

## A Study on Transformation towards Digital Banking

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### Abstract

The accelerating disruptive effect of information technologies (IT) on value chains and business models is abolishing existing speed limits across industries. In particular, it is forecasted to have one of the greatest impacts on the financial services sector, provoking consequences such as disintermediation, loss of earnings, and reorganization of the value chain with new actors. Banks currently face a situation similar to that of Kodak or Olivetti, for instance, many years ago. Digitization led to a fundamental transformation of their core products and value chains, which were already digital in nature.

As time-to-market for digital banking products becomes shorter and shorter, thousands of Financial Technology (FinTech) start-ups and other non-banks are rising to the occasion by developing new products, services, and business models for all areas of banking in payments, investments, and financing along the entire value chain, touching all areas from front to back office, as client adoption of these new services accelerates.

### INTRODUCTION

Digitization is transforming the financial services industry. The primary drivers behind this process are the enormous developments in IT and the convergence of these technologies, such as smart phones and tablet PCs with new electronic services, i.e. crowd investing services or electronic banking marketplaces. These developments not only enable new business processes, but lead to completely new business models and even indicate an entire change of the banking value chain in the same way as value chains in other industries, such as the media or travel industry, were radically transformed (Ito et al., 2017). The banking industry is currently undergoing a transformation in six areas:

- Banking clients 2025
- Banking operating models 2025
- Banking revenue models 2025
- Digital banking platforms 2025
- Data-driven banking 2025
- Banking value chain 2025

### BANKING CLIENTS 2025

Recent developments in IT empower clients and lead to a fundamental change in client behaviour induced by digital natives (Palfrey & Gasser, 2016), affecting existing business models and leading to different expectations of financial service providers. The first area of change is a general transformation in client behaviour, such as the shift from ownership to experience oriented, temporary usage towards the so-called “Sharing Economy” affecting all industries (Sundararajan, 2016). Examples

are car2go from Daimler offering access to shared mobility services and Next bike offering bike rental services. In the banking industry, for instance, clients share information about banking products on social networks and even share their assets to jointly create new digital banking products without banks.

## BANKING OPERATING MODELS 2025

An “operating model” is an abstract representation of how an organization operates across process, organization, and technology domains in order to accomplish its function (De Vries et al., 2011). In contrast to a bank’s operating model, a bank’s business model describes how an organization creates, delivers, and captures value for its clients and sustains itself in the process (Osterwalder & Pigneur, 2011). While business models consider revenues, costs, and resulting profitability, operating models concentrate on costs as a primary objective that focuses on efficiency, a topic ranked among the top two priorities of banks (Crosby et al., 2013). A drop in profit margins currently challenges many banks vis-a-vis their operating models due to declining revenue margins and stable cost margins.

## BANKING REVENUE MODELS 2025

Traditionally, the business model of a bank was very simple. As an intermediary it offered a lower interest rate to the depositor and a higher interest rate to the borrower. The bank’s margin was the interest rates differential minus its costs. Alongside this simple model, banks developed additional products from which they receive additional revenues from their clients. Examples of basic products are bank accounts and deposits, debit and credit cards, as well as transactions conducted through them. More sophisticated products include custom-tailored products, such as structured products. In contrast to other industries, such as the legal industry, banks do not usually charge clients for advisory services. Instead, most banks include advisory costs in their product costs that are very often received as kickbacks from third-party providers.

## DIGITAL BANKING PLATFORMS 2025

Banks’ IT costs depend on the bank’s size and range from 4.7% to 9.4% (Gopalan et al., 2012). The absolute amount can reach up to EUR 3 billion at HSBC or EUR 2.6 billion at Deutsche Bank (Lodge et al., 2013). In contrast, insurance companies, for example, spend only up to 3.3% and airlines up to 2.6% of their revenues on IT. Although banks invest the highest amounts in IT, they are not among the leaders in innovation of customer-related services.

## DATA-DRIVEN BANKING 2025

Data-driven banking is closely related to the term “Big Data.” The increasing amount of data and the availability of new technologies provide for new possibilities in banking. The use of data in banking is not new. In the 1980s and 1990s, banks already used historical data in data warehouses to better understand and manage their businesses. But data was also used as an driver of new businesses. Data-driven banking addresses both efficiency gains in operating models and more effective client interaction that generates new revenues. An example of the first area comes from the British government, which employs a new “behavioural insights team.” This team identifies areas of data-driven applications to save money in existing processes.

## BANKING VALUE CHAIN 2025

Changing client behaviour and the innovative application of IT have a strong transformational potential on value chains. Among the prominent examples are the computerized reservation systems in the travel industry, the ordering systems in the pharmaceutical industry, the electronic home shopping systems in retail, in addition to the electronic stock markets in the financial sector. In a more recent example, the convergence of the media, computer, and telecommunications industry has replaced the traditional physical distribution of content and physical media, such as CDs, books, and DVDs as well as many of the physical stores.

## CONSEQUENCES

The developments in the aforementioned six areas could lead to an entire reorganization of the existing national and global banking system. The consequences for the banking industry can be structured along the innovation degree (incremental vs. disruptive) and the core banking processes (back office vs. front office) and may result in four major patterns.

First, banks provide secure custody and transaction services as one of their core competencies since their evolution as financial institutions.

Second, although banks already operate complex IT infrastructures, the emergence of new block chain-based environments could challenge the status quo soon (Ito et al., 2017). Over the past decades, banks have heavily invested in their back office infrastructures to meet increasing regulatory requirements and automate their internal processes. Currently, new initiatives based on block chain infrastructures may lead to new infrastructures making those investments obsolete and requiring collaboration between incumbents, start-ups, and regulators to define standards and regulation governance (WEF, 2016a). For this, new roles such as a “Digital Block chain Bank” may evolve.

Third, many banks currently increase their digital banking capabilities based on their existing IT infrastructures.

Fourth, banks have deep knowledge in complex banking products and processes that are implemented in existing IT infrastructures. Although the new Fin Tech start-up companies provide innovative solutions for many areas, most of them still require transaction and custody processes that banks have provided as core competencies for centuries.

## CONCLUSION

Although the transformation in the banking industry presents great challenges for the status quo, it contains many opportunities for those companies that face them. Still, many view financial technologies such as block chain only as new “transport systems“, similar like the change from tape-recorded videos to youtube videos. But as history has shown, the conversion towards new infrastructures very often leads to a fundamental reconfiguration of the status quo. Independent of any success or failure of single companies, the transformation of the industry is changing the nature of banking 2025 as a core part of today’s global economy. We should therefore heavily invest in research on this evolving future financial.

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