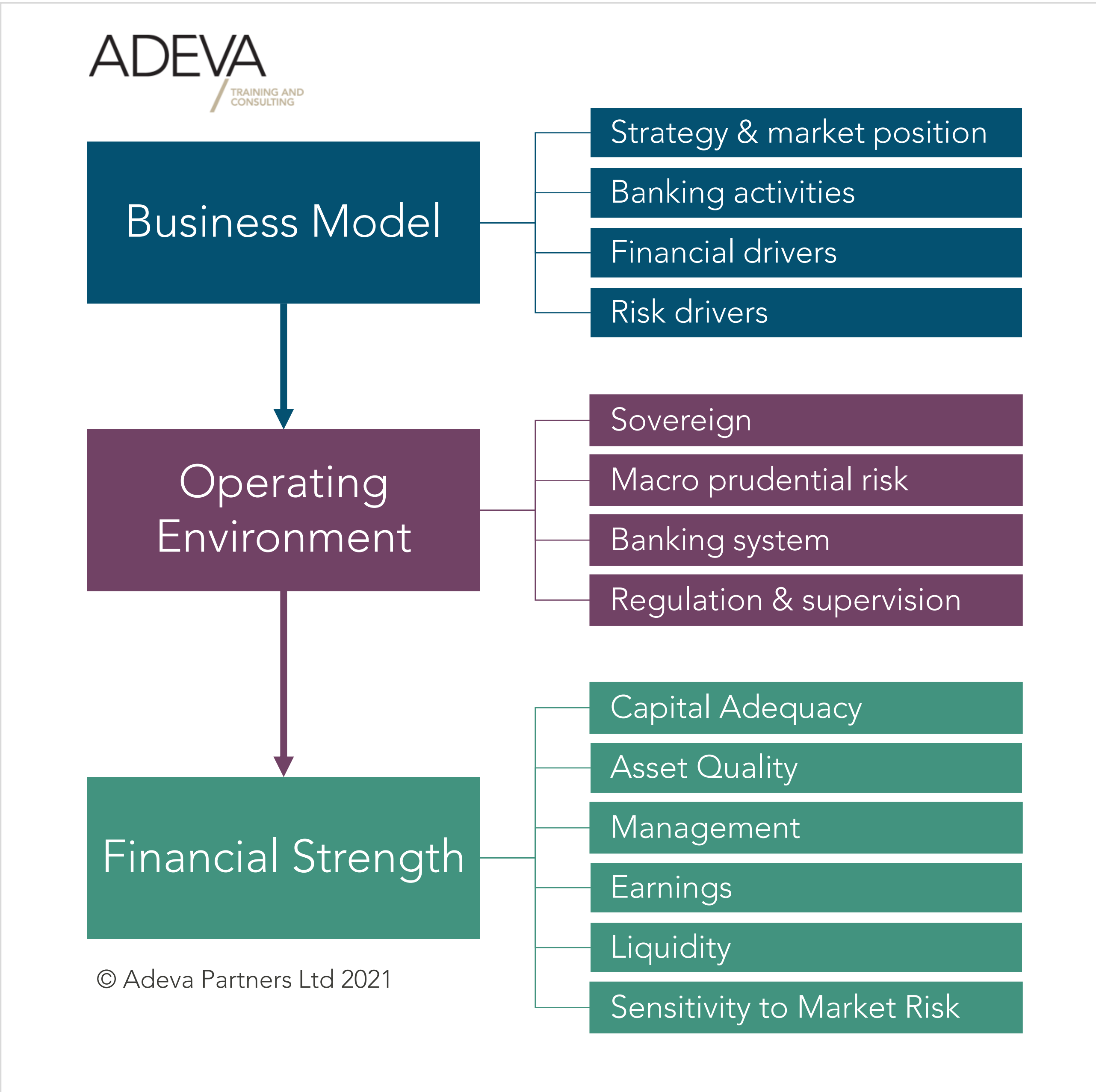
The report also highlights the key areas of change required for an incumbent bank to evolve

- Senior leadership to be focused on digital transformation
- Simpler business mix by geography and products
- Better financial returns

Top 5 things to consider for digitalisation

✓	Assess the challenge of new competitors such as FinTech and Tech giants (e.g. Amazon, Google) entering the space and eroding profitability
✓	Adapt analysis to include digitalisation performance indicators where provided
✓	Look at the % of annual budget that banks are investing in IT and AI (giving you a good indication of the senior leadership's focus)
✓	Consider the impact of disruptive tech like cryptocurrency and blockchain
✓	Investigate the efficiency and profitability of servicing existing clients and acquiring new ones

Of course, digitalisation is only a small part of what we look for in our analysis. Here's a quick reminder of [Adeva's Structured Approach to Bank Analysis.]



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